

GOLDEN APPLE OF DISCORD: INTERNATIONAL COST-SHARING ARRANGEMENTS

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I. INTRODUCTION

How is Apple Inc.—the American purveyor of beautifully designed products like the iPhone—able to allocate over seventy percent of its profits overseas, where tax rates are much lower?¹ This was the question posed by a 2013 Senate investigative subcommittee hearing on offshore profit-shifting of U.S. companies. Many U.S.-based multinational companies reduce their tax bills by using strategic transfer pricing between subsidiaries that move profits to low or no-tax jurisdictions and expenses to higher-tax countries. More specifically, highly profitable technology companies such as Apple are able to set up cost-sharing arrangements² (CSAs) and agreements with foreign subsidiaries that defer indefinitely billions of dollars in U.S. taxes by moving substantial intangible and economic value outside the U.S. A Treasury Department study found that the potential for improper income shifting was “most acute with respect to cost sharing arrangements involving intangible assets.”³ As an example, in recent years Apple has conducted about ninety-five percent of its high-value research and development (R&D) efforts in the U.S., and yet has allocated about seventy percent of its profits to foreign subsidiaries rather than the U.S.⁴ Apple disclosed in 2014

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1. Apple’s profits allocated to Irish subsidiaries reached seventy percent in its 2012 fiscal year and eighty-eight percent in its 2013 fiscal year. *Apple’s CEO Discusses F2Q 2014 Results - Earnings Call Transcript*, YAHOO! FINANCE (April 23, 2014) [hereinafter *2014 Earnings Call*], <http://finance.yahoo.com/news/apples-ceo-discusses-f2q2014-results-003308794.html>; *Apple’s CEO Discusses F2Q 2013 Results - Earnings Call Transcript*, YAHOO! FINANCE (April 23, 2013), <http://finance.yahoo.com/news/apples-ceo-discusses-f2q13-results-224607807.html> (reporting that Apple held offshore \$102 billion a year). Martin A. Sullivan, *Apple Reports High Rate But Saves Billions on Taxes*, 134 TAX NOTES 777 (Feb. 13, 2012) (suggesting that U.S. transfer pricing rules are a sieve that allows Apple, like many companies with high-value intangibles, to shift large amounts of profits offshore legally).

2. A cost-sharing arrangement is “an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.” Treas. Reg. § 1.482-7(a)(1) (West 2012). Unless otherwise stated, all references to the Treasury Regulations hereinafter are to the regulations effective in 2012.

3. JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING (JCX-37-10) at 7 (2010), available at <https://www.jct.gov/publications.html?func=startdown&id=3692> (citing U.S. TREASURY DEPT., REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES” (2007)).

4. *Offshore Profit Shifting and the U.S. Tax Code-Part 2 (Apple Inc.): Hearing Before the S. Permanent Subcomm. on Investigations, Comm. on Homeland Sec. & Govern-*

that it holds “offshore” eighty-eight percent of its \$150.6 billion in cash, representing mostly profits.⁵

The U.S. Senate’s Permanent Subcommittee on Investigations⁶ reported in its May 2013 hearing⁷ how Apple Inc. transfers economic rights to its Irish subsidiaries through, among other tax strategies, CSAs with those subsidiaries.⁸ The Senators tossed out a golden apple of discord,⁹ followed by a media food fight over U.S. corporate tax policy. The primary allegation of the Senate subcommittee report is that “multinational corporations have exploited and, at times, abused or violated U.S. tax statutes, regulations and accounting rules to shift profits and valuable assets offshore to avoid U.S. taxes.”¹⁰

mental Affairs, 113th Cong. 6, 23 (2013) [hereinafter *Apple Hearing*]. According to Apple’s CEO Timothy D. Cook, Apple carefully manages its foreign cash holdings to support its overseas operations in the best interests of its shareholders. *Apple Hearing*, at 123 (written statement of Apple CEO Timothy D. Cook).

5. 2014 *Earnings Call*, *supra* note 1, at 7. The cash may be technically held offshore because it is assigned to an Irish subsidiary, but Apple’s subsidiary Braeburn Capital Inc. in Reno, Nevada manages the cash, Austin, Texas bookkeepers track it, and New York banks hold it. *Apple Hearing*, *supra* note 4, at 4. Edward D. Kleinbard, University of Southern California’s Gould School of Law Professor and former staff director for the Congressional Joint Committee on Taxation, asserts that “[t]he offshore companies are a fiction and the statement that the money is offshore is a fiction.” David Kocieniewski, *For U.S. Companies, Money ‘Offshore’ Means Manhattan*, N.Y. TIMES (May 21, 2013), http://www.nytimes.com/2013/05/22/business/for-us-companies-money-offshore-means-manhattan.html?_r=0.

6. In 2012, the Permanent Subcommittee began holding on offshore profit-shifting, highlighting tax strategies of companies such as Microsoft and Hewlett Packard in 2012, Apple Inc. in 2013 and Caterpillar in 2014. *See, e.g., Apple Hearing*.

7. Apple agreed to an effective tax rate of two percent with Ireland when it first set up its Irish subsidiary over thirty years ago, although in recent years it has actually paid in Ireland a fraction of one percent. John Spain, *Ireland: A Tax Haven for American Tech Companies like Google, Twitter and Apple but Without the Sun*, IRISH CENTRAL (May 31, 2013), http://www.irishcentral.com/story/roots/ireland_calling/ireland-a-tax-haven-for-american-tech-companies-like-google-twitter-and-apple-but-without-the-sun-209636591.html. By comparison, Ireland’s declared corporate income tax rate is 12.5 percent. *Id.*

8. *Apple Hearing*, *supra* note 4, at 168. In a separate 2012 study, the Senate panel reported that two other domestic technology giants, Microsoft and Hewlett-Packard, also used various tax-reducing strategies to defer billions of dollars in federal taxes. *Offshore Profit Shifting and the U.S. Tax Code-Part 1 (Microsoft and Hewlett Packard): Hearing Before the S. Permanent Subcomm. on Investigations, Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 3 (2012) (opening statement of Sen. Carl Levin) [hereinafter *Microsoft and HP Hearing*].

9. An “apple of discord” causes controversy, dispute, trouble, or jealousy. According to Greek mythology, the goddess Eris (meaning “strife”) inscribed the golden apple of discord with the word “Kallisti” (meaning “to the most beautiful”) and tossed it among the wedding-feast guests. *See* APOLLODORUS, EPITOME II at 172–73 (E. Capps et al. eds., J. G. Frazer trans., G. P. Putnam Sons 1921) (300-100 B.C.). This action sparked the vanity-fueled dispute of goddesses Hera, Athena, and Aphrodite that led eventually to the Trojan War. *Id.*

10. *Apple Hearing*, *supra* note 4, at 153 (memorandum of Senators Carl Levin and John McCain to the Members of the Permanent Subcommittee on Investigations). *See*

In the theoretical tax-neutral world, a tax does not cause a company to alter its economic decisions. The current Internal Revenue Code¹¹, in contrast, provides U.S.-based multinational entities (MNEs) with significant incentive to shift income to low-tax jurisdictions.¹² To wit, many MNEs have established CSAs with related foreign companies in lieu of licensing arrangements as more tax-efficient access to the parent company's intellectual property (IP) and other intangible assets.¹³ As a result, CSAs become effective conduits to transfer an MNE's future IP revenue to offshore affiliates in low-tax or no-tax jurisdictions, thereby reducing the MNE's overall global tax rate.

Cost-sharing arrangements (CSAs) are regulated under the arm's-length standard found in section 482 of the Internal Revenue Code (I.R.C.) that generally respects the tax consequences of arrangements made among two or more members of the same multinational group. This presumes that taxpayers are not attempting to evade taxes by the allocation of costs and the taxpayers can show that the arrangements reflect a reasonable allocation of income among parties.¹⁴

In 1968, the Treasury Regulations introduced CSAs in the transfer-pricing context.¹⁵ Congress originally intended the cost-sharing regulatory mechanism to reduce disputes arising from related parties' exploitation of intangibles.¹⁶ While related-party

Microsoft and HP Hearing, supra note 8, at 160 (memorandum of Senators Carl Levin and Tom Coburn to the Members of the Permanent Subcommittee on Investigations).

11. Unless otherwise stated, all references to the Internal Revenue Code (I.R.C.) hereinafter are to the Internal Revenue Code of 1986, as amended, and effective in 2012.

12. See, e.g., PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANT, AND CORPORATION TAXATION 82 (2010), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/PERAB-Tax-Reform-Report-8-2010.pdf>; JANE G. GRAVELLE, CONG. RESEARCH SERV., TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 10 (2009); Douglas Shulman, IRS Commissioner, *Prepared Remarks at the 23rd Annual Institute on Current Issues in International Taxation, Washington, D.C.*, IR-2010-122, 236 DAILY TAX REPORT K-4 (Dec. 9, 2010), available at <http://www.irs.gov/irs/article/0,,id=232223,00.html>.

13. The U.S. Treasury Regulations distinguish CSAs from other types of shared business activities termed "shared-service arrangements." Treas. Reg. § 1.482-9(b)(7) (West 2011). The regulations, however, apply the term "cost-sharing arrangement" to R&D activities. Treas. Reg. § 1.482-7(a) (West 2012). In the transfer-pricing context, the regulations introduced CSAs in broad terms in 1968. Treas. Reg. § 1.48202(d)(4) (1968).

14. Empirical data show that the income of U.S. MNEs earned in low-tax foreign affiliates is disproportionate to other economic factors such as sales, payroll, property, plant, and equipment in such affiliates. See MICHAEL McDONALD, INCOME SHIFTING FROM TRANSFER PRICING: FURTHER EVIDENCE FROM TAX RETURN DATA (DEPT' OF TREASURY, OTA TECHNICAL WORKING PAPER NO. 2, 2008).

15. Treas. Reg. § 1.482-2(d)(4) (1968). The 1968 Treasury Regulations dealt with cost sharing in a single paragraph. *Id.*

16. Early transfer-pricing cases involved R&D costs and CSAs. See, e.g., *Ciba-Geigy v. Comm'r*, 85 T.C. 172 (1985).

disputes may have diminished, tax controversies between the government and taxpayers have not, as Congressional hearings with companies such as Apple Inc. so aptly demonstrate.

Meanwhile, the IRS “continue[s] to marshal, coordinate, and augment its resources dedicated to [CSA and] transfer pricing enforcement”¹⁷ since its resounding defeat in the 2009 textbook transfer-pricing case involving CSAs, *Veritas Software Corp. v. Commissioner of Internal Revenue*.¹⁸ The Tax Court held that U.S.-based Veritas¹⁹ owed no additional taxes, thereby rejecting the IRS’s valuation of a CSA’s lump-sum buy-in payment and its assessment of \$1.675 billion in taxes and penalties.²⁰

Such government-taxpayer cost-sharing disputations like the *Veritas* case and the Apple-focused Congressional hearing illustrate the controversies throughout the last several decades over changes in and interpretations of the CSA and transfer-pricing regulations. What some in the IRS and Congress label as abusive tax schemes are what U.S.-based MNEs like Veritas and Apple view as legitimate business and tax planning.²¹ The Government Accountability Office, the investigative branch of Congress, reports that companies, like the equipment-manufacturer Caterpillar,²² continue to enter into CSAs with foreign subsidiaries in countries or private financial jurisdictions generally considered havens for avoiding taxes.²³

17. *Microsoft and HP Hearing, supra* note 8, at 149.

18. *Veritas Software Corp. v. Comm’r*, 133 T.C. 297 (2009), *nonacq.*, 2010-49 I.R.B.

19. *Veritas* is the Latin word meaning “truth.” See *Vincit Omnia Veritas*, MERRIAM WEBSTER DICTIONARY (2012), <http://www.merriam-webster.com/dictionary/veritas> (phrase defined as “truth conquers all things”).

20. *Veritas Software Corp.*, 133 T.C. at 315–16.

21. The IRS considers U.S. companies’ offshoring of rights to core intangible property to be the its “most significant international enforcement challenge.” *Microsoft and HP Hearing, supra* note 8, at 148 (written testimony of the IRS Chief Counsel William J. Wilkins). Further, the IRS points to buy-ins as one of its most significant compliance challenges. See, e.g., I.R.S. Industry Director Dir. #1 on Transfer of Intangibles Offshore/ §482 Cost Sharing Buy-in Payment, LMSB-04-0307-027 (April 5, 2007), available at <http://www.transferpricing.com/pdf/Transfer%20of%20Intangibles%20Offshore%20Directive%201.pdf>.

22. See S. PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. & GOVERNMENTAL AFF., 113TH CONG., CATERPILLAR’S OFFSHORE TAX STRATEGY 4–5 (Comm. Print 2014). See *generally infra* Part II.B.1 (discussing the arm’s-length standard).

23. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-157, INTERNATIONAL TAXATION: LARGE U.S. CORPORATIONS AND FEDERAL CONTRACTORS WITH SUBSIDIARIES IN JURISDICTIONS LISTED AS TAX HAVENS OR FINANCIAL PRIVACY JURISDICTIONS 4 (2008) (noting that eighty-three of the 100 largest U.S. publicly traded corporations in 2007 maintained subsidiaries in countries or private financial jurisdictions generally considered havens for avoiding taxes). Symantec recently reported using “revenue-sharing arrangements” in its SEC 10-Q Form filing. SYMANTEC CORPORATION, FORM Q-10: QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE

Veritas highlights the irreconcilable views of the IRS and taxpayers on how to measure the bundle of rights and benefits in a CSA, or even what should be included in the bundle. The Tax Court found that U.S.-headquartered *Veritas* had followed the legal roadmap that Congress and the Treasury have drawn over decades for pricing transfers of intangibles, and that the IRS had valued the buy-in well beyond the limits of the tax code's plain language.²⁴ The taxpayer victory in *Veritas* sparked discussion and speculation on how the IRS would be addressing CSAs going forward and its likelihood of success in enforcement under the cost-sharing regulations that were finalized in 2011.²⁵ A 2013 Congressional case study of Apple suggests that significant controversy remains over how companies move the value of their intangible property rights to foreign affiliates through CSAs.

Part II of this paper describes CSAs within the context of tax and legal principles, and how the taxpayer has the informational advantage over the IRS in crafting its CSAs and buy-ins, as illustrated in the case studies of Apple and *Veritas*. Part III asserts that the IRS remains hard pressed to overcome the taxpayer's informational advantage even with its increased scrutiny of MNEs' tax returns and the more extensive 2011 cost-sharing regulations. As presented in Part IV, Congress could expand the subpart F²⁶ regime of the Internal Revenue Code section 482 to tax excess profits associated with intangible assets transferred to low- or zero-tax jurisdictions. This expansion would address prophylactically the widening gap between the tax-assessed and actual economic value of offshored income. Yet the most promising long-term solution to offshore income shifting is for Congress to repeal the unworkable cost-sharing regulations and reduce the corporate tax rate as part of a phased-in and comprehensive corporate tax reform.

