

Questions from Rep. Reichert

1. **Mr. Secretary, with respect to the international tax rules, the active royalty exception in tax code section 954 distinguishes between, on one hand, active royalties received from unrelated entities, which enjoy U.S. tax deferral due to the active nature of the income, and, on the other, active royalties received from related entities, which are immediately subject to U.S. taxation as subpart F income despite the same active nature of the income. This may have the practical effect of discouraging a U.S. parent company from owning the payor of the royalties, through a controlled foreign subsidiary, even when there are business reasons to own or acquire the payor of the royalties. One proposal to address this is to apply the section 954(c)(2)(A) active royalty exception to royalties (which fully meet the active conduct of a trade or business standard) that are received from either unrelated or related entities. Would you support a proposal to expand the active royalty exception to royalties received from related entities? If so, would additional safeguards be needed to assure that arm's length pricing standards are met?**

Our international tax rules currently allow deferral of U.S. tax on royalties (as well as certain other payments) received by a controlled foreign corporation from a related person to the extent the royalties are attributable to active income of the payor (income that would not be subject to current U.S. taxation). We believe this rule largely, if not entirely, addresses the issue you have raised. The Administration's FY-2012 budget proposes a one-year extension of this provision, which will otherwise expire at the end of the year.

The Administration continues to be concerned about the inappropriate shifting of profits to low tax jurisdictions through transfers of intangibles offshore. For this reason, the Administration's Budget included proposals specifically targeting our concerns in the area of transfer pricing and the outbound transfer of intangible assets.

The Administration's proposal is intended to serve as a backstop to current rules for valuing intangible property rights transferred to a related person and to prevent the inappropriate shifting of income resulting from the transfer of high value intangibles offshore. It is consistent with and complementary to the principles of the current transfer pricing rules.