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In this article, the authors argue that a recent *Tax Notes International* article is fundamentally wrong in its critical appraisal of the government's proposal not to allocate research and development expenditures to subpart F inclusions and global intangible low-taxed income for foreign tax credit limitation purposes.

I. Introduction

Two critical (and distinct) principles of the U.S. international tax regime underlie the proper functioning of the research and development expense allocation system.

The first principle is the proper allocation of income and expense between and among members of a controlled group of corporations, in particular the cross-border aspects of that allocation. The rules governing that principle — as it relates to R&D expense and the resulting intangible property derived therefrom — are found in sections 482 and 367(d). Those rules are designed to ensure that the right taxpayer takes into account the proper amount of income and expense. In other words, those rules are responsible for the proper allocation of income and expense among U.S. taxpayers and foreign affiliates within a controlled group.

Once that allocation is achieved, the second principle involves the proper allocation of primary and secondary taxing rights over the income of U.S. taxpayers as between the United States and any applicable foreign jurisdiction. That principle is implemented via the foreign tax credit system and the limitations thereon. It requires a proper matching of types of income and expense of a taxpayer to determine the net amount of U.S. and foreign-source income. This determination, in turn, dictates how much income the United States can tax in the first instance, and how much it can tax only after granting (through the FTC) first bite at the apple to the foreign jurisdiction.

In December 2019 Treasury issued proposed regulations regarding the allocation and apportionment of R&D expense. The proposed regulations are true to these principles. They leave the task of income and expense allocation among affiliated entities to the sections 482 and 367(d) regimes, while appropriately matching income and expense of a U.S. taxpayer so that the FTC system can achieve its intended purpose: allowing the United States to tax U.S. income, while preventing the double taxation of foreign-source income. Instead of allocating R&D to all classes of gross income of a taxpayer that are related to a relevant product category, the proposed regulations allocate R&D expenditures to a defined (but broad) category of gross intangible income, principally royalties, deemed royalties, and income from the sale of products or provision of services with imbedded intellectual property. Dividends and other deemed dividend-type income inclusions — such as under the subpart F and global intangible low-taxed income regimes — are specifically excluded.

In a recent article criticizing the 2019 proposed regulations, Stephen E. Shay, Reuven S. Avi-Yonah, Patrick Driessen, J. Clifton Fleming Jr., and Robert J. Peroni argue that not allocating R&D expenditures to subpart F income and GILTI is wrong as a matter of statutory interpretation going back to 1977, and as a matter of tax policy, with the result that it creates a subsidy for U.S.-performed R&D.[1] While they don't articulate a specific proposal, they seem to be advocating allocating R&D expenditures in a manner similar to the prior regulations that were promulgated in 1995.

These arguments are fundamentally wrong. A careful analysis of the prior regulations, the relevant code provisions (and the relevant changes made by the Tax Cuts and Jobs Act), and the development of the law since 1977 reveals the flaws in their historical argument. A more thorough understanding of the effect of the prior and proposed regulations on research-intensive taxpayers demonstrates that the 2019 proposed regulations represent a sensible improvement on, rather than a radical break from, the prior regulations. And a critical analysis of their tax policy arguments reveals that their preferred approach results in a system that by its nature subjects foreign income to double taxation; that imposes the most pain on those paying the highest foreign taxes (which is counterintuitive if your goal is discouraging income shifting to lower-tax jurisdictions); and that leaves taxpayers with only two avenues for self-help: relocating their R&D expense (and potentially activities) to outside the United States or increasing the income earned in lower-tax foreign jurisdictions. Both are contrary to sound policy and the apparent goals of Shay et al.

By way of background, this article first provides an overview of the prior R&D expense regulations promulgated in 1995 and the 2019 proposed regulations. It then provides an affirmative defense of the proposed regulations by explaining the basic principles underlying expense allocation, the historical context beginning with the 1977 R&D expense allocation regulations and culminating in the 2019 proposed regulations, and why those principles and that history fully support the approach taken in the proposed regulations. Finally, the last section of this article rebuts the critique by Shay et al. of the proposed regulations.

[1]Stephen E. Shay et al., "Why R&D Should Be Allocated to Subpart F and GILTI," *Tax Notes Int'l*, June 22, 2020, p. 1393.