II. INTERNATIONAL COST-SHARING ARRANGEMENTS FOR INTANGIBLE-ASSET TRANSFERS

The controversy over cost-sharing arrangements like those of Apple Inc. leads to discussion on CSAs within the context of 1) arm's-length versus commensurate-with-income standards, 2)

ACT OF 1934 23 (July 31, 2013), <http://www.sec.gov/Archives/edgar/data/849399/000119312513312695/d572172d10q.htm>.

24. *Veritas Software Corp.*, 133 T.C. at 316.

25. *See, e.g.*, Treas. Reg. § 1.482-7 (2013).

26. Subpart F, refers to Title 26 Subtitle A Chapter 1 Subchapter N Part III Subpart F of the Internal Revenue Code containing the general rules for the U.S. Federal income taxation of American shareholders of foreign-controlled corporations. I.R.C. § 952 (2007) *et. seq.*

intangible assets' mobility, 3) the economic-substance doctrine, and 4) taxpayers' informational advantage over the IRS in transfer pricing. Even with the newer 2011 cost-sharing regulations, the IRS may still be limited in its CSA enforcement based on the *Veritas* outcome and the ongoing information asymmetry between the MNEs and the IRS.

A. *The Debate over Apple's Cost-Sharing Arrangements*

In their search for additional tax revenue to cut large budget deficits and debts, the United States and other countries have focused on how a highly profitable global company can use CSAs and other tax-reducing strategies to shift income to lower tax jurisdictions, thereby significantly reducing the company's total tax obligation.²⁷ Even Ireland has become concerned with how Apple and other companies structure themselves and their foreign subsidiaries so that a certain portion of their income becomes "stateless," i.e. not attributable to any jurisdiction, Ireland or otherwise.²⁸ The discord over Apple's ability to reduce its overall tax burden illustrates the part that CSAs play in strategic tax reduction. On one side of the debate, Senator Carl Levin and others assert that a CSA enables Apple to shift profits away from the U.S. where intellectual property was developed and unfairly concentrate the lion's share of worldwide profits in Apple's Irish subsidiaries.²⁹ More specifically, critics have

27. ORG. FOR ECON. CO-OPERATION AND DEV., ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 8-9 (2013), <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (discussing how the globalized market has created opportunities for MNEs to minimize their tax burdens, causing a "base erosion" of taxable income). See also TREASURY OF AUSTRALIA, RISKS TO THE SUSTAINABILITY OF AUSTRALIA'S CORPORATE TAX BASE—SCOPING PAPER 45 (2013) (concluding Australia corporate tax base faces significant tax-revenue reduction due to shortcomings in the international tax framework such as the "increase[ed] use of strategies to exploit gaps and inconsistencies in tax treaties, the increased 'digitisation' of the economy and the challenges for the international community to effectively curb the harmful tax practices of some jurisdictions,"); Lee Sheppard, *How Does Apple Avoid Paying Taxes*, FORBES, May 28, 2013, <http://www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes/> ("Apple's tax avoidance is testing the patience of strapped European governments that are looking for ways to get American multinationals to pay tax.").

28. Irish Minister for Finance, *2014 Budget Statement* at 5 (2013), <http://budget.gov.ie/Budgets/2014/Documents/Budget%20Speech%20by%20Minister%20for%20Finance.pdf> (indicating plans to "bring[] forward a change in the Finance Bill to ensure that Irish registered companies cannot be 'stateless' in terms of their place of residency."). This suggested amendment to Irish law was enacted in 2013. Finance (No. 2) Act, 2013 (Act No. 41/2013) (Ir.), § 39 at 63–64, available at <http://www.irishstatutebook.ie/pdf/2013/en.act.2013.0041.pdf> (amending section 23A of Principal Act (company residence)).

29. Senator Carl Levin pointed to Apple's paying from 2009 to 2012 almost no tax on \$74 billion of profits that Apple attributed to its Irish subsidiary Apple Sales International (ASI), which had no employees for three of the four years and only 250 employees in

highlighted how U.S.-based Apple has been able to attribute seventy percent of its \$34.2 billion in 2009–2012 profits to foreign subsidiaries businesses, paying an average of less than two percent of tax on those profits.³⁰ This equates to around fourteen percent of income tax overall on Apple's entire worldwide profits.³¹ As a comparison, Apple paid an effective income tax rate of around 9.8 percent on its income earned globally in 2012, while Wal-Mart Stores, Inc. (dba Walmart) paid around twenty-four percent.³² Critics suggest that it is un-American to avoid paying a fair share of taxes in the country where the substantial value-creating operations are.³³

The other side of the debate emphasizes that only Congress should be blamed because it created the Swiss-cheese corporate tax code, and Apple should not be blamed for the tax code's gaping holes like cost-sharing regulations through which income is shifted.³⁴ Apple, although perhaps more aggressive in its tax

the last year. *Apple Hearing, supra* note 4, at 2-3, 14 (opening statement of Senator Carl Levin; testimony of Professor J. Richard Harvey, Villanova University School of the Law).

30. One critic suggests a more reasonable division might be to reverse the recipients of the 70-30 split: Apple Inc. to receive seventy percent of profits attributed to Apple's success of product design and other functions, and foreign subsidiaries to receive the remaining thirty percent. Martin A. Sullivan, *Apple Reports High Rate But Saves Billions in Taxes*, 134 TAX NOTES 777–78 (Feb. 13, 2012). See also Joe Nocera, *Here Comes the Sun*, N.Y. TIMES, May 22, 2013, <http://mobile.nytimes.com/2013/05/23/opinion/nocera-here-comes-the-sun.html> (observing that "Apple is as much an innovator in tax avoidance as it is in technology").

31. *Apple Hearing, supra* note 4, at 55-56 (testimony of Phillip Bullock, Apple Senior Vice President and Chief Financial Officer).

32. Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, Apr. 29, 2012, at A1, available at <http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html>; Press Release, Walmart Reports Q4 EPS of \$1.67, Feb. 21, 2013, <http://news.walmart.com/news-archive/investors/walmart-reports-q4-eps-of-167-full-year-eps-of-502-walmart-us-gains-market-share-adds-47-billion-in-comp-sales-for-year-company-announces-fy-14-dividend-of-188-up-18-or-1787345> (reporting Wal-Mart Stores, Inc.'s effective tax rate of 30.9 percent). For analyses of MNE's effective tax rates, see Reuven Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX L. REV. 375 (2012) and Melissa Costa & Jennifer Gravelle, *Taxing Multinational Corporations: Average Tax Rates*, 65 TAX L. REV. 391 (2012).

33. The 2012 Democratic vice presidential candidate Joe Biden suggested that paying more in taxes is the patriotic thing to do for wealthier Americans (like 2012 Presidential candidate Mitt Romney). *Biden: Paying Higher Taxes is "Patriotic,"* CBS NEWS (Sept. 18, 2008), available at http://www.cbsnews.com/2100-250_162-4457026.html.

34. John Bruton & Kevin Murphy, *Don't Blame Ireland for America's Tax Blunders*, WALL ST. J. (May 31, 2013), at A13, available at <http://online.wsj.com/news/articles/SB10001424127887323728204578513852280987968> (Bruton as former Irish prime minister and first European Union ambassador to the U.S. suggesting that the U.S. should focus on its high thirty-five percent tax rate that encourages U.S. companies to keep profits overseas and its overly complex 74,000-page, four-million-word tax code); *The Apple Tax Diversion*, WALL ST. J. (May 21, 2013), available at <http://online.wsj.com/news/articles/SB10001424127887324102604578497263976945032>

planning than other companies, cuts its taxes with the same tools that MNEs have been using for years to minimize their worldwide tax liability.³⁵ Further, Congress arguably encourages such offshoring of income by having the world's highest nominal corporate tax rate of thirty-five percent.³⁶

Apple Inc. faces a high combined federal and California corporate income tax rate of over forty-three percent.³⁷ By keeping its income overseas, Apple, like many other major corporations, avoids the highest tax rates in the world—the capstone of what has evolved in recent years to nominally the world's most progressive tax system.³⁸ Apple proponents believe that antiquated tax laws handicap Apple and other U.S. MNEs by disadvantaging them when they repatriate their profits back to the U.S.³⁹ Finally, those with the pro-Apple tax position assert Apple is a true patriot to create thousands of American jobs⁴⁰ and

(editorial suggesting that Senators were beating up Apple for abiding by the law that they wrote).

35. Howard Gleckman, *The Real Story on Apple's Tax Avoidance: How Ordinary It Is*, FORBES (May 21, 2013), <http://www.forbes.com/sites/beltway/2013/05/21/the-real-story-about-apples-tax-avoidance-how-ordinary-it-is/> (suggesting that Apple is “charging a relative pittance” to a foreign subsidiary for use of IP, thereby maximizing a foreign affiliate’s profit and minimizing its IP income in the U.S.).

36. I.R.C. § 11(b) (2014); Mieko Nakabayashi & James Carter, *America Goes It Alone on High Corporate Taxes*, WALL ST. J., July 19, 2013, at A9, available at <http://online.wsj.com/article/SB10001424127887324348504578606381626042740.html>.

37. I.R.C. § 11 (generally applying the marginal corporate tax rate of thirty-five percent); CAL. REV. & TAX CODE § 23151(f)(2) (West 2013) (generally applying the marginal tax rate of 8.84 percent to a corporation’s net income in California).

38. The left-leaning Washington Post editorial board opines that companies like Apple avail themselves to tax loopholes “as a rational response to the fact that the top U.S. corporate rate is high by international standards.” *Apple is Shifting Its Tax Burden*, WASH. POST (May 21, 2013), http://www.washingtonpost.com/opinions/apple-is-shifting-its-tax-burden/2013/05/21/a3a81404-c24f-11e2-9fe2-6ee52d0eb7c1_story.html. Unsurprisingly, the Tax Foundation, a right-leaning U.S. think-tank, in 2014 analyzed the corporate tax competitiveness of Organization for Economic Cooperation and Development (OECD) countries based on more than forty variables across five major categories, and ranked the U.S. thirty-two out of thirty-four, which is near the bottom of the competitiveness scale. KYLE POMERLEAU & ANDREW LUNDEEN, INTERNATIONAL TAX COMPETITIVENESS INDEX 2, 5 (2014).

39. In the Senate hearing, Senator Rob Portman pointed out that Apple’s Korean rival Samsung Electronics has a fourteen-percent global effective tax rate, roughly equivalent to that of Apple. *Apple Hearing*, *supra* note 4, at 55. Yet Apple would pay significantly more tax if it repatriated its overseas profits back to the U.S. *Id.* at 56. Unlike Apple, the Korean-based Samsung can bring its foreign income back home without it being taxed further. *Id.*

40. Apple CEO Timothy D. Cook testified that Apple created or supported 600,000 American jobs. *Apple Hearing*, *supra* note 4, at 36. The actual number of Apple’s U.S. employees, however, is around 50,000. *Id.*

to minimize its taxes, which according to Judge Learned Hand is as American as apple pie.⁴¹

B. *Cost-Sharing Arrangements Gilded with Buy-In Payments*

In a cost-sharing arrangement, related companies agree to share the costs of developing intangible property in proportion to the companies' reasonably anticipated benefits from the developed intangible assets.⁴² The theory is that each party expects to separately exploit the intangibles.⁴³ While the goal is that each participant's share of costs is reasonably related to the anticipated benefits, determining the proper transfer price can be challenging because it involves projected costs and benefits.

Suppose a U.S. parent company like Apple develops patented software and product designs and then constructs a CSA with a foreign subsidiary to further develop products based on associated intellectual property (IP). Because each entity pays for a share of costs based on expected benefits, the foreign subsidiary is not required to pay the parent additional amount when it earns income from the IP as it would under a traditional royalty arrangement with its parent. Even with the foreign subsidiary's required buy-in payment, the CSA remains attractive in reducing the parent's U.S. tax liability.

Cost-sharing arrangements are well-known and standard fare as part of MNEs' tax-reducing strategies. A typical CSA has two key parts: 1) a buy-in payment (also called "platform contribution transaction" or "PCT")⁴⁴ from a business affiliate to compensate one or more companies for preexisting intangibles⁴⁵

41. See *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) (Judge Learned Hand writing, "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes.").

42. Treas. Reg. § 1.482-7(a)(1) (2013).

43. *Id.* Thus, each party is considered an owner of the developed intangible and can exploit it independently and royalty free. A CSA provides an alternative to a royalty-paying arrangement where one company funds R&D, and then licenses the developed intangible property to others. Congress intended that the cost-sharing regulations would match costs shared with intangible benefits received. CSA participants make a "buy in" or platform-contribution payment to the participant that provides existing resources, capabilities, or rights that are reasonably anticipated to contribute to the development of the intangibles. Treas. Reg. § 1.482-7(c).

44. Treas. Reg. § 1.482-7(b) ("A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity . . . that is reasonably anticipated to contribute to developing cost shared intangibles.").

45. I.R.C. § 482 references § 936(h), which defines the term "intangible property." Intangibles include a "(i) patent, invention, formula, process, design, pattern, or know-

and for incurring the initial costs and risks undertaken in the initial development; and 2) an ongoing cost-sharing system to divide the costs and risks in developing future IP and other intangible assets between or among business affiliates. Frequently a U.S. parent company gives a foreign subsidiary an exclusive licensing right within a limited geographical region to make and sell products of identified patents, trademarks and/or copyrights. The ongoing CSA specifies how the costs of intangible assets that the parent develops are allocated between the parent and its subsidiary.

The foreign subsidiary's buy-in payment to the U.S.-based parent company is taxable income, but the parent has an incentive to set the price as low as possible.⁴⁶ Assuming the price paid is low compared to future profits that the license rights generates, the subsidiary's expenses as well as the parent's future taxable income are reduced.⁴⁷ Thus, the U.S. parent may successfully shift future taxable profits out of the U.S. and into a lower tax jurisdiction.⁴⁸

In concept, the transfer-pricing tax code and rules should establish a framework for arriving at reasonably equitable pricing for CSAs and prevent excessive income shifting to related foreign entities. I.R.C. section 482 requires that the transfer prices for intangibles be commensurate with income, which as described in the U.S. Treasury's cost-sharing regulations, allows the IRS to adjust periodically the transfer price of the transferred intangibles when the actual income earned deviates significantly from the original transfer prices to which the related parties agreed.⁴⁹

how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual." I.R.C. § 936(h)(3)(B) (2007). The IRS has taken the position that "intangibles" include not only the intangibles specifically listed in I.R.C. § 936(h)(3)(B) but also contributed R&D workforce, goodwill and going-concern value and opportunity; *See* Treas. Reg. § 1.482-7(g)(7) (examples that include intangibles such as workforce, goodwill, and going concern as part of valuing and allocating costs associated with CSAs).

