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Legislative language for Administration's "excess returns" proposal raises issues

The Obama Administration recently released legislative language for five revenue-raising proposals in the international tax area from its fiscal year (FY) 2012 Budget. The proposal that has generated the most interest and uncertainty since the Administration released its Budget in February would create a new Subpart F category of income for "excess returns" on transfers of intangibles to a controlled foreign corporation (CFC) from a "U.S. related person." The legislative language answers many of the questions observers had raised about the proposal, but some uncertainties remain.

This provision would be effective for tax years beginning on or after January 1, 2013, which is a year later than the effective date proposed for this provision in the FY 2012 Budget. For prior discussion, see WNTS Insight, "Treasury Department provides 'Green Book' explanation of FY 2012 Administration tax proposals," March 9, 2011.

The Joint Committee on Taxation staff (JCT) in June released its analysis of this proposal. For prior discussion, see WNTS Insight, "JCT analyzes Obama Administration proposals on intangibles, excess returns," June 23, 2011. See also WNTS Insight, "Joint Tax Staff provides detailed analysis of Obama Administration intangibles proposals," August 26, 2010.

Analysis of Proposal

Proposed section 954(a)(4) would create a new category of Subpart F income called "foreign base company excess intangible income" (FBCEII), which would be defined under proposed section 954(f). The language clarifies such fundamental issues as:

- the scope of covered intangibles;
- the rate of return that would be considered excessive, rendering income potentially subject to FBCEII treatment;
- the mechanism for associating a transferred intangible with an excessive return; and
- the level of foreign tax below which a CFC potentially would be subject to FBCEII treatment.

Association of intangible to excess return

The income subject to potential FBCEII treatment includes gross income from the sale, lease, license, or other disposition of property in which a “covered intangible” is used (directly or indirectly), and from services related to the covered intangible or in connection with property in which the covered intangible is used (directly or indirectly).

Covered intangibles

Under the proposal, any section 936(h)(3)(B) intangible would be considered a “covered intangible,” and therefore potentially give rise to the new category of Subpart F income, if it is sold, leased, licensed, or otherwise transferred (directly or indirectly) to a CFC by a "U.S. related person" (as defined in section 954(d)(3)). In addition, an intangible subject to any shared risk or development agreement (including any cost-sharing agreement) between the CFC and any related person would be covered.

Observations: The proposed legislative language covers a broad range of scenarios in which a CFC’s acquisition or development of intangible property could trigger the application of the new Subpart F provision. This is because the proposed Subpart F provision could be implicated when a CFC acquires an intangible through a purchase, license, cost-sharing arrangement, or other transfer not specifically enumerated. Further, when a CFC acquires or develops intangible property pursuant to a cost-sharing arrangement, the language does not explicitly require that a U.S. person be a party to the agreement. In other words, a covered intangible could arise from a CFC-to-CFC cost-sharing arrangement to which no related U.S. person has provided any intangible property -- meaning that Subpart F income could be triggered under the new provision even if there had been no transfer of the intangible from a U.S. person at all. This result may have been unintended. At a minimum, the reach of the term "covered intangible" appears potentially overbroad in light of the stated policy concerns regarding "outbound" migration of intellectual property.

The section 936(h)(3)(B) definition, which has spawned significant controversy in recent years, provides a list of various items that are considered intangible property provided they have substantial value independent of the services of any individual. The Administration also has -- consistent with prior budget proposals -- proposed to amend the section 936(h)(3)(B) definition explicitly to include goodwill, going concern value, and workforce in place. If the excess income proposal were enacted together with this change in the section 936(h)(3)(B) definition, the excess income provision would apply not only with respect to items of intangible property expressly covered by section 936(h)(3)(B) under current law, but also with respect to more broadly defined elements of intangible value such as goodwill. The IRS has taken the position in some cases that the current section 936(h)(3)(B) definition already encompasses goodwill and workforce in place, although they are not explicitly listed in the current definition.