II. Overview of the Prior and Proposed Regs

A. The 1995 Regulations

The existing (as of today) final regulations governing the allocation and apportionment of R&D expenditures were first proposed in 1973[2] and finalized in 1995[3] after 22 years of vigorous debate. The 1995 regulations provide that R&D expenditures are allocated to all income of an affiliated group of corporations "reasonably connected with the relevant broad product category . . . and therefore . . . all items of gross income as a class related to such product category" including sales, royalties, dividends, and deemed dividends.[4] The product category is determined by reference to the three-digit classification of the Standard Industrial Classification Manual (SIC code).[5] Taxpayers are permitted to aggregate SIC codes, but cannot subdivide them.[6] The SIC codes for the wholesale and retail trades are not separately taken into account for taxpayers with products in other product categories.[7] The only exception to this allocation is that R&D expenditures mandated solely to meet the legal requirements of a governmental entity are allocated to that governmental entity's geographic source if the expenditures cannot be expected to generate more than de minimis gross income outside that source.[8]

Once the allocation is made, R&D expenditures are then apportioned under one of two elective methods. Under the sales method, for taxpayers performing activities constituting more than 50 percent of their R&D expenditures in a single geographic source, 50 percent of their R&D expenditures are apportioned exclusively to that source.[9] The remaining 50 percent are apportioned based on the ratio of revenues from product category sales that generate gross income

[2]Prop. reg. section 1.861-8 (available at 38 F.R. 15840 (1973)).

[3]Reg. section 1.861-17.

[4]Reg. section 1.861-17(a)(1).

[5]Reg. section 1.861-17(a)(2)(ii).

[6]Reg. section 1.861-17(a)(2)(i).

[7]Reg. section 1.861-17(a)(2)(iv)-(v).

[8]Reg. section 1.861-17(a)(4).

[9]Reg. section 1.861-17(b)(1)(i), (c).

in a statutory grouping to revenues from total sales in that product category.[10] Sales revenues include revenue from sales by related parties.[11] Sales by unrelated parties are also included when the affiliated group licenses or sells intangible property to that unrelated party.[12] Thus, for example, when an affiliated group in the United States develops, manufactures, and sells products in the United States that generate 60 percent of the group's sales revenues in a product category and licenses the relevant intangible property to a foreign affiliate, which in turn manufactures and sells the products generating 40 percent of the group's sale revenue from sales outside the United States, a total of 80 percent of the affiliated group's R&D expenditures would be apportioned to the U.S.-source gross income from U.S. sales (50 percent exclusive apportionment plus 60 percent of the remaining 50 percent after exclusive apportionment), and 20 percent would be apportioned to foreign-source income from foreign sales. Before the 2017 enactment of the TCJA, both royalties paid by the foreign affiliate and dividends (whether actual or deemed subpart F inclusions) generally would have been in the same statutory and residual grouping (that is, in the same baskets for FTC purposes) under the look-through rules of section 904(d)(3), generally the general basket.[13] If apportioned amounts exceed the gross income related to the intangible property, the excess is allocated against other amounts in the same basket.[14] Thus, for example, R&D expenditures in excess of general basket royalties generally were allocated to any dividends or subpart F inclusions in that same basket.

Under the sales method, taxpayers with cost-sharing arrangements have no apportionment of R&D expenditures to products that have benefited from cost-shared expenditures.[15] Given that cost-sharing participants bear the cost of group R&D expenditures based on their share of reasonably anticipated benefits from those expenditures,[16] the regulations conclude that the participant's sales do not benefit from the remaining expenditures of the U.S. affiliates.

Taxpayers could alternatively elect to apportion product category R&D expenditures based on the gross income method.[17] That method apportions expenditures based on total gross income in the statutory grouping compared with total gross income in the product category.[18] For FTC purposes this method was generally favorable because the statutory grouping included, in addition to foreign-source royalties, any foreign-source dividends and subpart F inclusions, both of which are taxable (that is, net) income based. They are also to some extent discretionary given that taxpayers can often control the timing of actual dividends and could avoid or mitigate subpart F inclusions because subpart F applies only to limited types of income. In contrast, total gross income includes all gross income from domestic sales, the amount of which is not reduced by below-the-line, deductible expenses. Because of this favorable apportionment metric, the method permits only a 25 percent exclusive apportionment based on geographic source and contains a floor under the allocation to the statutory grouping at 50 percent of the amount determined under the sales method. No exception for cost-shared R&D is provided under the gross income method.