46. *Microsoft and HP Hearing*, *supra* note 8, at 167.

47. *Id.*

48. *Id.*

49. Treas. Reg. § 1.482-4(f)(2)(i) (2013). (Congress intended the commensurate-with-income standard to apply to transfer pricing of intangibles as a super-royalty rule). Reuven S. Avi-Yonah, *Xilinx Revisited*, in TAX NOTES 1621, 1621 (2010).

See Yariv Brauner, *Cost Sharing and the Acrobatics of Arm's Length Taxation*, 38 INTERTAX 554, 566 (2010), available at <http://www.ifausa.org/dman/Document.phx/Events/%5Eeman.208/Conference+Handouts/Colloquium+Session+1%3A+Cost+Sharing+and+the+Acrobatics+of+Arm's+Length+Taxation?fol>

1. Arm's-Length and Commensurate-with-Income Standards Applied

The first of two standards applied to CSAs is the arm's-length standard.⁵⁰ The arm's-length principle is used to determine the apportionment of value between or among CSA parties determined from the reasonably anticipated benefits (RABs). In general, a CSA that is qualified under the regulations must provide a method to calculate each related parties' share of intangible development costs (IDCs), based on factors that reflect each parties' share of RABs.⁵¹

The IRS uses the legal fiction of the arm's-length standard to evaluate the transfer pricing associated with CSAs.⁵² The standard treats transactions of related parties as if they were unrelated or nonmarket transactions made in accordance with typical market forces.⁵³ It also assumes taxpayers can act for tax purposes according to legal fiction and asks what would a price

derId=Events%2F%255Eeman.208%2FConference%2BHandouts&cmd=download (citing Amy S. Elliott, *Transfer Pricing Standards Should be Applied Together, IRS Official Says*, WTD 134-2 (2010)). See generally Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

50. See OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, 31-58 (2010), available at <http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm> (giving a general overview of the arm's-length standard).

51. The preamble to the 2011 final cost-sharing regulations indicates that the inclusion of IDCs applies regardless of whether the transaction involves a license, a transfer, or retention of rights. Preamble to Final Regs. on Cost Sharing Arrangements [hereinafter 2011 Preamble], 76 Fed. Reg. 80082, 80083 (Dec. 22, 2011), available at www.gpo.gov/fdsys/pkg/FR-2011-12-22/pdf/2011-32458.pdf. Thus, for example, the CSA participants must pay arm's-length consideration for the value of an assembled workforce beyond the proportional cost of workers' salaries and benefits already paid by the CSA participant. This concept might extend to other items such as goodwill and going-concern value, although these are not specifically mentioned in the Final Regulations or the preamble.

52. I.R.S. Notice 88-123, *A Study of Intercompany Pricing under Section 482 of the Code*, 1988-2 C.B. 458, 475 (1988), available at <http://www23.us.archive.org/download/studyofintercomp00unit/studyofintercomp00unit.pdf> (arguing in favor of continued adherence to the arm's-length standard because the standard "is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; [and] it is incorporated into most tax treaties to which the U.S. is not a party"). Courts accept a substantially similar approach to the arm's-length standard. See generally *Bausch & Lomb, Inc. v. Comm'r*, 92 T.C. 525 (1989), *aff'd per curiam*, 923 F.2d 1084 (2d Cir. 1991) (holding that the transfer price was an arm's-length price, even with the differences between the controlled and uncontrolled sales); *Sundstrand Corp. v. Comm'r*, 96 T.C. 226 (1991) (holding the same).

53. In the early 1960s, the U.S. officially adopted the traditional arm's-length standard approach to transfer pricing and persuaded other countries to follow that standard. Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 90 (1990). Changing to a different standard or approach now would likely create other problems for the U.S.

be but for a relationship between parties.⁵⁴ While appearing to be objective, the arm's-length standard still involves subjective judgments within a facts-and-circumstances analysis, but the idea is that if a price is an arm's-length price, it should withstand IRS scrutiny.⁵⁵ If it does not, the price is subject to reallocation.

The second of the two standards applied to CSAs is the commensurate-with-income standard. Congress added the commensurate-with-income standard to I.R.C. section 482 in 1986 in large part because of the information asymmetry between the taxpayer and the IRS.⁵⁶ This second standard allows the IRS, with the benefit of hindsight, to adjust transfer prices of a taxpayer to better reflect the actual value of the transferred intangible.⁵⁷ The IRS attempts *ex post* to value cost-shared intangible assets based on the income standard—a standard embodied in the first sentence of section 482 and applied to intangible assets in the second sentence.⁵⁸ The arm's-length standard, unlike the commensurate-with-income

54. Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 160 (2008) (“The key difficulty that this arm's-length based regime faces is the frequent reliance on comparability and valuation, which often results in [a] high level of compounded inaccuracy. This inaccuracy is inevitable under an arm's-length based regime, because by definition such a regime does not account for the fundamental difference between related and unrelated transactions and creates a (necessarily false) fiction that such transactions are interchangeable.”).

55. Professor Edward D. Kleinbard, a former chief of staff of the Joint Committee on Taxation, considers it “fantastic” that a wholly owned subsidiary would independently negotiate arm's-length contractual terms with its parent, or have both capital and an appetite for risk separate from those of its parent. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX. REV. 700, 711–12 (2011). He also observes that low-tax affiliates entering into CSAs with their high-tax parent companies rarely lose money. *Id.* at 736.

56. DEPT. OF TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES, 64–65 (2007), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf> (noting the “information asymmetry” between the taxpayer and the IRS as a key justification for the CWI standard).

57. The IRS maintains that no conflict exists between the *ex post* commensurate-with-income and *ex ante* arm's-length standards. This position, however, may reflect more of a reluctance of the Treasury and the IRS to push up against the Organization for Economic Cooperation and Development (OECD) than a strong commitment to arm's-length and avoidance of perceived conflicts with treaties. The interests of the international tax community, for example, may have exerted enough concentrated pressure that the Ninth Circuit Court of Appeals reversed its position in *Xilinx* to hold that stock-option compensation could not be a part of the CSA costs because no arm's-length agreement would include stock options. Avi-Yonah, *supra* note 49, at 1621 (suggesting that the arm's-length standard in treaties is subject to the savings clauses, and should not affect the U.S. taxation of a U.S. resident like *Xilinx*).

58. Congress intended the commensurate-with-income standard to apply to transfer pricing of intangibles as a super-royalty rule. *Id.* (asserting that the commensurate-with-income standard of the code should trump the arm's-length standard, which is only in the regulations). See also Brauner, *supra* note 49. See generally Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

standard, generally involves a taxpayer's exclusive *ex ante* and not *ex post* analysis to determine the initial CSA and buy-in valuations.⁵⁹

2. Challenges of Intangible Assets' Mobility

The Apple tax controversy spotlights the mobility of income across country borders, seemingly unattached to the source of that income. "The nation's tax code is based on the concept that a company earns income where value is created, rather than where products are sold."⁶⁰ As in most developed countries, the U.S. corporate tax code is based on two basic tax principles: 1) profits lie where the activities, functions, risks and assets are located, and 2) profit should be commensurate with the location of those activities. Nevertheless, these early twentieth-century tax principles assume a transaction begins and ends in one country, an incorrect assumption for many twenty-first century business practices. Further, the tax codes written for an industrial age are ill-suited to today's digital economy where high value is placed on intangible IP such as patents.⁶¹

For tax purposes, the challenging question to answer here is what precisely is the value of Apple's products and where does that value get created.⁶² In theory, the U.S. tax system attempts to trace the value of a product to its economic roots. Each economic step within the supply chain, even within the same company, may be viewed as a separate transaction. Figuring out how to divide the economic pie among the U.S. parent and its foreign subsidiaries and branches of a multinational company like Apple remains challenging.

Current tax code, even armed with the more rigorous 2011 cost-sharing regulations, does little to address the increasing divide between the tax-assessable and actual economic value of U.S.-developed intangibles transferred at values that unrelated companies presumably would pay in an arm's-length transaction. Since 2011, the Senate investigative subcommittee hearings on

59. See Brauner, *supra* note 49.

60. Duhigg & Kocieniewski, *supra* note 32, at A1.

61. *Id.* at A1. Businesses like Apple derive significant value from patent royalties and digital products that are more easily moved to low-tax countries than tangible commodities and manufactured products. Downloaded music from Apple's iTunes, unlike a tomato or a cotton ball, can be sold from almost anywhere.

62. Kenneth Kraeme et al., *Capturing Value in Global Networks: Apple's iPad and iPhone* 7 (2011), available at http://pcic.merage.uci.edu/papers/2011/Value_iPad_iPhone.pdf (determining that "Apple continues to keep most of its product design, software development, product management, marketing and other high-wage functions in the U.S.").

offshore profit-shifting of U.S. companies concluded that Apple and other MNEs continue to use CSAs to move valuable IP rights to offshore subsidiaries.

Critics of current tax code assert that gaps in the code allow multinational firms to use complex business and tax structures to take advantage of a disparity between the value of a product for economic purposes and the value of a product for tax purposes to move value outside the U.S. Economists may intuit that most of Apple's income should be sourced and thus taxed in the U.S. For tax lawyers, however, the source of value is less clear in light of current tax code.

3. Required Economic Substance Aside from Lower Tax Payments

The U.S. tax system does not authorize tax-lowering strategies that lack economic substance. The economic-substance doctrine, as newly codified in 2010 as I.R.C. subsection 7701(o), provides that certain tax benefits are not allowable if a transaction does not have economic substance under a two-prong test.⁶³ A transaction is to be treated as having economic substance only if 1) the transaction changes the taxpayer's economic position in a meaningful way aside from paying fewer federal taxes and 2) the taxpayer has a substantial purpose for entering into such transaction other than to reduce the federal taxes it owes.⁶⁴

Some tax practitioners have suggested that Apple's CSAs with two Irish subsidiaries—Apple Operations International (AOI)⁶⁵ and Apple Sales International (ASI)—fail the economic-substance test and should be disregarded for tax purposes.⁶⁶

63. I.R.C. § 7701(o) (2010) codifies the common-law “economic substance” doctrine that courts have applied to deny tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than income-tax reduction.

64. I.R.C. § 7701(o). The IRS Office of Chief Counsel issued Notice CC-2012-008 to give guidance on examination and litigation procedures when applying the economic-substance doctrine. IRS Office of Chief Counsel, Notice CC-2012-008 (April 3, 2012), available at <http://www.irs.gov/pub/irs-ccdm/cc-2012-008.pdf>.

65. Apple Inc. entered into a CSA with Apple Operations International (AOI), its primary holding company whose operations Apple Inc. manages and controls. Ireland considers AOI to be a U.S. firm and not an Irish company under Irish law because Apple controls and manages AOI from the U.S. *Apple Hearing*, *supra* note 4, at 135 n.8, 156, 175. Meanwhile, the U.S. considers AOI to be a controlled foreign corporation (CFC) as defined in I.R.C. § 957. Therefore, Apple has taken the position that AOI has no tax residency (neither Ireland nor the U.S.) and thus AOI files no corporate tax return. *Id.* at 172.

66. See, e.g., Lee Sheppard, *How Does Apple Avoid Paying Taxes*, FORBES, May 28, (2013), <http://www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes/>;

This is because the only apparent purpose of the CSAs is to minimize taxes, and the facts would be practically the same aside from the increased amount of tax owed if no CSAs were in place.

As a specific example, Apple allocated \$22 billion of its pre-tax income to ASI⁶⁷ in 2011 under a longstanding CSA where ASI jointly owns the economic rights to Apple's IP of products sold outside of the Americas.⁶⁸ ASI agreed to share Apple's product development costs and then divide the net income from the shared economic rights of Apple's IP. Apple and ASI shared R&D expenses based on each entity's percentage of worldwide sales: sales in the Americas were credited to Apple Inc. and sales in the rest of the world were credited to ASI.⁶⁹ Apple Inc. paid approximately forty percent or \$1.0 billion, while ASI paid the remaining almost sixty percent or \$1.4 billion.⁷⁰ According to the Senate Subcommittee report, Apple and ASI in 2011 used their 40-60 split of R&D costs and shared economic rights in Apple's IP to help shift \$74 billion in worldwide sales income away from the U.S. to Ireland where Apple had negotiated a tax rate of less than two percent.⁷¹ This arrangement helped reduce the current income tax to a mere \$10 million, at a 0.06 percent tax rate that Apple negotiated with the Irish government.⁷² Some tax

David Hasen, *David Hasen: Apple Demonstrating Blatant Lack Respect Tax*, SAN JOSE MERCURY NEWS, (May 24, 2013), http://www.mercurynews.com/ci_23310792/david-hasen-apple-demonstrating-blatant-lack-respect-tax; Dave Johnson, *Apple Avoiding Billions And Billions Of Dollars In Taxes*, CAMPAIGN FOR AMERICA'S FUTURE (May 20, 2013), <http://ourfuture.org/20130520/apple-avoiding-billions-and-billions-of-in-taxes>; CITIZENS FOR TAX JUSTICE, *Apple Holds Billions in Foreign Tax Haven* (May 20, 2013), <http://www.ctj.org/pdf/appletaxhavens0513.pdf> (suggesting Apple's "cash hoard reflects profits that were shifted, on paper, out of countries where the profits were actually earned into foreign tax havens"). *But see, Apple Hearing, supra* note 4, at 177 (suggesting that if companies like Apple are allowed to continue use tax-minimizing strategies as they currently are, the companies will provide jobs and growth to the U.S.); Joshua Green, *Ten Reasons Why Cook Dominated Congress*, BLOOMBERG BUSINESSWEEK (May 21, 2013), <http://www.businessweek.com/articles/2013-05-21/10-reasons-tim-cook-dominated-congress>; Chris Umiasowski, *Apple Already Pays \$1 Out of Every \$40 Tax Dollars the U.S. Collects. How Much More does the Senate Want? IMORE* (May 20, 2013, 11:00 PM), <http://www.imore.com/apple-already-pays-1-out-every-40-tax-dollars-us-collects-how-much-more-does-senate-want>.

67. *Apple Hearing, supra* note 4, at 177.

68. *Id.* at 81 (written statement of Professor J. Richard Harvey, Jr., Villanova University School of the Law); *id.* at 176 ("The key roles played by ASI and AOE stem from the fact that they are parties to an R&D cost-sharing agreement with Apple Inc., which also gives them joint ownership of the economic right to Apple's intellectual property overseas.").

69. *See generally id.* at 177.

70. *Id.* at 176.

71. *Id.* at 5.

