

**Testimony Before the
Committee on Ways and Means**

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**Washington, D.C.
July 22, 2010**

I. Introduction

Good afternoon, Mr. Chairman and Members of the Committee. My name is Bill Morgan. I am an economic consultant at Horst Frisch Incorporated. We are a firm of 15 people that specializes in the economic analyses of transfer prices.

Day-to-day, I advise multinational clients and the IRS about the "arm's length" standard. I am not a lawyer, but an economic advisor. I ask the question, "Is this the way arm's length parties would price the same transaction?".

My brief statement is intended to provide an objective economic perspective on my experience with transfer pricing, and specifically on the problem I see with respect to the intercompany sale of valuable intangible property for less than arm's length prices.

My comments focus on defining the problem, suggesting a source of the problem, and suggesting solutions that may warrant further investigation.

II. Problem

Treasury and others have summarized the evidence showing that U.S. multinationals continue to shift income to low-tax jurisdictions.¹ Shifting income in a manner consistent with an arm's length standard is fine, but doing it in a manner which violates that standard is not.

Most importantly, if some taxpayers are getting away with inappropriate income shifting, it only encourages otherwise moderate tax directors -- at the behest of an anxious CFO or shareholders -- to engage in unreasonable behaviors in order to reduce effective tax rates. Consequently, the process is dissolving into one based less on rational thinking, and more on the ability of a company and its advisors to negotiate their way to a prize in the audit lottery.

¹ See, for example, U.S. Department of Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, pages 55-61.

The Joint Committee on Taxation has identified the problem as especially acute with respect to 1) "buy-ins" under cost sharing arrangements, and 2) section 936 conversions.²

Given the limited time, I am going to use cost sharing as a primary example, but it is true that similar tax planning strategies can produce the same results.

A. Cost Sharing Objectives

One of the original reasons for adopting cost sharing³ was to avoid the need to value intangibles since the costs of creating those intangibles would be borne by the cost share participants.⁴

Taxpayers have argued that another reason for cost sharing is that they need such arrangements in order to spread the high risk of research and development and other intangible development costs.

Under current rules, the first objective is not being met, and the second is being met through what appears to be a violation of the arm's length standard.

B. Cost Sharing Not Meeting Objectives

1. The Need to Value Intangibles

First, valuing intangibles is difficult, and cost sharing has not alleviated that problem. This is best evidenced by the recent Tax Court case involving Veritas,⁵ a U.S. manufacturer of storage software. Veritas entered into a CSA with a subsidiary it established in Ireland, using a common tax planning legal structure. At issue was the value of "buy-in" payments made from Ireland to the U.S. as consideration for "pre-existing" intangible property.

In the case, the taxpayer estimated its non-U.S. intangible value at \$118 million, while the IRS estimated the value of intangibles at \$1.675 billion. These figures differ by a magnitude of over 14 times! The taxpayer and the IRS both used

² Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment*, September 2009, page 37.

³ A cost sharing arrangement (CSA) is an agreement between two or more parties to share in the costs and risks of intangible development in exchange for an ownership interest in the developed intangibles.

⁴ See *A Study of Intercompany Pricing*, Treasury Department, Discussion Draft, October 18, 1988, page 121. In other words, cost sharing was originally viewed as a way to allocate intangible income among related parties without requiring the complex determination of intercompany royalty rates. See also preamble to the 1995 cost sharing regulations.

⁵ *Veritas, Inc. v. Commissioner*, 133 T.C. No 14 (2009).

smart people and applied the same set of rules, but came up with wildly different results.⁶

Cost sharing has not eliminated the need to value intangibles; but, if anything, cost sharing has exacerbated it.

2. Transferring Risk

A second commonly stated goal of cost sharing is to share the high risk of intangible development. Companies may be achieving this goal, but they are doing so at tremendous cost.

Yale Professor Michael Graetz has described an abusive shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." The same applies here.

Veritas traded its rights to sell in all non-U.S. markets, using its valuable technology, marketing, and other intangibles, for \$118 million. Based on what we know about Veritas's prospects for the non-U.S. markets at the time of the CSA,⁷ I think it is fair to say that if this deal were struck at arm's length, shareholders would be justifiably outraged.

For Veritas U.S., the potential for significant income was in the U.S. one day, and in Ireland the next. Veritas U.S. may have reduced its risk with respect to developing the non-U.S. markets, but the price it paid for surrendering its potential income defies common sense. At arm's length, companies do not reduce risk by selling valuable assets on-the-cheap.

The case highlights the uncertainty surrounding the definition of "pre-existing intangibles," as opposed to what the court termed "subsequently developed intangibles."⁸ This uncertainty is, in part, what appears to have driven the discrepancy in the IRS and taxpayer valuation estimates, and in general may allow companies to transfer significant income to related parties for less than arm's length prices.

⁶ My experience is that such a difference is not an isolated example.

⁷ I was not involved in the Veritas case, nor have I seen forecasted financial data for Veritas's non-U.S. operations. I deduce the potential for high income from the opinion's summary of the IRS's expert reports at pages 24-28. Brian Becker, whose report was not used at trial, applied, among other methods, a foregone profits method and concluded a value of \$2.5 billion. John Hatch, the IRS expert, applied a discounted cash flow method and derived the \$1.675 billion value. If either of these are close to representing a reasonable discounting of all future profits, then Ireland's potential income appears significant compared to the taxpayer's \$118 million value estimate. Since the taxpayer applied a comparable uncontrolled transaction (CUT) method and estimated the buy-in payments using the CUT royalty rate multiplied by sales, I could not draw any conclusions regarding potential profits from the opinion's summary of the taxpayer's method.