FBCEII treatment applies when a covered intangible is “used directly or indirectly” in the property giving rise to the income. Use of the word “indirectly” raises the question whether the language nonetheless requires a meaningful link between the intangible and the property giving rise to the income. For example, even if the definition of a section 936(h)(3)(B) intangible were expanded to include goodwill, the goodwill should constitute a covered intangible only if such goodwill actually is “used” in the property sold within the meaning of section 954(f). Otherwise, the reach of this provision would be overbroad. Nevertheless, the requisite nexus between the intangible and the property giving rise to income is uncertain.

Excess return threshold

The threshold for an excess return is a 50-percent markup over the CFC's directly allocable costs, specifically excluding interest and taxes. This threshold may be low for some industries. However, for taxpayers with significant research and development (R&D) costs, it should be noted that all such costs would be treated under proposed section 954(f) as properly allocable to income derived from a covered intangible, provided that such R&D costs are “properly allocable” to the same line of business in which the relevant gross income is derived. This treatment could increase the amount of costs against which the margin is measured, thereby potentially reducing the amount of FBCEII.

Observations on threshold

The language describing the determination of excess income raises some of the most difficult conceptual and technical issues in the Administration's proposal. Under the proposed legislative language, income from the sale, lease, or license of property in which a covered intangible is used (directly or indirectly), or from the provision of services related to a covered intangible, would be treated as excess income to the extent of the amount that exceeds the specified threshold. The statute apparently would provide an “all or nothing” determination for this purpose. That is, all the income from the sale of an item of property or the provision of a service would be tested against the threshold if a covered intangible were used with respect to that property or service, even if some or most of the income was attributable to other intangibles (e.g., intangibles acquired by the CFC outside the United States and used in connection with the same property or service).

This "all or nothing" approach could produce results that arguably are too harsh given the stated policy goals. The presence of a covered intangible of *any value* could be sufficient to taint the entire amount of income attributable, for example, to a sale of property in which the covered intangible is used, even if the property is designed and made based primarily from other intangible property which is unrelated to covered intangibles. It is unclear whether this result is intended. By analogy, under existing regulations, Subpart F determination is not necessarily an "all or nothing" choice. That is, Subpart F characterization may apply to a portion (or portions) of income derived from a single transaction. See reg. sec. 1.954-1(e). If a CFC uses both a covered intangible and other intangible property to generate a single item of income, the portion of such income, to the extent not attributable to the covered intangible, would not appear to implicate the policy concerns underlying the proposal, so it may not be appropriate to treat that portion of income as FBCEII. However, clarification is needed regarding this critical aspect of the proposed legislation.

In addition, it is unclear how income connected with a covered intangible should be determined when the CFC sells several different products or operates in several different business lines, only some of which use a covered intangible. The draft statutory language does not offer guidance on this issue, which could present administrative difficulties for both taxpayers and the IRS.

Finally, the use of a gross income measure to calculate excess income is problematic. The threshold appears to mirror a common profit level indicator used in the transfer pricing area -- the ratio of gross profit to operating expenses. The ratio can vary depending on how particular costs are classified on the CFC's income statement between cost of goods sold (COGS) and operating expenses. Such a calculation could result in excess income in the case of a manufacturer earning only a routine manufacturing return, even in a case in which the manufacturer did not earn any residual intangible income – let alone income that might have been inappropriately shifted.

For example, a manufacturer that incurs a large amount of manufacturing costs reflected in its COGS, but only a small amount of operating expenses, could realize only a routine return on its total costs but still exceed the excess income threshold when that routine income is tested against the manufacturer's small operating expense amount. The routine return could well exceed 150 percent of operating expenses in this situation. For example, a manufacturer with COGS of $98x and operating expenses of $2x that realizes an operating profit equal to 10 percent of its total costs (or $10x) would far exceed the 150-percent threshold, because its gross income would equal $12x ($110x - $98x) while 150 percent of its operating expense would equal only $3x. This may not be a common fact pattern, but it reveals what may be a conceptual flaw in the excess income calculation.

"Same-Country" Exceptions

Proposed section 954(f) would exclude certain "same-country income" from FBCEII. For example, FBCEII excludes income from the sale, lease, license, or other disposition of property in which a covered intangible is used, if the property is sold, leased, licensed, or otherwise disposed for use or consumption in the relevant CFC's country of incorporation. FBCEII also would exclude services income that otherwise would be subject to the new provision if the services are performed in such country. Presumably, the FBCEII rules would look to section 954(d) and section 954(e) for guidance on country of use and country of performance, although clarification would be needed to confirm this point.