72. *Id.* at 84 (written statement of Professor J. Richard Harvey, Jr., Villanova University School of the Law).

practitioners question whether Apple or ASI took any risk with the CSA since Apple supplied the funds that ASI end up paying back to Apple for the initial rights. Indeed, prior to 2012, ASI had no employees of its own.⁷³

Did Apple and ASI have a substantial purpose for entering into such a CSA other than to reduce the federal taxes Apple owes? Apple's CEO Timothy D. Cook says yes. He offers evidence of required economic substance: ASI and another Irish subsidiary AEO have funded part of Apple's R&D over many years, thereby taking a risk under their CSAs.⁷⁴ Back in the 1990s, when Apple was struggling financially and losing market share, ASI and AEO were losing money alongside Apple and were not realizing offsetting gains.⁷⁵ Mr. Cook suggests that CSAs encourage companies like Apple to keep R&D efforts and associated high-paying, income-tax generating jobs stateside and not to move jobs overseas.⁷⁶ However, he acknowledges that the U.S. corporate tax system "has not kept up with the digital age and the rapidly changing global economy."⁷⁷

4. Taxpayer's Informational Advantage over the IRS

With CSAs, the taxpayer has a significant informational advantage over the IRS because the transfer of intangibles by their very nature can be difficult to quantify or even fully identify.⁷⁸ The IRS must rely in part on a taxpaying company's own projections of cash flows, risks, and so forth. The preamble to the 2005 proposed cost-sharing regulations suggests that "it is exceedingly unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result."⁷⁹

73. *Id.* at 81. In 2011, about four percent of Apple employees and one percent of Apple customers were located in Ireland.

74. *Apple Hearing*, *supra* note 4, at 132 (written statement of Apple's CEO Timothy D. Cook).

75. *Id.*

76. *Id.* Mr. Cook defended Apple's global organization as an efficient and fiscally prudent way for Apple to manage cash that overseas sales generate, and asserted that AOI helps Apple mitigate legal and financial risk.

77. *Id.* at 122 (written statement of Apple's CEO Timothy D. Cook).

78. *See* GRAVELLE, *supra* note 12, at 2 (indicating that tax "[ev]asion] is often a problem of lack of information, and remedies may include resources for enforcement, along with incentives and sanctions designed to increase information sharing"); Thomas A. Gresik, *The Taxing Task of Taxing Transnationals*, 29 J. ECON. LIT. 800, 801 (2001) (arguing that informational asymmetries between governments and transnationals, and across governments add a layer of strategic effects that impedes governments' efforts to benefit from transnational activity).

79. Preamble to Prop. Treas. Reg. § 1.482-7 [hereinafter 2005 Preamble], 70 Fed. Reg. 51115, 51125 (Aug. 29, 2005) (preamble to proposed cost-sharing regulations). From a tax practitioner's perspective, however, the IRS does not give appropriate weight to the

One of the reasons that MNEs thrive is because indirect and intangible knowledge such as trade secrets spills over significant value from parent to subsidiary.⁸⁰ This spillover might not even be identified as an intangible transfer under a CSA. Yet, by virtue of being part of an MNE family, a subsidiary nonetheless receives benefits that would not be shared with nonfamily members.

Granted, establishing a true value of intangible assets can be difficult. The MNE may not be able to identify or accurately quantify the transferred value. Often transferred intangibles, such as technical knowledge, are specialized enough that comparable intangibles of unrelated parties do not exist. Because accurate economic information on an intangible's value can be difficult to find, MNEs can use private information to strategic advantage with possible discretion in setting some transfer prices.⁸¹

C. *The Cost-Sharing Arrangement in Veritas Software Corp. v. Commissioner*

In 2009, the U.S. Tax Court first directly addressed CSA issues of income allocation in *Veritas Software Corp. v. Commissioner*. Most CSA disputes like *Veritas* are intensely factual and resolve privately, short of litigation. Thus, *Veritas* offers a rare glimpse into the tax court's interpretation of the arm's-length standard as applied to CSAs, and how the IRS is attempting to identify more transferred-intangible value that it sees escaping taxation. In *Veritas*, the IRS was largely unsuccessful in using arguments based on proposed and now finalized cost-sharing regulations that did not exist during the tax years at issue in the case.⁸²

expansive information-gathering powers of the IRS or the certainty that the IRS will only use its power to make periodic adjustments to more tax revenue for the government. Gregg D. Lemein, *Sharing Intangible Property within a Multinational Group: Facts Versus Theories* in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1151, 1202 (2007) (PLI Course Handbook).

80. See generally Kleinbard, *supra* note 55, at 770.

81. Kleinbard, *supra* note 55, at 770.

82. Had the temporary regulations or the final regulations been in effect for the transactions at issue, the court might have ruled somewhat differently. Tax experts have differing opinions on how the 2011 finalized regulations will affect CSAs in the long term. Lee A. Sheppard suggests that CSAs were the favorite strategy for intangibles migration until the temporary cost-sharing regulations went into effect. Lee A. Sheppard, *News Analysis: Intangibles Migration and Excess Profits*, 130 TAX NOTES 1379 (March 17, 2011); 2011 TNT 54-1. Lynnley Browning & Nanette Byrnes, *Motorola deal Offers Google Tax, Patent Benefits*, REUTERS (Aug. 31, 2011),

The IRS presented three primary theories to justify its expansive buy-in valuation: 1) an “aggregate” evaluation approach; 2) an assumption of perpetual life of preexisting tangibles; and 3) platform contributions. Ultimately, the Tax Court rejected these theories and concluded that the IRS’s valuation methodology, at least as implemented by the IRS’s expert, led to an “arbitrary, capricious, and unreasonable” determination.⁸³

1. IRS Theories for Income Reallocation in *Veritas*

In 1999, Veritas US and Veritas Ireland entered a three-part CSA: 1) an assignment of certain European sales agreements; 2) terms for sharing research and development (R&D) costs; and 3) an exclusive technology licensing agreement.⁸⁴ Veritas US granted Veritas Ireland the right to use certain covered intangibles⁸⁵ to develop and market software, and agreed to split costs in R&D related to IP.⁸⁶ They also agreed that the buy-in

<http://www.reuters.com/article/2011/08/31/us-motorolamobility-google-tax-idUSTRE77U1QX20110831>.

83. *Veritas Software Corp. v. Comm’r*, 133 T.C. 297, 314 (2009). The Tax Court’s opinion, based on the 1996 cost-sharing regulations, focused on the IRS’s litigation missteps, the incredible positions of the IRS’s experts, and the taxpayer’s strong factual evidence. The Tax Court, however, also considered and rejected the IRS’s interpretations of section 482 that it had been asserting since the 2007 release of the now withdrawn Coordinated Issues Paper on Cost Sharing Arrangements. I.R.S. Coordinated Issue Paper, Sec. 482 CSA Buy-In Adjustments, LMBS-04-0907-62 Sept. 27, 2007), available at <https://www.scribd.com/doc/104957028/Coordinated-Issue-Paper-Sec-482-CSA-Buy-In-Adjustments>

84. *Veritas Software Corp.*, 133 T.C. at 299.

85. Covered intangibles are defined as any and all inventions, patents, copyrights, computer programs, flow charts, formulae, enhancements, updates, translations, adaptations, information, specifications, designs, process technology, manufacturing requirements, quality control standards and other intangible property rights in existence as of the effective date of the CSA that relate to the design, development, manufacture, production, operation, and maintenance, and/or repair of any or all of the products covered by the agreement. *Id.* at 308. The *Veritas* agreement defined its research as “all software research and development activity and process development activity.” *Id.* at 308 n.14.

86. This CSA was one piece of a business restructuring. The U.S.-based Veritas Software Corporation (“Veritas US”) shifted almost all of its foreign income to a subsidiary in Bermuda, incorporated a wholly owned Irish company—Veritas Software Holding, Ltd. (VSHL) as a resident of Bermuda for tax purposes, and directed VSHL to incorporate its wholly owned Irish subsidiary, Veritas Software International, Ltd. (VSIL). *Id.* at 307, 309. The *Veritas* court referred to the two Irish companies collectively as “Veritas Ireland.” *Id.* at 307. This arrangement with the subsidiaries took advantage of the income tax rates of Ireland at 12.5 percent and Bermuda at zero percent that are significantly lower than the thirty-five percent marginal income tax rate for U.S. corporations. Jesse Drucker, *The Tax Haven That’s Saving Google Billions*, BUSINESS WEEK (Oct. 21, 2010), http://www.businessweek.com/magazine/content/10_44/b4201043146825.htm. Ireland’s favorable economic conditions make it a fairly standard place for U.S.-based multinational companies to do business in Ireland. *Id.*

payment under the CSA would be adjusted on an *ex post* basis of actual income to reflect an arm's-length payment for the preexisting intangible property.⁸⁷

To determine a price for the buy-in payment,⁸⁸ the taxpayer used the comparable-unrelated-transaction (CUT) method.⁸⁹ The CUT analysis was based on internal comparable arrangements between Veritas and third parties involving bundled products where the unrelated companies incorporated Veritas software into their own products, as well as unbundled products that companies sold separately.⁹⁰ During 1999 and 2000, Veritas Ireland paid Veritas US approximately \$172 million for the buy-in rights.⁹¹ They entered into a qualified CSA at what they determined to be an arm's-length price.⁹² In 2002, the parties agreed to reduce this amount to \$118 million.⁹³

The IRS strongly disagreed with the reduced buy-in valuation. In 2006, the IRS issued a notice of tax deficiency to Veritas US based on the government's initial buy-in valuation of \$2.5 billion, after employing several methods that had valued the

87. *Veritas Software Corp.*, 133 T.C. at 309.

88. The CSA granted Veritas Ireland use of Veritas US's intangibles such as trademarks, names, services, and marketing, and in exchange, Veritas Ireland agreed to pay an annual royalty adjustable to maintain an arm's-length price. *Id.* at 308–09. Veritas Ireland's buy-in payment amounted to roughly \$150 million, adjustable over time to reflect an arm's-length price. *Id.* at 309. The initial payment of \$6.3 million in 1999 was adjusted to \$166 million in 2000, and then to \$188 million in 2002. The agreement covered the future value of any intangibles developed through the companies' shared R&D. Veritas US first determined the royalty that Veritas Ireland needed to pay by comparing similar royalty agreements it entered with its customers, and valued Veritas Ireland's buy-in payment by estimating that the transferred intangibles had a four-year useful life based on its innovation rate. *Veritas Software Corp.*, 133 T.C. at 306. *See* Brauner, *supra* note 49 (*suggesting that CSAs are intended as safe harbors for R&D costs shared by joint ventures*).

89. The CUT method is a transfer-pricing methodology that determines an arm's-length royalty rate for an intangible by reference to uncontrolled transfers of comparable intangible property under sufficiently comparable circumstances. Treas. Reg. § 1.482-4(c). The Veritas taxpayer used the declining royalty CUT method. *Veritas Software Corp.*, 133 T.C. at 303.

90. *Veritas Software Corp.*, 133 T.C. at 330–31.

91. *Id.* at 303.

92. *Id.* at 332. In a qualified CSA, controlled participants share the cost of developing one or more items of intangible property. Treas. Reg. § 1.482-7(a)(1). When a controlled participant makes preexisting intangible property available to a qualified CSA, that participant is deemed to have transferred interests in the property to the other participant and the other participant must make a buy-in payment as consideration for the transferred intangibles. Treas. Reg. § 1.48-7(g)(1) and (2). The buy-in payment can be a lump-sum payment, installment payments, or royalties as the arm's-length charge for the use of the transferred intangibles. Treas. Reg. § 1.482-7(g)(2), (7).

93. *Veritas Software Corp.*, 133 T.C. at 309.

buy-in amount from \$1.9 billion up to \$4 billion.⁹⁴ During pretrial proceedings, the IRS abandoned its original analysis and submitted a new one that reduced the amount of the buy-in by \$825 million to \$1.675 billion.⁹⁵

2. Akin-to-Sale Aggregation Theory

The IRS contended that the taxpayer's valuation of the buy-in payment to Veritas US using the comparable uncontrolled transaction (CUT) method to value a license was insufficient because the company's transfer of intangibles was closer to that of a sale of a going-business than a license.⁹⁶ The IRS justified its \$1.675 billion valuation amount for the buy-in on the theory that the CSA between Veritas US and Veritas Ireland was "akin to a sale" as a geographic spin-off of the parent's international operations rather than a licensing arrangement.⁹⁷ The IRS did not value any of the specific intangibles that it thought were transferred, and instead used the "aggregation" regulation⁹⁸ to support its akin-to-sale theory.⁹⁹ The IRS aggregated the value

94. For its analysis, the IRS used the forgone-profits method, the market capitalization method, and an analysis of arm's-length business acquisitions. *Id.* at 311. The forgone-profits method has various names, among them the discounted-cash-flow method, the income method, and the investor method, the latter introduced in Temp. Treas. Reg. § 1.482-7T(b)(2)(ii) (West 2009). The 2009 temporary regulations list the CUT method, the income method, the price acquisition method, the market capitalization method, and the residual profit split method as methods to value the buy-in of a CSA. Treas. Reg. § 1.482-7(b)(2)(ii) (West 2009). Of those methods, only the CUT method and profit split method were specified as valuation methods by the regulations in force in 1999. *Veritas Software Corp.*, 133 T.C. at 330. The current regulations also allow for an unspecified method if the method arrives at the most reliable result. Treas. Reg. § 1.482-7(g)(vi) (West 2009).

95. *Veritas Software Corp.*, 133 T.C. at 319. Alternatively, the Commissioner stated that Veritas Ireland could pay Veritas US a 22.2-percent perpetual royalty. *Id.* at 313.

96. Note that the IRS's first step in determining how cross-border payments are taxed is to characterize the transaction under Internal Revenue Code sections 861 through 865 as a sale of inventory, a rental of property, a license, a sale of IP, a provision of services, and so forth. From the perspective of the IRS, the Veritas transaction looked more like a sale than a license.