Notwithstanding the limitations on the gross income method, historically it has been preferable to many taxpayers with relatively low levels of foreign dividends and subpart F income. Cost-sharers, needless to say, generally have elected the sales method to avoid any allocation of unreimbursed U.S. R&D expense to foreign-source income.

B. The 2019 Proposed Regulations

The proposed R&D expense allocation and apportionment regulations, released in December 2019, begin with what appears to be a

[10] Reg. section 1.861-17(c)(1).

[11] Reg. section 1.861-17(c)(1)(i).

[12] Reg. section 1.861-17(c)(1)(ii), (c)(2).

[13] In some limited circumstances, royalties (both related and third-party) could be in the passive basket, which would draw allocations to that basket.

[14] Reg. section 1.861-17(c)(1)(i).

[15] Reg. section 1.861-17(c)(3)(iv).

[16] Reg. section 1.482-7(b).

[17] Reg. section 1.861-17(d).

[18] Reg. section 1.861-17(d)(ii).

fundamentally different premise: that R&D expenditures are treated as definitely related and thus allocable to gross intangible income within a three-digit SIC product category rather than to all income in that category.[19] There is no allocation to other forms of income, in particular dividends and deemed income inclusions under subpart F, and most importantly, the GILTI regime. The rationale stated in the preamble is that successful R&D gives rise to intangible income to the R&D performer, whether in the form of product sales, services, royalties, gain on sale of intangible property, or section 367(d) inclusions, all of which are included in the definition of gross intangible income. Given the factual connection between R&D expenditures and intangible income, it makes sense to allocate the expenditures to that class of gross income when there is an expectation that similar income will be earned in the future.[20]

The 2019 proposed regulations eliminate the mandatory allocation of R&D to a country for which the research is undertaken solely to comply with regulatory requirements. The preamble observes that it has become increasingly rare to have research of value in only one jurisdiction, as products have become more global and regulatory regimes more coordinated. Thus, the provision serves little purpose and can generate difficult factual disputes.[21]

The proposed regulations also eliminate the gross income method. The preamble states that the method was eliminated because, by allocating R&D expenditures to all gross income in a product category without regard to whether there was any connection to intangible property created from successful R&D, the method could create inappropriate results.[22] The preamble could have added that the method always reflected a political compromise (discussed in more detail later) that was perhaps unduly generous to some taxpayers.

The proposed regulations retained the sales method (renamed the gross receipts method) with specified refinements, none of which is particularly fundamental.[23] The sales-based apportionment determines the amount of R&D expenditures that are apportioned to the statutory and residual groupings in which the taxpayer has gross intangible income related to such sales;[24] under the 1995 regulations, that same apportionment determines the R&D expenditures allocable to the statutory and residual groupings in which the taxpayer has any gross income related to such sales. Before the TCJA, this difference had little practical effect for FTC purposes because gross intangible income and dividends, subpart F inclusions, and other income from sales in the product category were almost always in the same statutory grouping; that is, the same FTC basket. After the TCJA, however, income of a U.S. taxpayer from foreign affiliate product category sales would typically be in two FTC baskets: the general basket for royalties or other gross intangible income of the U.S. taxpayer, and the GILTI basket for income of a foreign affiliate from product sales net of any payments for royalties or other intangible income. The 2019 proposed regulations thus view R&D expenditures as properly allocated to the basket in which gross intangible income would arise, and not the GILTI basket.[25] As under the 1995 regulations, if the gross intangible income is less than the allocated R&D expenditures in the general basket, the allocation offsets other income in that basket, including, for example, any general basket subpart F income.[26] Finally, the TCJA did

[19] Prop. reg. section 1.861-17(b)(1).

[20] *See* prop. reg. preamble explanation of provisions E.1.

[21] *See id.* at E.2.

[22] *See id.* at E.1.

[23] Prop. reg. section 1.861-17(d). One substantial refinement clarifies that sales by a CFC to a U.S. affiliate for ultimate sale to U.S. customers are treated as foreign or domestic based on the sourcing of the gross intangible income attributed to that sale. Prop. reg. section 1.861-17(d)(1)(iii).