Level of foreign tax

Under the Administration's proposed section 954(f), the amount of FBCEII may be excluded, in whole or in part, based on the effective tax rate imposed on the potential FBECII. Specifically, all the relevant income would be characterized as FBCEII if the item of income is subject to an effective tax rate of 10 percent or lower, and none of the relevant income would be characterized as FBCEII if the income is subject to an effective tax rate of 15 percent or higher. Between 10 and 15 percent, the proposal imposes a sliding scale based on the "applicable percentage" of the five percentage points between 15 and 10 percent (i.e., a 12-percent effective rate would result in a 60-percent FBCEII inclusion).

Observations: The proposal requires taxpayers to calculate the effective tax rate imposed on the potential FBCEII without taking into account any losses incurred in, or carried over into, the current year. Thus, a CFC carrying start-up losses forward to early years of high profitability apparently could ignore the impact of the losses on its tax rate in those years. However, the proposal does not specify what method taxpayers should use to calculate the CFC's effective tax rate. The draft legislative language does not address other aspects of the determination of the effective tax rate, such as whether to use U.S. or foreign tax principles to measure taxable income, a potential area of uncertainty that was highlighted in the JCT analysis.

In coordination with other provisions, the Administration proposes that FBCEII would constitute a separate FTC basket under section 904 and would not be treated as any other kind of foreign base company income under section 954. On the other hand, if an item of income is tested under the new FBCEII provision but excluded from Subpart F (for example, under the same-country exception described above), the income still would have to be tested under other foreign base company income provisions. For example, a CFC's sales and services income still would need to be tested under section 954(d) and (e), respectively. In addition, given that FBCEII is treated as having its own FTC basket, there still may be a need to bifurcate a CFC's sales income between FBCEII and, for example, foreign base company sales income under section 954(d) for FTC basketing purposes if both Subpart F categories apply.

Observations

Changes to the proposal as described in the Administration's FY 2012 Budget apparently were made in response to comments from the JCT and others, requiring a closer connection between the transferred intangibles and the excess income. The 50-percent markup, the addition of certain R&D costs to expenses directly allocable to covered intangibles (i.e., R&D costs that are "properly allocable" to the same line of business that generated the potential FBCEII), and the 15-percent effective tax rate ceiling for FBCEII generally seem taxpayer favorable. However, given that a number of OECD countries have statutory tax rates under 20 percent and Ireland currently has a 12.5-percent tax rate for trading income, this revised effective tax rate test might apply to income derived from operations located in many OECD countries and not just income derived from perceived "tax haven" countries.

The proposed section 954(f) language suggests that it would apply to all covered intangible transfers (sales, licenses, cost-sharing agreements, etc.), whenever they may have occurred in the past. The rate of return and effective tax rate numbers specified in the legislative language do not correspond precisely to the numbers previously stated by Treasury as used in its prior revenue estimates ($20.8 billion over 10 years).

The reach and impact of the proposal could be increased or amplified by the Administration's separate proposal to expand the section 936(h)(3)(B) definition of intangible property to include goodwill, going concern, and workforce in place.

Finally, the new Subpart F category of income could apply even if the covered intangible was transferred before the enactment date, because the provision would apply to income "from transactions connected with or benefitting from" covered intangibles in tax years beginning on or after January 1, 2013, without regard to when the covered intangible was developed or transferred. Similarly, there is no guidance on when, if ever, an intangible could shed its "taint" as a "covered intangible." That is, the rule in theory could apply to an intangible that was transferred many years ago, so long as the intangible is still considered "used directly or indirectly" in the property giving rise to current income. Clarification is needed as to the manner in which a covered intangible's useful life affects the determination as to whether, and the extent to which, the intangible is being used currently to generate income. However, the approach would work in practice only if the CFC continued to operate and develop the intangible on its own, rather than through a cost-sharing arrangement.

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