97. *Id.*

98. The IRS used an "aggregate" valuation approach requiring a three-step analysis. *Id.* at 313. First, estimate the arm's-length royalty amounts that would be due each period of the CSA. *Id.* Second, chose a discount rate to convert estimated future payments into value in dollars as of the date of the signed contract. *Id.* Third, calculate the buy-in payment as equal to the present value of the royalty payments in step one, discounted by the rate determined in step two. *Id.*

99. *Veritas Software Corp. v. Comm'r*, 133 T.C. 297, 314 (2009). *Cf. Veritas Software Corp.*, 133 T.C. § 1.482(f)(2)(ii) (West 2009). While the *Veritas* court contemplated in the regulations in force at the time at issue, the final cost-sharing regulations reflect the IRS's view that an aggregate valuation of all contributions is likely to lead to a more reliable result than other approaches. 2011 Preamble, *supra* note 51, at 80082.

of existing intangibles because it thought the assets “collectively possess[ed] synergies that imbue the whole with greater value than each asset standing alone.”¹⁰⁰ The IRS expert, however, was unable to opine on whether his methodology captured the synergistic value of the transferred intangibles.¹⁰¹

The court rejected the IRS’s akin-to-sale aggregation theory, at least in part, because it violated Treasury Regulation section 1.482-1(f)(2)(ii)(A), which requires the IRS to evaluate a transaction as structured unless it lacks economic substance.¹⁰² The taxpayer provided enough evidence to convince the Court that the CSA was economically substantive, and establishment of foreign subsidiaries and the CSA was necessary and critical in expanding the presence of the company in other countries.¹⁰³ Further, the court determined that aggregation did not provide the most reliable valuation under the 1996 Treasury Regulations because the IRS’s aggregated subsequently developed intangibles with preexisting intangibles under the IRS’s expanded definition of buy-ins (newly termed “platform contribution transaction”), which were not a part of the transfer.¹⁰⁴

3. Theory of Perpetual Useful Life

The facts of *Veritas* illustrate that some classes of technology become quickly obsolete and it is often difficult to determine the length of a technology’s useful life for purposes of calculating the CSA buy-in.¹⁰⁵ The IRS assumed in its calculations that the

100. *Veritas Software Corp. v. Comm’r*, 133 T.C. 297, 320(2009). Aggregating the future value of the CSA into the buy-in payment was unorthodox because buy-ins are intended to compensate the U.S. parent for the value of the intangibles that it contributed, and the CSA is intended to compensate the parent for any additional value created through joint R&D with its foreign subsidiary. Ilan Benshalom, *Sourcing the “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX. REV. 631, 653 (2007).

101. *Veritas Software Corp.*, 133 T.C. at 320.

102. *Id.* at 321 n.29. The commissioner termed the effective spinoff “akin to sale.” *Id.* The commissioner argued in the alternative that, even if the CSA was not akin to a sale, the intangibles’ perpetual value supported the 22.2-percent annual royalty. *Id.* Thus, the IRS placed itself in a difficult strategic position: if the court disregarded the “akin to sale” theory, the IRS would have to support the reasonableness of its deficiency assessment by arguing that the intangibles maintained perpetual economic value—an unproven argument. *Id.*

103. *Id.* The court noted that the *Veritas* cost-sharing arrangement, which had economic substance, was structured as a license of preexisting intangibles and not a sale of a business. *Id.*

104. *Id.* at 320–24.

105. *Id.* at 324. The useful life (or economic life) of an asset represents the period of time that the asset will generate income or enable cost savings. The useful life of an asset may be longer or shorter than the legal life of the asset, depending on the competitive fac-

economic useful life of any contributed intangibles to the CSA activity lasts for the entire expected period of development and exploitation with no declining value.¹⁰⁶ This position also presumes that the contributions of preexisting intangibles become the basis of or platform for future intangible developments.¹⁰⁷ In sharp contrast, Veritas US estimated the economic useful life of its existing intangibles to range from two to four years.¹⁰⁸

While the IRS viewed Veritas software as having a perpetual life in the context of a platform contribution,¹⁰⁹ the court determined that the useful life of Veritas's software products was about four years.¹¹⁰ The court also found that the IRS improperly included in its buy-in valuation the value of *subsequently* developed intangibles in violation of the then-current 1999 CSA regulations, which limited a buy-in value to *preexisting* intangibles.¹¹¹

tors. *Id.* Intangible assets are typically expensed according to their respective life expectancy. Int'l Public Sector Accounting Bd., INTANGIBLE ASSETS, INTERNATIONAL ACCOUNTING STANDARDS IPSAS31, ¶ 87–88 (2010). Examples of intangible assets with identifiable useful lives include copyrights and patents. Intangible assets like trademarks and goodwill have indefinite economic useful lives, so they may be reassessed each year for impairment where a loss for accounting purposes should be recognized. *Id.* at ¶ 118, 109.

106. *Veritas Software Corp.*, 133 T.C. at 313. The IRS asserted that the platform contributions of Veritas US must be exclusive and perpetual, not the value of just short-term IP rights. *Id.* at 308. The IRS moderated its view somewhat in its Action on Decision following the 2009 *Veritas* ruling. *Veritas Software Corp. v. Comm'r*, 133 T.C. 297 (2009), *action on dec.*, No. 2010-49 (Dec. 6, 2010). It said that the useful life is limited to that period over which the initial buy-in (now referred to as a platform contribution transaction or "PCT") continues to contribute to the income earned from cost-shared intangibles. *Id.* The preamble of the finalized regulations, however, says the income method should include all income from the cost-shared intangibles for the duration of the CSA activity, which, according to the preamble language, would include the initial PCT even if it no longer contributed to the R&D done under the CSA. 2005 Preamble, *supra* note 81, at 51125. The 2011 cost-sharing regulations suggests that a PCT "does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles." Treas. Reg. § 1.482-7(c)(1) (West 2011).

107. 2005 Preamble, *supra* note 81, at 51125.

108. *Veritas Software Corp.*, 133 T.C. at 324. It incrementally reduced the royalty rate over the buy-in period. *Id.*

109. The IRS in the preamble of the 2005 Proposed Regulations suggests that "a valuation method for PCTs is likely to be less reliable if it assumes a useful life for any contribution to the CSA that does not extend through the entire anticipated period of development and exploitation." 2005 Preamble, *supra* note 81, at 51125. Additional guidance on the useful life of IP is conspicuously absent from the proposed regulations. *Id.*

110. *Id.* at 306. Veritas US, to the court's satisfaction, showed that its intangibles consistently had a finite life, after which the pace of innovation made them obsolete. *Id.* Further, Veritas showed that it overwrote the computer software at issue with new code within four years. *Id.*

111. *Id.* at 321 (citing Treas. Reg. § 1.482-1(f)(2)(i)(A)).

As demonstrated in *Veritas*, the arm's-length standard of the section 482 and the 1999 regulations constrained the IRS's reach for perpetual life of an intangible.¹¹² The IRS has pulled away somewhat from its advocacy of perpetual useful life.¹¹³ The 2011 regulations describes the useful life of a buy-in as equaling or being greater than the anticipated period of intangibles development and subsequent exploitation of newly developed intangibles.¹¹⁴

4. Platform-Contribution Theory

In *Veritas*, the IRS determined the scope of intangibles covered by the CSA based on platform-contribution theory.¹¹⁵ The IRS saw the experienced R&D and marketing teams of Veritas US as part of a platform contribution for which compensation was due, above and beyond the ongoing payments for R&D costs associated with the CSA's make-or-sell rights.¹¹⁶

By using the term "platform contribution"¹¹⁷ from the 2005 Temporary Regulations rather than the term "pre-existing intangible" from the applicable 1996 Regulations, the IRS posited a more expansive definition of covered intangibles to "include 'workforce in place,' goodwill, and going-concern value."¹¹⁸ The

112. *Id.* at 323. IRS Senior Economic Adviser Bill Morgan and IRS Deputy Commissioner Michael Danilack assert that the *Veritas* ruling drove a wedge between how economists and attorneys define an arm's-length standard meant to clearly reflect income. Mark A. Oates & James M. O'Brien, *IRS Economists Say the Darndest Things!*, 39 INT'L TAX J. 5, 5 (2013) (Veritas's former trial lawyers responding to Bill Morgan's lament over the *Veritas* decision).

113. *Id.* at 8.

114. Thus, a declining royalty payment, such as that obtained by application of the residual profit split method, would be insufficient consideration for preexisting IP. Treas. Reg. § 1.482-7(b)(5)(ii) (2011).

115. *Veritas Software Corp.*, 133 T.C. at 329. The 2011 regulations contain platform contributions. Treas. Reg. § 1.482-7(b)(1)(ii) (2011).

116. *Veritas Software Corp.*, 133 T.C. at 324. The IRS observed that before its CSA, Veritas US had gained many of the rights transferred to Veritas Ireland by purchasing competing companies. *Id.* at 313. Because Veritas Ireland received those rights through the CSA in addition to access to Veritas US's marketing and R&D, the IRS argued that the whole platform of intangibles created synergistic value, and that the CSA effectively spun off part of the parent's foreign business in a sale-like transaction. *Id.*

117. The IRS's more expansive view of PCTs is presented in the preface to and the text of the 2005 proposed cost-sharing regulations. 2005 Preamble, *supra* note 81, at 51125; Treas. Reg. § 1.482-7(g) (2005). As described, a platform contribution encompasses more than make-and-sell rights (make, copy, license, and sell) and includes the right to exploit existing intangibles with further development. Treas. Reg. § 1.482-7(a)(2)(iv) (2011).

118. *Veritas Software Corp.*, 133 T.C. at 316; Treas. Reg. § 1.482-7(g) (2005) (using "PCT" to refer to a "preliminary or contemporaneous transaction"); *cf.* Treas. Reg. § 1.482-

IRS argued that the buy-in payment should compensate the U.S. parent for its “platform contribution”—the subsidiary’s access to the parent’s R&D team, marketing team, distribution channels, customer lists, trademarks, trade names, brand names, sales agreements, and so forth.¹¹⁹

The Tax Court rejected the more expansive view of intangibles and pointed out that intangible property subject to section 482 was a statutorily defined term that excluded, for example, income attributable to services, income arising from goodwill and going-concern value, and income attributable to the efforts of the transferee.¹²⁰ Further, it found that the workforce-in-place (Veritas’s R&D and marketing teams) value did not have discernible value beyond services of any one individual, and thus was outside the definition of intangible assets under Treasury Regulation section 1.482-4(b) (1996), which requires intangible assets for transfer-pricing purposes to have commercially transferrable value.¹²¹

D. Cost-Sharing Regulations after Veritas

Despite a series of IRS attempts to modify its regulations over the last twenty years and significant money spent on transfer-pricing enforcement, MNEs may still have an extraordinary ability to shift profits to affiliates that are incorporated in low- and zero-tax countries where they do relatively little business.¹²² The revenue implications for the U.S. Treasury are great, given the ease with which MNEs can

7(a)(2), (b)(1)(ii) (2011) (using “PCT” to refer to a “platform contribution transaction”); Treas. Reg. § 1.482-7(g)(2) (1996) (using the term “pre-existing intangible”).

119. *Id.* at 314, 329. While not mentioned in the regulations in force at the time of the Veritas CSA, under the current Treas. Reg. § 1.482-7(c), platform contributions are described as preexisting resources, capabilities, or rights that are reasonably anticipated to contribute to the developing of cost-shared intangibles under the CSA. Thus, platform contributions are not limited to intangibles defined in I.R.C. § 936(h)(3)(B).

120. *Id.* at 323–24 (citing I.R.C. § 936(h)(3)(B)). The court noted that the IRS’s income method took into account items subsequently developed intangibles in violation of Treas. Reg. § 1.482-7(g)(2) (1996).

121. *Id.* at 322–323, 323 n.31. Note that the preamble of finalized 2011 Treasury Regulations § 1.482, however, now includes workforce-in-place (like R&D and marketing teams of Veritas) as part of the regulations’ expanded definition of cost-shared intangibles (“platform contributions”), using language very similar to I.R.C. § 36(h)(3)(B). See 2011 Preamble, *supra* note 51, at 80082.

122. For a description of tax base erosion through arm’s length transfer-pricing rules, see Brauner, *supra* note 49 at 2 *et seq.*, and Harry Grubert, *Foreign Taxes, Domestic Income, and the Jump in the Share of Multinational Company Income Abroad: Sales Aren’t Being Globalized, Only Profits* (Dec. 7, 2009), http://web.gc.cuny.edu/economics/SeminarPapers/spring2010/Grubert_March16.pdf.

shift IP and other intangibles offshore and the ever-increasing trend for the MNEs to do so.¹²³

Now with the trillions of dollars in federal fiscal deficits casting a long shadow, the government is looking to more aggressively pursue what it sees as billions of dollars in lost tax revenue through the cost-sharing strategies of MNEs.¹²⁴ Meanwhile, the IRS trudges on with the 2011 finalized regulations that attempt to capture more of the income shifted overseas through its “platform contribution transaction” theory raised in *Veritas* and formalized in the final regulations.¹²⁵ One wonders whether the more detailed provisions for platform contribution transactions (also called “buy-ins”) in the 2011 finalized cost-sharing regulations will become any more effective so long as the informational asymmetry between the taxpayer and the IRS remains.¹²⁶

1. Platform-Contribution Provisions in the 2011 Treasury Regulations

The Treasury and the IRS revamped the 1996 regulations to what are now the 2011 cost-sharing regulations, in part because of their lack of valuation guidance for CSAs and more specifically the buy-in payments.¹²⁷ The final CSA regulations in section 1.482-7 reflect the ongoing concern that foreign corporations enter into CSAs and buy-in (PCT) arrangements that systematically undervalue intangibles, resulting in profit from intangible exploitation escaping taxation.¹²⁸

123. The accumulated earnings of foreign subsidiaries of U.S. resident parent companies have increased substantially from about \$1 trillion in 2008 to \$2.1 trillion in 2013. PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS 82 (2010), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/PERAB-Tax-Reform-Report-8-2010.pdf> (estimating over \$1 trillion of aggregate global undistributed foreign earnings attributable to U.S. corporations based on 2008 corporate financial statements); Kevin Drawbaugh & Patrick Temple-West, *Untaxed U.S. Corporate Profits Held Overseas Top \$2.1 Trillion: Study*, REUTERS, April 8, 2014, <http://www.reuters.com/article/2014/04/09/us-usa-tax-offshore-idUSBREA3729V20140409> (reporting that U.S. corporation foreign profits topped \$2.1 trillion in 2013).

124. See Drawbaugh & Temple-West, *supra* note 125.

125. Treas. Reg. § 1.482-7 (2011).

126. Since the *Veritas* decision, taxpayers with buy-in disputes seem to have received fairly favorable settlements with the IRS in appeals. Perhaps the IRS, with a hardline position, hopes to reverse the *Veritas* result in *Amazon.com v. Commissioner* docketed for a U.S. Tax Court trial in November 2014. *Cases Set for Trial: Amazon*, 22 TAX MGMT. TRANSFER PRICING REP., 22 TMTR 1147, 1149 (Jan. 23, 2014).