[24] Prop. reg. section 1.861-17(d)(1). Shay et al., *supra* note 1, somewhat curiously, question why the 2019 proposed regulations retained CFC sales in the apportionment calculation under the sales (now called gross receipts) method, if R&D expense is not allocable to CFC dividends (actual and deemed). They cite that as evidence that the changed allocation rules may have been a late change to the proposed regulations. *See* Shay et al., *supra* note 1, at n.21. But both CFC sales and third-party licensee sales have always been taken into account in the apportionment calculation under the sales method, notwithstanding that one clearly does not earn dividends or subpart F income or GILTI from third-party licensees. Allocation to a particular type of income (that is, royalties earned from related and third-party licensees) and not others (that is, actual and deemed dividends) has no effect, one way or the other, on the inclusion of licensees' sales under the sales method. It is not clear why Shay et al. view that as strange, let alone as evidence of a late-breaking change in the regulations.

[25] *See* prop. reg. preamble explanation of provisions E.3.

[26] Prop. reg. section 1.861-17(d)(2).

not change the separate limitation loss rules of section 904(f)(5), under which any R&D expenditures in excess of general basket income is apportioned to income in other baskets, including, most importantly, the GILTI basket.

The 2019 proposed regulations slightly refined the treatment of cost-sharing arrangements, but left in place the basic rule that no allocation should occur to sales when the related intangible property is developed under a cost-sharing arrangement.

III. Why Treasury Got It Right

A. Overview

Shay et al. object to the proposed regulations' allocation of R&D expenditures only to gross intangible income rather than to all income in a product category (in particular GILTI). They assert that "it is impossible to identify with meaningful confidence income that benefits from the R&D — that is the income to which the R&D should be allocated."[27] They argue that the proposed regulations represent an unjustified departure from long-standing practice regarding R&D expense allocation and apportionment, and they provide three policy arguments in support of their argument that R&D expenditures should be allocated to all classes of gross income and not only intangible income. While they do not proffer a specific alternative proposal, their arguments logically would lead to allocation of R&D expenditures to GILTI, and perhaps the reinstatement of some form of the gross income method used under the 1995 regulations.

An application of the basic principles for allocating deductions to gross income, a review of the history of the allocation of R&D expenditures and the treatment of intangible income going back to the late 1970s, and a thorough (and critical) analysis of the policy arguments made by Shay et al., all make clear that the 2019 proposed regulations are grounded in sound tax policy and economic concepts and are a definite improvement over (but not a radical break with) the 1995 regulations, particularly in light of related changes made to the foreign-source income basketing rules in the TCJA.

B. Expense Allocation Principles

Tax accounting requires the allocation of deductions to items of income, including items of property that generate income, in many contexts; expense allocation for FTC limitation purposes is only one of those contexts. With most expenses, the allocations are reasonably apparent. Expenses incurred in connection with activities for the sale of goods or the provision of services are allocated directly to the stream of gross income from those activities. That is universally true even if the activities involved have an indirect benefit to the seller or service provider beyond that stream of income by, for example, gaining know-how useful in the generation of future income.

The purpose of (if not the rules for) expense allocation for the FTC limitation is relatively straightforward. The FTC rules are designed to ensure that the United States does not impose double taxation on net foreign-source income; it does so by ceding primary taxing jurisdiction over net foreign-source income within specific defined categories (commonly called baskets) to foreign jurisdictions. At the same time, the system seeks to preserve the United States' primary taxing jurisdiction over net U.S.-source income. To accomplish both goals, rules are necessary to measure gross income within each of the relevant categories, and then to allocate and apportion deductions to arrive at a measure of net income within each relevant category (U.S.-source on one hand, and each basket of foreign-source income on the other). If expenses are not allocated or are under-allocated to foreign-source income, the United States is effectively subsidizing the foreign fisc by ceding primary taxing jurisdiction over U.S.-source income to foreign jurisdictions. Conversely, if expenses are over-allocated or misallocated to foreign-source income, that income is subject to potential double taxation. The goal of expense allocation in the FTC system is thus to identify the relevant categories of expense and match them, in as rational a manner as possible, to the corresponding categories of income, so as to arrive at a relatively accurate measure of net income within each relevant category of income, and thereby the amount of allowable FTCs within each category.