⁸ *Veritas*, pages 41, and 44-45.

The term "pre-existing intangibles" is used in the 1995 cost sharing regulations, but it is not clearly defined. Treas. Reg. §1.482-7(g)(2) states only that "If a controlled participant makes pre-existing intangible property ... available to other controlled participants ..., then each such other controlled participant must make a buy-in payment to the owner."

The opinion notes that "The regulation [Treas. Reg. §1.482-7(g)(2)] unequivocally requires a buy-in payment to be made with respect to transfers of 'pre-existing intangible property.' No buy-in is required for subsequently developed intangibles."⁹ Unfortunately, the regulations nor the opinion provide a definition of "subsequently developed intangibles" either.

From an economic perspective, expected income from any subsequently developed intangibles, to the extent foreseen on the valuation date (e.g., the date of the CSA), must be attributable to current (i.e., pre-existing) intangibles. The very essence of a valuable intangible is the intangible's ability to produce high expected income. If a company expects premium returns from future intangible development (i.e., income from "subsequently developed intangibles"), then market competition for access to those returns dictates that the future premiums be discounted into the current price. That is to say, if a company already expects premium returns on future development, why transfer rights to those returns for anything less than their risk-adjusted present value? Evidence that pre-existing intangibles embody income from subsequently developed intangibles is the high price arm's length parties are willing to pay for access to expected premium returns.¹⁰

The lack of clarity in the regulations with respect to the nature of the transferred intangibles appears to have worked to the taxpayer's advantage in *Veritas*.¹¹

III. Source of Problem

If a taxpayer's purpose for entering into a CSA is to share the risk of intangible development, then let's make sure the taxpayer can transfer the *risk* but cannot transfer the intangible *value* at an unreasonably low price.

My view is that the 1986 Tax Act, the 1988 Treasury White Paper, and the 1994 transfer pricing regulations clarified issues -- and work pretty well -- with respect to the *license* of intangibles. Cost sharing and other strategies have introduced the concept of a substantive *sale* of a comprehensive group of intangibles, and this is where the problem lies. The economic substance of many transactions is characterized by taxpayers as a limited license; however, because essentially all

⁹ *Veritas*, page 45.

¹⁰ An example is the valuation of a firm's equity, which captures returns from future dividends and stock appreciation.

¹¹ Treasury issued temporary cost sharing regulations on January 5, 2009. It remains to be seen how these rules will affect intangible transfers under cost sharing.

potential income is transferred, the transaction is really the economic equivalent of a sale. This mischaracterization can have a significant effect on value.

From a law and regulatory perspective, most of the tools are there to encourage realistic valuations, including primarily the arm's length standard, best method rules, aggregation provisions, realistic alternatives language, and rights to make periodic adjustments.

Regardless, when interpreting and applying these rules, taxpayers can derive intangible values that seem to defy common sense.

IV. Suggestions for Solution

The problems with intercompany intangible transfers are real, but that does not mean we should throw out a history of regulatory development that works; rather, the solution should address the problem specific to transfers of high value intangibles for less than arm's length prices.

I have two suggestions:

- First, recognize that the problem arises primarily when a collection of intangibles are substantively sold to related parties and develop rules for identifying and then dealing with this.¹²
 - Rules should provide criteria under which an intangible transfer is substantively a sale. For example, if a taxpayer adopts cost sharing, it acknowledges that the transferred rights must be valued in a manner consistent with that of a sale.¹³ Other rules could be examined to capture the nature of a sale versus a license.¹⁴
 - Rules could be developed to provide guidance on valuing intangibles in situations where the transfer is substantively a sale. There is already a significant body of valuation literature and case law in this area.
- Second, influence behaviors by forcing final-offer arbitration, as found in model tax treaties, when a taxpayer's intangible transfer is deemed a sale.

I am not a lawyer or an arbitration expert, but I understand this format may encourage a "coming together" of taxpayer and IRS valuations, and may

¹² This may require changes to section 367(d), section 482, and/or the regulations thereunder.

¹³ If, on the other hand, a taxpayer wanted to license partial or restricted rights in return for limited income, then it could structure its arrangement as a license of make-and-sell rights under existing intangible property provisions (Treas. Reg. §1.482-4).

¹⁴ Such rules should ensure that the substantive nature of the contributed intangibles includes rights to all future cash flow, which may embody, among other things, income attributable to identifiable intangibles (like patents) and unidentifiable intangibles (like goodwill).

reduce the disparate valuations like those in the Veritas case. Additionally, taxpayers could save time and legal fees, and ensure confidentiality of proprietary company information under this dispute resolution format.

V. Summary

Cost sharing is not meeting its objectives. My experience is that companies are able to license to related parties high value intangibles in transactions more appropriately characterized as a sale of a broader group of intangible property. The simple evidence is the high potential income of the subject intangibles, present on the day of the transfer, which is not captured in the intangible valuations. Solutions, which may require law and regulatory changes, should focus on this issue.

Thank you for allowing me the opportunity to appear before the Committee today. I would welcome the opportunity to explore these issues further with you and your staffs.