127. *Id.*

128. RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 316 (2008). Among the perceived abuses that the 2011 regulations try to address are: using limited-rights transfers to produce low valuations, using license that rapidly step down the royalty rates (*à la Veritas*), valuing intangibles by assuming that the intangible's useful life expires before the

The Tax Court decided the *Veritas* case under the less detailed 1996 cost-sharing regulations, which were effective at the time of the *Veritas* CSA. Despite its loss in court, the IRS carries forward in the 2011 regulations three key concepts in *Veritas* that the Tax Court rejected. First, the regulations use the income method, which the *Veritas* court rejected, to determine the value of PCT payments within the controversial investor model. Second, the IRS expands the definition of covered tangibles to be included in platform contributions. Third, it advocates an aggregate approach to valuing intangibles over the period of the intangible development. These three approaches result from unabated efforts to tax the income that the Treasury and the IRS see shifting offshore through CSAs.

a. Investor Model to Value Payments for Platform Contributions

The investor model introduced in the PCT provisions of the 2011 cost-sharing regulations use an income method¹²⁹ to determine the value of PCT payments. Under the model, each participant is viewed as making an aggregate investment, attributable to both cost contributions (ongoing share of intangible development costs) and platform contributions (the buy-in), for purposes of achieving an anticipated return appropriate to the risks of the CSAs over the term of the development and exploitation of the intangibles resulting from the arrangement.¹³⁰ The model uses an income-valuation method that attributes value to a wide range of IP originating at the parent corporation.¹³¹ While the regulations seem to favor the income method, they do not preclude use of other methods to evaluate the PCT payment.

Without going into further detail about the valuation methods, the investor model appears to be treating a CSA more as a

next generation of products begins, and claims that “make or sell rights” satisfy the buy-in requirements. Thomas Kittle-Kamp, *The New Code Sec. 482 Cost-Sharing Regulations*, 9 GLOBAL TAX BRIEFING 13 (June 20, 2007).

129. Treas. Reg. § 1.482-7(g). The other valuation methods in the cost-sharing regulations include the comparable uncontrolled transaction, comparable uncontrolled service, income, the acquisition price, market capitalization, residual profit split, and unspecified methods. Treas. Reg. § 1.482-7(g). The acquisition price, market capitalization, and residual profit split valuation methods largely borrow from common appraisal methods for valuing IP. Kittle-Kamp, *supra* note 130, at 13.

130. Thus, the taxpayer must determine 1) what an investor would have paid at the outset for an opportunity to participate in the arrangement; and 2) what a participant with external contributions would require as compensation to allow an investor to join.

131. Joseph DiSciullo & Robert Goulder, *Temporary Cost-Sharing Regs Uncorked on New Year's Eve*, 122 TAX NOTES 205, 205 (Jan. 12, 2009).

financing transaction where, for example, a U.S. parent company is viewed as holding most of the risk, and therefore should be allocated most of the residual profits of the development efforts covered by the CSA.¹³² Some tax practitioners fault the investor model for presuming that minimal excess profit should be attributed to the ongoing research conducted in a CSA and that the subsidiary participants add little value to the R&D under the CSA.

To counter, some CSAs require very little R&D from a foreign subsidiary, and yet because of an initial buy-in, the subsidiary appears to reap an undue financial reward from the parent's technological developments. This was likely the IRS's view of the Veritas CSA when the IRS used the income method to value the buy-in PCT paid by Veritas US.¹³³

The measuring stick for whether the valuation under the investor model is incorrect is if a hypothetical investor would not invest in a CSA because its total anticipated return is less than the total anticipated return that could have been achieved through an alternative investment realistically available. In theory, the income method values the PCT payment and each participant's share of reasonably anticipated benefits under "arm's length" and so-called "realistic alternative" requirements.¹³⁴

b. Expanded Definition of Platform Contributions

The 2011 cost-sharing regulations make clear that compensable PCTs are not limited to intangibles defined in section 936(h)(3)(B) of the Internal Revenue Code. The regulations give an example of a possible platform contribution as the value of services that a contributed R&D workforce performs.¹³⁵ The preamble to the 2011 regulations defines a platform contribution expansively as any resource, capability, or right that a participant possesses, separately from the intangible development activity,

132. See Tax Executives Institute, *TEI Comments on Proposed Cost Sharing Regulations*, 57 TAX EXECUTIVE 628, 629-30 (Nov. 28, 2005) (suggesting that the investor model is flawed because a third party negotiating at arm's length would not agree to bear the full risk of an unsuccessful intangible development while accepting a limited return on its overall investment).

133. While the IRS may not have referred to the investor model in *Veritas*, its experts nonetheless used the income method not found in the 1996 regulations to determine the requisite buy-in payment for Veritas. *Veritas Software Corp. v. Comm'r*, 133 T.C. 297, 313, 316, 319, 327 (2009).

134. Treas. Reg. § 1.482-7(g)(4)(v) (2013) (income method that discounts the differential income stream at an appropriate rate).

135. Treas. Reg. § 1.482-7(d)(4) Ex. 3.

whether developed or acquired before or during the course of the CSA, which is reasonably anticipated to contribute to developing cost-shared intangibles.¹³⁶

The platform contributions seem to extend beyond the traditional intangibles such as patents, copyrights, and customer lists as trade secrets.¹³⁷ While the definition of a PCT does not specifically include goodwill, going-concern value, or business opportunity, some of the valuation methods for PCTs could effectively include those assets in the PCT payment.¹³⁸ The question remains open on whether PCT intangibles might fall within the section 367(d)(vi) category “of any similar item, which has substantial value independent of the services of any individual.”¹³⁹

Many commentators criticize the regulation’s definition of platform contribution as overbroad.¹⁴⁰ They argue that platform contributions that included elements such as workforce in place, goodwill or going-concern value, or business opportunity, either do not constitute intangibles or are not normally transferred as part of a CSA transaction, and therefore are not compensable.

In *Veritas*, the Tax Court rejected the IRS’s inclusion of workforce in place, goodwill, and going-concern value in the PCT value because the regulation in force at the time of the CSA had no such authorization to include them as intangibles.¹⁴¹

A related problem to broadening the definition of PCT intangibles is that third-party comparable transactions rarely, if ever,

136. 2011 Preamble, *supra* note 51, at 80083. Although now withdrawn, the I.R.S. Coordinated Issue Paper on buy-in adjustments also details the broader view of what intangibles are included in buy-in costs. I.R.S. Coordinated Issue Paper, Sec. 482 CSA Buy-In Adjustments, LMBS-04-0907-62 Sept. 27, 2007, available at <http://www.irs.gov/businesses/article/0,,id=174320,00.html>.

137. I.R.C. § 936(h)(3)(B) (2014) (listing twenty-seven types of intangibles).

³Treas. Reg. § 1.482-4 (governing intangible transactions generally).

138. Treas. Reg. § 1.482-7(g)(4). While not binding, the preamble to the regulations indicate that the PCTs are intended to encompass any existing inputs including “resources, capabilities, or rights, such as expertise in decision-making concerning research and product development, manufacturing or marketing intangibles or services, and management oversight and direction.” 2011 Preamble, *supra* note 51 at 80082.

139. I.R.C. § 367(d).

140. Alan Shapiro et al., *The New U.S. Cost Sharing Regulations: Past, Present, and Future* 2 (2009), available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_tax_costsharingregs_020209\(1\).pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_tax_costsharingregs_020209(1).pdf).

141. *Veritas Software Corp. v. Comm’r*, 133 T.C. 297, 315–16 (2009). Another way that the IRS attempted to expand the value of the platform contribution in *Veritas* was treating software as a long-lived foundation giving incremental value to subsequent R&D work. Kleinbard, *supra* note 55, at 709 n.14 (2011). The court also rejected the argument of the IRS that the buy-in payment should account for the foreign subsidiary’s access to the U.S. parent’s R&D, marketing teams and distribution channels, customer lists, trademarks, trade names, brand names, and sales agreements. *Veritas Software Corp.*, 133 T.C. at 315–16.

include intangibles such as workforce-in-place. Thus, no hypothetically comparable third-party transaction may exist, making it impossible to measure the *ex ante* value of the RABs by even the most fictionalized of arm's-length standards. Despite this limitation, the IRS sustains its assertion that the arm's-length standard applies to CSAs.¹⁴² One can only speculate whether a court would find the expanded definitional or durational scopes of platform contributions as inconsistent with the arm's-length standard or as unenforceable.¹⁴³

c. Aggregation Approach to Valuation of Platform Contributions

By bundling traditional IP and operating contributions, the IRS and the Treasury are promoting the view that platform contributions should be valued in the aggregate. The preamble to the 2011 cost-sharing regulations states that section 367(d) intangible contributions to a CSA may be aggregated with PCTs where appropriate.¹⁴⁴ This suggests that separate PCT intangibles should be aggregated when it is "more reliable" to value them as a group.¹⁴⁵ As a practical matter, this aggregation approach under the income method tends to limit a foreign subsidiary to routine returns with perhaps a risk adjusted return for its investment in a CSA.¹⁴⁶

The Tax Court soundly rejected this aggregation method for the Veritas buy-in valuation under the 1999 regulations.¹⁴⁷ Opponents of aggregation point out that expertise of the R&D team in *Veritas* is routinely provided and valued for transfer pricing purposes in settings other than cost sharing.¹⁴⁸

A PCT valuation method that values all the intangibles in the aggregate also might be over-inclusive and therefore unreliable, if the valuation includes income from transfers for which compensation was not legally required under section 367.¹⁴⁹ The

142. Brauner, *supra* note 54 at 81 (noting that the IRS rhetorically insists on an arm's-length standard in the context of cost sharing over the years).

143. An arm's-length measure cannot apply where no comparable transaction exists even hypothetically. See *Avi-Yonah*, *supra* note 49, at 1621.

144. 2011 Preamble, *supra* note 51, at 80082.

145. Treas. Reg. § 1.482-7(g)(2)(iv) (2014).

146. Shapiro, *supra* note 142, at 2.

147. *Veritas Software Corp. v. Comm'r*, 133 T.C. 297, 321 (2009).

148. Dolores W. Gregory, *Expansive View in Preamble Goes Beyond Text of Cost Sharing Rules, Practitioners Say*, TRANSFER PRICING REPORT (Feb. 9, 2012), available at <http://www.bna.com/expansive-view-preamble-n12884907754/>.

149. *Id.* See I.R.C. § 351 (2012)(transfer to corporation controlled by transferor). See I.R.C. § 367 (2012) (transfers of property from the U.S.).

taxpayer may argue that once a platform contribution is transferred, the cost-sharing regulations should not require the foreign participant to pay more for the bundled intangibles than is required by section 367(d) and its related regulations.¹⁵⁰ As a result, aggregation likely confuses rather than clarifies valuation issues under the cost-sharing regulations.¹⁵¹

2. Continued Information Asymmetry Between the IRS and Taxpayers

The information asymmetry between the taxpayer and the IRS was a key justification why Congress added the commensurate-with-income standard to section 482 in 1986, and remains the rationale for and foundation of the periodic-adjustment rules under the PCT provisions.¹⁵² Even under the 2011 regulations, the IRS's ability to evaluate CSAs remains hampered, not only by the absence of true arm's-length comparables, but by an asymmetry of information vis-à-vis the taxpayer.¹⁵³

The taxpayer is best positioned to know its business and prospects, although the IRS is required to ascertain the reliability of the taxpayer's *ex ante* expectations of the CSA in light of significantly different *ex post* outcomes. The increased complexities or "clarifications" of the cost-sharing and PCT regulations, such as the investor model and broadened definition of platform contributions, may ultimately result in higher IRS valuation numbers. Yet the final regulations do not necessarily increase the reliability of the information brought to the calculations or bridge the information gap between the IRS and taxpayer.

The income method of the investor model is questionably more reliable in its gathering and assessment of taxpayer information. It requires the IRS to evaluate *ex post* the expectations of the CSA participants and determine whether the terms of the initial arrangement reflect a valid upfront valuation of reasonably anticipated benefits from the arrangement.¹⁵⁴ The theory is that periodic adjustments impute an arm's-length arrangement

150. Gregory, *supra* note 150, at 2.

151. *Id.*

152. REPORT TO THE CONGRESS, *supra* note 56, at 64–65 (noting the "information asymmetry" between the taxpayer and the IRS as a key justification for the commensurate-with-income standard).

153. While the IRS insists that the latest PCT provisions present no conflict with the arm's-length standard, the platform valuation methodologies in practice seems to abandon the arm's-length standard of a transfer price. See Treas. Reg. § 1.482-7.

154. The legislature anticipated *ex post* evaluation of *ex ante* taxpayer expectations. H.R. Rep. No. 99-426, at 425 (1985) ("The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer.").

that better reflect the profit potential of transferred intangibles where the taxpayer's pricing fails to reflect a reasonable *ex ante* valuation.¹⁵⁵

As an example of where the regulations are making information gathering more complicated, the IRS now must ask what percentage of a foreign subsidiary's post-buy-in profits is attributable to intangibles developed up to the buy-in date and what percentage is attributable to intangibles built after that date.¹⁵⁶ Any determination on which intangible or how much of it was developed from another intangible puts the technical taxpayer at a distinct informational advantage over the number-crunching IRS. Thus, the 2011 cost-sharing regulations may provide the IRS an arguably better calculator for higher valuations but not more reliable data to input.

As the PCT regulations now stand, they require the IRS in its own *ex ante* analysis to determine what the taxpayer should have reasonably anticipated as cost-shared intangible development costs (IDCs) but did not include in the PCT.¹⁵⁷ Requiring the IRS to determine the reasonable expectation or anticipations of a particular taxpayer continues to put the IRS at a greater risk of acting arbitrarily. The uncertainty remains when the valuation of preexisting intangibles now includes not only the value of intangibles as they existed at the buy-in date, but also the value of the rights to reinvest in those intangibles.

E. *Cost-Sharing Arrangements in Tax-Reduced Apple-Beats Deal*

The 2011 cost-sharing regulations do not appear to be slowing down U.S.-based companies from shifting significant profit via CSAs to their offshore subsidiaries. California-based Beats Electronics, LLC—co-founded by Apple-friendly music mogul Jimmy Iovine¹⁵⁸ and gangsta rapper Dr. Dre—is a recent exam-

155. REPORT TO THE CONGRESS, *supra* note 56, at 64 (explaining that periodic adjustments are only allowed for the IRS because “it is extremely unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result”). The periodic-adjustment rules, however, do not allow the IRS to make adjustments to buy-in payments just because the actual return exceeded the anticipated return. *Id.*

156. Taxpayers often attach value to preexisting intangibles by asking how long the current intangibles would be productive if they invested no additional time or capital to them. In contrast, the IRS view seemed to be that the value of preexisting intangibles includes not only the value of intangibles as they existed at the buy-in date, but also the value of the rights to continue to invest in those intangibles.