[27] *See* Shay et al., *supra* note 1.

Expense allocations for FTC purposes are governed by regulations under sections 861 and 862, principally reg. section 1.861-8. Under those regulations, as a general matter, expenses are allocated to the "class of gross income" to which they are "definitely related."[28] Classes of gross income are flexibly defined to include compensation for services, interest, rents, royalties, gains from dealings in property, and "gross income derived from business."[29] A deduction is "definitely related" if it is incurred "incident to" an "activity . . . which . . . could reasonably have been expected to generate gross income, . . . whether or not there is any item of gross income in such class . . . during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class."[30]

Applying these general concepts to specific situations has not led to many serious disputes because in most instances the relationships are relatively clear. Deductions for activities that relate to the creation and maintenance of property are definitely related to the income from that property. For example, expenses involved in promoting and maintaining a trademark are allocated to royalties and other revenues related to the exploitation of that trademark. If a taxpayer owns valuable foreign trademarks in the United States and licenses them to its foreign affiliates, its U.S. costs in exploiting and maintaining the foreign trademarks are properly allocable to its license revenues because they are "definitely related" to that class of gross income and not related to subpart F inclusions or dividends received from those foreign affiliates. Similarly, deductions for activities related to the sale of goods or provision of services are allocated to the income from such sales and services. If, for example, U.S. marketing personnel develop plans for foreign affiliate marketing of products, the relevant deductions are allocated to the services payments required to be made by the foreign affiliates under the transfer pricing rules of reg. section 1.482-9, and not to any subpart F inclusions or dividends paid by those foreign affiliates. That is true whether the transfer pricing for the services under that regulation is based on the costs incurred by the U.S. affiliate or on the revenues or profits of the foreign affiliate.

As applied to R&D expenditures, these general rules would logically allocate the expenditures to the class of gross income arising from the exploitation of the intangible property intended to be developed as a result of those expenditures. There are, however, two complicating elements in that logic as applied to R&D expenditures that are deducted under section 174.

First, intangible property is typically created over multiple years and yet the related R&D expenditures are deductible in the year incurred.[31] The general allocation rules do contemplate such situations and provide that deductions for property should be allocated to the class of gross income that such property "could reasonably have been expected to generate."[32] For deductible R&D expenditures, that general principle could be implemented, for example, with a rule allocating the expenditures based on expected future gross income, somewhat similar to the rules in cost-sharing for allocating R&D expenditures to cost-sharing participants based on reasonably anticipated benefits.[33]

A second difficulty in allocating R&D expenditures to gross income from intangible property is that frequently such income is imbedded in the gross income from the sale of products or the provision of services. That problem, of course, is not limited to intangibles arising from R&D expenditures; trademarks and other marketing intangibles, for example, often also generate income imbedded in goods or services. In all such cases, it is not necessary to identify the portion of the gross income from sales or services attributable to intangible property if that income is not otherwise separately identified for tax purposes; under our source rules all the

[28] Reg. section 1.861-8(a)(2).

[29] Reg. section 1.861-8(a)(3)(ii).

[30] Reg. section 1.861-8(b)(2).

[31] This will no longer be the case for tax years beginning after December 31, 2021, at which point "specified research or experimental expenditures" will have to be capitalized and amortized over a five- or 15-year period. *See* section 174(a) (as amended by TCJA section 13206(a)).

[32] Reg. section 1.861-8(b)(2).

[33] Reg. section 1.482-7(b).

income from that sale or service will be in a single class of gross income and, by taking the full revenue from sales or services into account, the apportionment between the statutory and residual groupings will not be distorted (that is, will be apples-to-apples). But when intangible property is separately compensated for, the focus of any allocation regime should be on the class of gross income for that compensation when that class differs from that of gross income from the underlying sale of products or the provision of services.

The above general rules thus could be reasonably applied to allocate R&D expenditures consistent with the principles followed for marketing and other similar expenses. Yet under the 1995 regulations, section 174 expenditures are treated differently under special rules set forth in reg. section 1.861-17; these regulations treat expenditures deducted under section 174 as "definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)."[34] To understand why the regulations saw deductible section 174 expenditures as definitely related to such broad categories of income, rather than a narrower category specifically related to intangible property income, requires an understanding of the development of the regulations over the 22 years from 1973 to 1995.