157. Treas. Reg. § 1.482-7(d) (2014).

158. Adam Satariano, *Steve and Jimmy: The Roots of Apple's Bid for Beats*, BLOOMBERG (May 12, 2014) <http://www.bloomberg.com/news/2014-05-12/apple-s-deep->

ple of a U.S. business establishing CSAs¹⁵⁹ with newly formed foreign subsidiaries.¹⁶⁰ Organized in 2012, the royalty-holding, value-shifting Irish subsidiaries of Beats have no apparent business operations in Ireland and appear to be structured like those of Apple. In 2014 Apple purchased the privately held Beats Electronics, LLC for roughly \$2.5 billion and its related music-streaming Beats Music business for nearly \$500 million of mostly Apple stock.¹⁶¹

This Apple-Beats deal seems to involve tax deferrals, thanks in part to CSAs. First, Beats Electronics owners will likely defer income taxes¹⁶² owed from the sale proceeds because significant intangible value¹⁶³ already has been shifted offshore by Beats through CSAs and other transfer-pricing means. Second, assuming Apple's and Beats' Irish subsidiaries consummate the deal, Apple can use its Ireland-held profits to purchase the American company of Beats while still deferring U.S. tax on its unrepatriated profits.¹⁶⁴ While the government has been focusing

ties-with-iovine-key-driver-of-beats-deal.html (reporting on the "deep ties" between Apple cofounder Steve Jobs and Beats cofounder Jimmy Iovine).

159. Evidence of cost-sharing, intercompany royalty and management-fee arrangements between Beats Electronics and its Irish affiliates appears in the description of the "Beats by Dr. Dre" senior tax manager's position. LINKEDIN JOB POSITION POSTING, <http://www.linkedin.com/jobs2/view/10654285> (last visited June 1, 2014).

160. Patrick Seitz, *Apple Might Buy Beats Electronics with Foreign Cash*, INVESTOR'S BUSINESS DAILY (May 2, 2014) <http://news.investors.com/technology-click/052214-701898-apple-might-buy-beats-with-foreign-cash.htm>. Beats Electronics co-founders—music mogul Jimmy Iovine and gangsta rapper Dr. Dre—established their U.S.-based Beats Electronics LLC headphone company in 2006 and Beats Music LLC online streaming-music in 2012. That same year, Beats Electronics also established its Irish subsidiaries: Beats Electronics Holding Ltd., Beats Electronics Services Ltd. and Beats Electronics International Ltd. *Id.*

161. Cody Lee, *Apple Officially Welcomes Beats to the Family*, IDOWNLOADBLOG (Aug. 1, 2014), <http://www.idownloadblog.com/2014/08/01/apple-welcome-to-family-beats/>; Press Release, Apple Inc., Apple to Acquire Beats Music & Beats Electronics (May 28, 2014), available at <https://www.apple.com/pr/library/2014/05/28Apple-to-Acquire-Beats-Music-Beats-Electronics.html>. Apple is acquiring Beats Music LLC for nearly \$500 million in Apple Inc. stock. Hannah Karp et al., *Apple Paying Less Than \$500 Million for Beats Music Streaming Service*, WALL ST. J. (May 30, 2014) <http://online.wsj.com/articles/apple-paying-just-under-500-million-for-beats-music-streaming-service-1401403287>.

162. Beats Electronics as a limited liability company may have elected to be taxed under I.R.C. subchapter C, in which case, Beats' tax deferral would follow corporate tax rules. See generally I.R.C. subchapter C. Otherwise, Beats' income would be passed through to the owners and taxed under I.R.C. subchapter K. See I.R.C. § 701 (2012).

163. Intangibles such as royalty-producing music, utility and design patents, and business goodwill create much of Beats' value. See, e.g., M-CAM, Inc., *Is the Beats Electronics Acquisition Overpriced?*, Patently Obvious (May, 12, 2014) http://www.m-cam.com/sites/www.m-cam.com/files/PO%20Express-%20Beats%20Electronics_0.pdf.

164. Patrick Seitz, *Apple Might Buy Beats Electronics with Foreign Cash*, INVESTOR'S BUSINESS DAILY (May 2, 2014) <http://news.investors.com/technology-click/052214-701898-apple-might-buy-beats-with-foreign-cash.htm> (calculating the \$3 billion price tag might be

predominantly on the offshoring of profits by large publicly traded companies like Apple, some small privately held companies like Beats Electronics are also employing transfer-pricing tools like CSAs to reduce their U.S. tax bills. In general, U.S. businesses no matter the size appear undeterred by the 2011 cost-sharing regulations in setting up their tax-beneficial CSAs.

III. PROPOSED COST-SHARING SOLUTIONS: REGULATION REPEAL OR EXCESS PROFITS TAX

For the better part of two decades, the U.S. Treasury has been reviewing, revising, or commenting on the cost-sharing regulations, and tax practitioners have authored countless articles on the proper methods for calculating buy-in payments. Nevertheless, the cost-sharing regulations have not been working well in light of the recent legal losses and the added governmental costs in aggressive enforcement.¹⁶⁵ While the 2011 cost-sharing regulations now impose greater requirements and restrictions on MNE's cost sharing than earlier regulations, the Tax Court's strong adherence in *Veritas* to the arm's-length standard suggests that the IRS will likely face further challenges to the increased reach of the PCT regulations. MNEs such as Apple Inc. steadily employ CSAs to full tax advantage.

The IRS remains at an informational disadvantage to the taxpayer. The IRS is hard pressed to identify what additional intangible value—such as trade secrets and technical know-how—silently and invisibly shift over to controlled foreign entities. Such intangibles move invisibly alongside other highly mobile but more obvious intangibles that have been identified in a CSA.¹⁶⁶ The exchange of trade secrets and know-how between a parent and subsidiary adds real economic value not found in a third-party transaction. Yet the IRS has difficulty in identifying or quantifying the transferred value between related parties ex-

closer to \$2 billion in actual cost because Apple's unrepatriated money would not be reduced by the thirty-five percent corporate tax if the deal occurs between two Irish entities).

165. Complaints about expense and effectiveness of transfer pricing are longstanding. See Sandra Reid Robertson, *Transfer Pricing Solutions in the Global Economy*, 3 ANNUAL SURVEY INT'L & COMP. LAW, 177, 192 (1996) (suggesting that after thirty-five years of using the arm's-length transfer pricing standard only modest success in combating transfer-pricing issues had been achieved).

166. While beyond the scope of this paper, MNEs with businesses based on the internet cloud will further challenge the IRS in tracking the movement of intangibles. This problem even precedes the challenges of apportioning platform contributions and differentiating intangible property from services for cost-sharing purposes.

cept *ex post* when foreign subsidiaries earn extraordinary profits.¹⁶⁷

A number of alternatives or solutions have been proposed for cost sharing over the years. Some tax experts have suggested a formulary apportionment where competing tax jurisdictions agree on a formula and method(s) to allocate profits.¹⁶⁸ Others have recommended narrowing the scope of the regulations to allow parties to enter into a CSA only if they can clearly provide arm's-length comparables.

Yet another answer lies in the text of the statute itself: to reinvigorate the commensurate-with-income standard of section 482 by repealing the CSA regulations. The best solution is for Congress to repeal the cost-sharing regulations as part of its overhaul and simplification of at least the corporate if not the entire income tax system in the spirit of the 1986 tax reform.¹⁶⁹

As a second although less desirable solution, Congress could expand the subpart F regime to tax "excessive" profits that low- or zero-taxed foreign subsidiaries earn from certain cost-shared intangibles. This option does not get rid of the CSA complications but recaptures some of the diverted income, is more narrowly tailored, and is still consistent with the commensurate-with-income standard.

A. *Repeal of Cost-Sharing Regulations*

The repeal of cost-sharing regulations would pull cost sharing between U.S. parent companies and their business subsidiaries back into the commensurate-with-income standard, and directly eliminate many aggressive income-shifting schemes

167. Dane Mott et al., J.P. Morgan, North America Equity Research, GLOBAL TAX RATE MAKERS: UNDISTRIBUTED FOREIGN EARNINGS TOP \$1.7 TRILLION; AT LEAST 60% OF MULTINATIONAL CASH IS ABROAD 1 (2012).

168. See Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593 (2010) (analyzing formulary apportionment); see also Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 498 (2009); and Julie Roin, *Can the Income Tax Be Saved? The Promises and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169 (2008).

169. See Citizens for Tax Justice, *Apple Is Not Alone* (June 3, 2013), <http://ctj.org/pdf/applenotalone.pdf> (claiming that "[i]f the Securities and Exchange Commission required more complete disclosure about multinationals' offshore profits, it would become obvious that Congress should end deferral, thereby eliminating the incentive for multinationals to shift their profits offshore once and for all"); Kitty Richards & John Craig, Center for American Progress, *Offshore Corporate Profits: The Only Thing 'Trapped' is Tax Revenue* 7 (Jan. 9, 2014), <http://www.americanprogress.org/wp-content/uploads/2014/01/TrappedRevenues-brief1.pdf> (urging Congress to "simply repeal deferral—taxing all profits in the same way, whether they are booked in Iowa or Ireland . . . and put a stop to unproductive profit-shifting games").

through CSAs. The repeal of cost-sharing rules would not leave a void in the current transfer-pricing structure, however, because the regular transfer-pricing regulations already apply to other types of cross-border transfers of intangibles. The regulations and methods for pricing cost-shared intangibles evolved organically without specific rationalization, and therefore the cost-sharing regulations could be removed without violating public or IRS policies such as the arm's-length standard. Instead, the repeal would move toward the general principle of an income tax being commensurate with income and away from the current *ex ante* estimation model that uses a fictional arm's length ill-suited for measuring intangibles.

Like with most changes in tax law, a repeal of cost-sharing regulations would face challenges. As explained further below, it 1) would disturb the expectations and advantages of MNEs; 2) might encourage MNE headquarters to move offshore; and 3) could create conflict with strong international adherence to the arm's-length standard by other countries of the OECD.¹⁷⁰

1. Disturbance of Corporate Taxpayer's Expectation and Advantages

Undoubtedly, repealing current cost-sharing regulations would disturb existing taxpayer expectations. Taxing revenue from CSAs as subpart F income would affect in particular large U.S. MNEs with significant intangible assets already shifted overseas.¹⁷¹ Additionally, the repeal would disrupt MNE's future use of CSAs as an effective tax planning tool to shift income offshore and substantially reduce their U.S. tax liability.¹⁷²

The costs associated with a shift from cost-sharing to subpart F regulations are unknown. Yet a review of the requirements under the 2011 cost-sharing regulations shows no more long-term overhead requirements for a reversion to a subpart F scheme, particularly when the uncertainty of future enforcement under the CSA regulations is factored in.¹⁷³ In the end, the financial rewards from profit-shifting likely would be reduced

170. See *supra* notes 27, 50, and 57 (commenting on OECD's traditional adherence to the arm's-length standard and more recent concerns of tax-base erosion).

171. GRAVELLE, *supra* note 12, at 10–11. While beyond the scope of this paper, significant planning for the transition between the old and new tax regime would be necessary for any tax reform repealing cost-sharing regulations.

172. *Id.* at 22.

173. Repeal of cost-sharing regulations would at least in the short term increase compliance and administrative costs for the taxpayer and the IRS. Whether cost-sharing repeal would ultimately increase or decrease economic efficiency is unknown. Treas. Reg. § 1.482-7.

overall for most MNEs.¹⁷⁴ MNEs would likely experience reduced financial reward in setting up CSAs.

Repeal of the cost-sharing regulations also would strip at least some of MNEs' competitive advantage over smaller companies that operate exclusively in the U.S. and have had no access to such tax-reducing strategies as CSAs.¹⁷⁵ Yet the repeal of cost-sharing regulations overreaches, in the sense that the shift from cost-sharing to subpart F regulation would apply to CSAs in all countries and not just those in low- or zero-tax jurisdictions. The change even would disrupt business practices of U.S. businesses with controlled corporations located in high-tax foreign jurisdictions having no incentive to reduce taxes. Nonetheless, Professor Yariv Brauner argues that the repeal is still fair to MNEs, because it only denies the extraordinary benefit of *ex post* compensation that MNEs receive for their own *ex ante* miscalculations of R&D costs, and then, only when calculated PCT values of MNEs are inconsistent with the results of what unrelated parties do.¹⁷⁶

A few MNEs might even support the repeal of cost-sharing regulations if it were part of reform and simplification of the tax code deemed revenue neutral. Apple's CEO Tim Cook said that he supports a "dramatic" simplification of U.S. tax law that is revenue neutral, eliminates all corporate tax expenditures, lowers corporate income-tax rates, and offers a "reasonable tax" on foreign earnings that allows the free movement of capital back to the U.S.¹⁷⁷

2. Deterrence of Corporate Restructuring through Anti-Inversion Rules

The second challenge with a radical change in cost-sharing regulations, and more broadly transfer-pricing regulations, is that repeal might encourage more U.S. parent companies to reincorporate in another country in a so-called "corporate inversion" or to merge with a foreign company to allow sustained deferral of income back into the U.S.¹⁷⁸ A corporate inversion is a

174. GRAVELLE, *supra* note 12, at 22.

175. With a repeal of the cost-sharing regulations, the IRS might classify CSAs as flow-through tax entities for U.S. tax purposes, creating current subpart F income.

176. Brauner, *supra* note 49, at 567.

177. *Apple Hearing*, *supra* note 4, at 51 (testimony of Apple CEO Timothy D. Cook). Others like tax Law Professor Paul Caron would also support a simplification of tax law: one that included the repeal of "the tax rule that indefinitely exempts offshore profits from U.S. corporate income tax." Paul Caron, *CTJ: Ending Apple's Offshore Tax Shenanigans*, TAXPROF BLOG (May 5, 2012), http://taxprof.typepad.com/taxprof_blog/2012/05/ctj-ending.html.

178. United States Senator Ron Wyden, Senate Comm. on Fin.: Wyden Statement on Corporate Inversions and the Need for Comprehensive Tax Reform (July 22, 2014). Cor-

transaction through which a U.S.-based MNE alters its corporate structure so that a foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group.¹⁷⁹ Outbound transfer of intangibles in corporate inversions can force capital-gains realization and consequent capital-gains tax burden on MNE's shareholders.¹⁸⁰

3. Conflict with International Arm's-Length Standards

Perhaps the greatest obstacle to the repealing cost sharing under I.R.C. section 482 and associated regulations is the almost universal adherence to the arm's-length standard in the international transfer-pricing world.¹⁸¹ Thus, the third challenge in reinvigorating the commensurate-with-income standard within the U.S. by repealing cost-sharing regulations might be the disturbance of international expectations. The seeming universality of the arm's-length standard, which applies even beyond the inter-

porate inversions have become the 2014 hot-button tax issue for politicians and the public alike. The July 2014 hearing of the U.S. Senate Committee on Finance focused on the "inversion virus" that seems to be spreading since the June 2014 announcement of the proposed \$42 billion merger of Minnesota-based Medtronic, Inc. with the Irish company Covidien PLC. S. COMM. ON FINANCE, 113TH CONG., THE U.S. TAX CODE: LOVE IT, LEAVE IT OR REFORM IT! at 1 (July 22, 2014) (Wyden Statement on Corporate Inversions and the Need for Comprehensive Tax Reform), available at <http://www.finance.senate.gov/imo/media/doc/07222014%20Wyden%20Statement%20on%20Corporate%20Inversions%20and%20the%20Need%20for%20Comprehensive%20Tax%20Reform.pdf>. See also OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 1 (2002), available at <http://faculty.law.wayne.edu/tad/Documents/Country/Treasury%20inversion%20report%2005%2017%2002.pdf>.

179. *Corporate Inversion: Hearing Before the H. Comm. on Ways & Means*, 107th Cong. (2002), available at <http://waysandmeans.house.gov/legacy/fullcomm/107cong/6-6-02/6-6olso.htm> (statement of Pamela F. Olson, Acting Asst. Secretary for Tax Policy, U.S. Department of the Treasury). See Michelle Hanlon, *The Lose-Lose Tax Policy Driving Away U.S. Business*, WALL ST. J., (June 11, 2014), available at <http://online.wsj.com/articles/the-lose-lose-tax-policy-driving-away-u-s-business-1402527307> (MIT accounting professor opining that recent Congressional anti-inversion bills fail to address the reasons for cross-border mergers and reincorporation of U.S.-based MNEs, which are looking to stay competitive with foreign-based companies).

180. Assuming a corporate inversion under I.R.C. § 7874, the intangible transfers associated with the U.S. company reincorporating as a foreign corporation may require compensatory payments to the U.S. transferor. I.R.C. § 367(d)(2) (2012). The IRS and Treasury Department are working to tighten corporate inversion rules that would require taxpayers to pay additional taxes that have been avoided through MNEs' strategic tax planning. IRS Notice 2014-52 (2014), available at <http://www.irs.gov/pub/irs-drop/N-14-52.pdf> (announcing changes to the Treasury Regulations that they intend to reduce the potential tax savings that could be extracted from inversion transactions and generally tighten the rules on cross-border mergers).

181. As noted earlier, other countries are re-thinking their strict adherence to the arm's-length standard. See *supra* notes 20, 50, and 57.

national tax regime, may make the U.S. more reluctant to divert from the standard. The repeal of cost-sharing regulations could disrupt treaty relationships. While section 482 already allows and requires the narrow deviation from the normal application of the arm's-length standard when adjusting transfer prices to be commensurate with income, the international reaction if U.S. repealed cost-sharing regulations is unknown.¹⁸²

B. *The Excess-Profits Tax Alternative*

An excess-profits tax, under the commensurate-with-income standard, provides another alternative to the current cost-sharing regulations.¹⁸³ It would expand the subpart F regime to tax U.S. companies on "excessive" returns that low- or zero-taxed foreign subsidiaries earn from intangibles transferred offshore by U.S. companies.¹⁸⁴ Excess profit, also referred to as excess returns, is defined generally as the excess of gross income from transactions benefitting from such covered intangibles over directly allocable and apportionable costs excluding interest or taxes, increased by a percentage markup.¹⁸⁵ This subpart F income would be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under section 904.¹⁸⁶

Suppose a taxpayer transferred a covered intangible¹⁸⁷ through a CSA, either directly or indirectly from the U.S. to a re-

182. See, e.g., Kathleen Matthews, *Mogle Says IRS Can Retroactively Apply Much of Transfer Pricing Regs.*, 93 TN 89-1 (May 7, 1993).

183. DEPT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS at 43-44 (2011) [hereinafter 2012 GREEN BOOK], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf>.

184. *Id.* The Obama Administration proposed an excess-profits tax on transferred intangibles in its budgets for fiscal years 2012 and following. DEPT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS (2014), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>; DEPT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS (2013), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>; DEPT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS at 89-90 (2012) [hereinafter 2013 GREEN BOOK], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>; 2012 GREEN BOOK. Copies of the Green Books are available at http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx.

185. 2012 GREEN BOOK, *supra* note 185, at 44.

186. 2013 GREEN BOOK, *supra* note 186, at 89.

187. The Administration also proposed to clarify the definition of intangible property for purposes of §§ 367(d) and 482 to include workforce in place, goodwill, and going-concern value, and endorses the aggregate approach the IRS used in *Veritas* in situations

lated controlled foreign corporation. A certain amount of excess income from transactions connected with or benefitting from that covered intangible would be treated as subpart F income if the income were subject to a low foreign effective tax rate.¹⁸⁸

1. Excess-Profits Tax in Recent Federal Budget Proposals

The Obama Administration first released proposed legislative language for an excess-profits tax on transferred intangibles in its fiscal year 2012, and thereafter in its budgets for fiscal years 2013, 2014 and 2015.¹⁸⁹ The 2012 proposal included language for section 954(a)(4) with a new category of subpart F income called “foreign base company excess intangible income” (FBCEII) presented in the new section 954(f).¹⁹⁰ The FBCEII tax would be assessed on any amount of gross income above 150 percent of the CFC’s directly allocable and apportionable costs.¹⁹¹ Similar to other subpart F income, the FBCEII would have a same country exception and sufficient foreign-tax exclusion.¹⁹² Under the sufficient foreign-tax exclusion, an excess-profits tax would not apply to intangibles having an effective foreign tax rate of fifteen percent or greater.¹⁹³ The 2013 budget’s similar proposal added in the phase-in period of the excess returns tax for effective tax rates of ten percent to fifteen percent.¹⁹⁴ Under the 2013 proposal, the excess tax would apply where the foreign effective tax rate is ten percent or less, and in a sliding scale, where tax rates are between ten percent and fifteen percent.¹⁹⁵ A

where it achieved a more reliable result. Finally, the proposal suggests that the IRS may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken. 2013 GREEN BOOK, *supra* note 186, at 90.

188. *Id.* at 89.

189. *Id.*

190. *Id.*; *Legislative Language for Administration’s “Excess Returns” Proposal Raises Issues*, WNTS INSIGHT 3 (Oct. 21, 2011) [hereinafter WNTS INSIGHT], available at <http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=5050&Mailinstanceid=22228>. The proposal for fiscal year 2013 is almost identical to that of 2012, the only difference being the phase-in period of the excess returns tax for effective tax rates of ten percent to fifteen percent. 2013 GREEN BOOK, *supra* note 186, at 88–89.

191. WNTS INSIGHT, *supra* note 192, at 3.

192. *Id.* at 4.

193. 2013 GREEN BOOK, *supra* note 186, at 89.

194. *Id.*

195. *Id.* Rather than a backstop approach, some tax practitioners propose an upfront “homeless income” and “base-protecting” surtax on any payments from a U.S. parent to a foreign subsidiary. See, e.g., Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535, 539–40 (2012) (suggest-

relevant IP “transfer” would include CSAs typically not thought to entail a transfer of IP and a broader range of covered intangibles under a revised section 367.¹⁹⁶

2. Criticisms of the Excess-Profits Tax

The Obama Administration’s proposal speaks in terms of IP being transferred from the U.S. Yet the proposal as currently drafted does not distinguish between domestically and foreign-developed IP, and could taint income flow that is attributable to largely foreign-developed IP.¹⁹⁷ Thus, it creates a “cliff effect” based on the presence of *any* relevant U.S.-developed IP.¹⁹⁸ Another fundamental criticism of the excess-profits tax is that it might encourage MNEs to migrate more of their R&D activity offshore, further eroding the tax base.

David G. Noren, a tax practitioner and former legislation counsel on the staff of the Joint Committee on Taxation, suggested that if Congress thought the excess-profits tax were necessary, it should be more neutral with respect to the locations where R&D work is performed.¹⁹⁹ Others have expressed the need for more legislative language and more detail to fully evaluate the proposed tax. Nonetheless, the excess-profits tax inevitably creates tension between the tax-policy goal of restricting income-shifting, and other economic policy goals to preserve and create U.S. R&D jobs and technological leadership.

3. Reduced Conflict with International Arm’s-Length Standards

Similar to the option of repealing the cost-sharing regulations, an excess-profits tax would apply the commensurate-with-

ing the parent would need to show that it should pay less tax through a base-clearance certificate process with the IRS). For more discussion on homeless or stateless income, see Irish Minister for Finance, *supra* note 28, at 5; *see also* Kleinbard, *supra* note 55.

196. David G. Noren, *The Ways and Means Committee International Tax Reform Discussion Draft: Key Design Issues*, 41 TAX MGMT INT’L J. 167, 172 (2012) (describing the difficulty in determining the location of income creation from IP in the context of an excess profits tax and two other alternative Subpart F proposals targeting U.S. tax base erosion).

197. *Ways and Means International Tax Reform Discussion Draft: Hearing before the Subcomm. on Select Revenue Measures of H. Comm. on Ways & Means*, 112th Cong. 154 (2011) (written statement of David G. Noren, tax practitioner at McDermott Will & Emery LLP, page 4), available at <http://waysandmeans.house.gov/UploadedFiles/Norensrm1117.pdf>.

198. *Id.*

199. *Id.* In reviewing the draft of the Obama Administration’s proposal, Noren also expressed other concerns about the scope of costs included in the base that is marked up under the 150-percent rule and the treatment of royalties paid by a CFC for purposes of the excess income determination. Noren, *supra* note 199, at 5.

income standard to the transfer pricing of intangibles. Like the proposed repeal, the excess-profits tax might also conflict with the application of the arm's-length standard, the standard to which the OECD and many nations are fully committed.²⁰⁰ Yet, the incremental excess-profits tax is less likely to raise OECD arm's-length objections or concerns with treaties than an outright repeal of cost-sharing regulations. The more narrowly tailored excess-profit tax also would fit within the preexisting subpart F basket approach, thereby creating less administrative or implementation overhead than an outright repeal of cost-sharing regulations.

4. Greater Political Feasibility of Excess-Profits Tax over Repeal

Political feasibility is perhaps the most persuasive reason for favoring the excess-profits tax over an outright repeal of cost-sharing regulations. The excess-profits tax is a more modest and narrowly tailored change that would target the main income-shifting problem without broader international conflict over the arm's-length standard. By comparison, the international taxing community currently appears to tolerate the commensurate-with-income standard with taxpayer adjustments to CSAs in their attempts to align a buy-in amount to reflect actual income. The excess-profits tax arguably falls within the same commensurate-with-income line and might at least be grudgingly accepted by international taxing authorities of the OECD.

IV. CONCLUSION

Under the current statutory scheme, cost-sharing arrangements between U.S.-based businesses and their foreign subsidiaries remain a favorite tool to defer and reduce significant U.S. tax liabilities. Meanwhile, the Internal Revenue Service struggles to capture the elusive value of intangible transfers through its implementation of the 2011 cost-sharing regulations yet untested in the courts. As a result, the cost-sharing regulations are not slowing down U.S.-based companies from taking opportunity to shift significant profit via CSAs to their offshore subsidiaries. Nor are the regulations paring down the tax advantages that CSAs afford.

200. OECD, PROPOSED REVISION OF CHAPTERS I-III OF THE TRANSFER PRICING GUIDELINES (2009-10), available at <http://www.oecd.org/dataoecd/1/57/43655703.pdf> (asserting repeatedly its commitment to the arm's-length standard and its rejection of alternatives). See also *Silberstein Defends Arm's-Length Standard, Speaks to Restructuring Project, Other Issues*, 18 TAX MGMT. TRANSFER PRICING REP. 516 (2009).

In a Zeus-like decision over the golden apple,²⁰¹ Congress should recognize the apparent impossibility of determining the true beauty or economic value of U.S.-developed intangibles transferred offshore via CSAs. The discordant golden apple persists, as illustrated by 1) the divergent IRS and taxpayer valuations of the CSA in *Veritas Software Corp. v. Commissioner* in 2009 and 2) the ongoing public disputations over the success of MNEs such as Apple to defer billions of dollars of U.S. taxes on intangible property value transferred offshore.²⁰²

Equipped with the more detailed and complex guidance of the cost-sharing regulations finalized in 2011, the IRS still cannot overcome the taxpayers' informational advantages in crafting CSAs and buy-ins, as presented in *Veritas Software Corp. v. Commissioner*. *Veritas* highlights the irreconcilable views of the IRS and taxpayers on how to measure and what to include in the bundle of rights and benefits of a CSA. Further, the cost-sharing regulations are not deterring companies like publicly held Apple Inc. or privately held Beats Electronics LLC from aggressively using CSAs with their foreign subsidiaries to significantly reduce taxes.

As a result, the tax-deferred profits of U.S.-based MNEs that remain outside the country grew in 2013 to \$2.1 trillion with no slowdown in sight.²⁰³ More than anecdotal evidence suggests that the U.S.-based MNEs' accumulated tax-deferred overseas profits have become so large in size because MNEs have undervalued the intangible assets associated with their CSAs.²⁰⁴ In other words, MNE's valuations of intangible assets have not been commensurate with income. Assuming such undervaluing of transferred intangible assets remains, the U.S. domestic tax base will erode further. A solution to this profit-shifting erosion needs

201. Mythological Zeus knew he could not choose which of the three goddesses—Hera, Athena, or Aphrodite—was the fairest or most beautiful, because choosing any of them would bring him the hatred of the other two. H. ROSE, A HANDBOOK OF GREEK MYTHOLOGY 87 (1964). See *supra* note 9 (regarding the apple of discord as a precursor to the Trojan War).

202. A review of public filings showed that the largest U.S.-based publicly traded companies added \$206 billion in 2013 to their accumulated \$1.95 trillion in profits outside the U.S., up 11.8 percent from the year earlier. Richard Rubin, *Companies' Offshore Profits keep Piling Up*, BUSINESSWEEK (March 20, 2014), available at <http://www.businessweek.com/articles/2014-03-20/companies-offshore-profits-keep-piling-up>. For example, Apple's offshore profits more than quadrupled from \$12.3 billion in 2010 to \$54.4 billion in 2013. *Id.*

203. This number has grown ninety-three percent since 2008. *Overseas Earnings of Russell 1000 Tops \$2 Trillion in 2013*, AUDIT ANALYTICS, available at <http://www.auditanalytics.com/blog/overseas-earnings-of-russell-1000-tops-2-trillion-in-2013/>.

204. Drawbaugh & Temple-West, *supra* note 125.

to reinvigorate the commensurate-with-income approach as applied to intangibles being transferred internationally.

Congress could expand the subpart F regime of Internal Revenue Code section 482 to include an excess-profits tax associated with intangibles transferred to low- or zero-taxed foreign subsidiaries. This gap-closing measure, however, does not address the continued disincentive for taxpayers to repatriate previously earned income and the incentive to use cost-sharing agreements that shift income offshore where profits are not excessive.

The most promising long-term solution to offshore income shifting is for Congress to repeal the unworkable cost-sharing regulations and reduce the corporate tax rate as part of a phased-in and comprehensive corporate tax reform. In a spirit of political compromise, such a tax reform would need to balance the business interest in reducing the thirty-five percent corporate tax rate and the tax code's complexity against the governmental interest in reversing a multi-trillion-dollar shift of intangible value offshore. Only then will the discordant golden apple be cored, providing businesses with little tax advantage to shift profits offshore and greater incentive to contribute directly to the American economic pie.