C. The Historical Context

R&D allocation regulations were first proposed in 1973[35] and issued in their original final form in 1977.[36] They provided for an allocation based on two-digit SIC code product categories with apportionment within those categories under either a sales method or a gross income (then called the gross-to-gross) method.[37] Under both methods, government-mandated R&D was allocated to the mandating jurisdiction, and R&D performed under a cost-sharing agreement was excluded from further allocation. Under the sales method, 30 percent of remaining R&D expenditures (50 percent in 1977, 40 percent in 1978, and 30 percent thereafter) was automatically allocated to U.S.-source income when more than 50 percent of total R&D was performed in the United States.[38] Remaining amounts were allocated in proportion to sales revenue within the product category.[39] The gross income method included no exclusive apportionment to U.S.-source income, but allowed an apportionment based on a U.S. taxpayer's foreign-source gross income compared with total U.S. taxpayer gross income.[40] Given that taxpayers could minimize foreign-source gross income (for example, by not paying dividends from foreign affiliates), a floor of 50 percent of the sales method apportionment applied to taxpayers choosing the gross income method.

These regulations proved controversial. Multinational taxpayers argued that the allocation rules effectively disallowed deductions for R&D expenditures in circumstances in which their foreign affiliates could not get a deduction from foreign tax for those amounts, causing double taxation of income. They further argued that, as a result, taxpayers would be encouraged to transfer research activities to foreign countries in which the expenditures would be fully deductible.[41]

In response to these complaints, as part of the Economic Recovery Tax Act of 1981, Congress enacted a moratorium, requiring that all section 174 expenditures for research activities conducted in the United States be allocated to sources within the United States for all code purposes.[42] The provision applied to tax years beginning in 1982 and 1983, with a Treasury study mandated during that period. Treasury submitted its report in January 1983 and recommended a two-year

[34] Reg. section 1.861-17(a)(1).

[35] Prop. reg. section 1.881-8 (1973) (available at 38 F.R. 15840 (1973)).

[36] Reg. section 1.861-8 (1977).

[37] Reg. section 1.861(e)(3)(ii), (iii) (1977).

[38] Reg. section 1.861(e)(3)(ii)(A) (1977).

[39] Reg. section 1.861(e)(3)(ii)(B) (1977).

[40] Reg. section 1.861(e)(3)(iii) (1977).

[41] *See, e.g.*, James S. Byrne, "Opposition Developing to Allocation Rules," *Tax Notes*, Nov. 29, 1976, p. 3.

[42] Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 172, 249 (1981).

extension of the 1981 act's moratorium.[43] In the Deficit Reduction Act of 1984, Congress agreed to an additional two-year extension, but limited its application to geographic sourcing purposes under section 861.[44]

Over the 11 years from 1973 to 1984, multinationals argued against the allocation of R&D expense to foreign-source income on the grounds that they would not obtain a deduction for foreign tax purposes for any allocated amount.[45] Little mention was made of the fact that if the results of R&D were licensed to foreign affiliates, deductions could be obtained for royalty payments that would, in effect, compensate for the cost of R&D. Licenses and royalty deductions were probably not part of that discussion because, until the 1984 act, multinationals were typically not required to license their intangible property or otherwise receive compensation for the transfer of such property for use by their foreign affiliates in their active foreign businesses.

Before the 1984 act, then-section 367(a) permitted property, including intangible property, to be transferred outbound on a tax-free basis if the property was used in the transferee foreign affiliate's trade or business outside the United States, and the IRS determined that the transfer did not have the avoidance of federal income taxes as a principal purpose. Rev. Proc. 68-23, 1968-1 C.B. 821, set forth guidelines as to when the IRS would rule that an exchange did not have such a "bad" principal purpose.[46] Under those guidelines, intangible property (other than some tainted assets such as leases and accounts receivable) could generally be transferred to a foreign affiliate without charge when used in the foreign affiliate's active business. An exception required a toll charge for the transfer of U.S. intangibles (related to selling products back into the United States), but no charge was required for transfers of foreign intangibles needed for sales into foreign markets. Thus, U.S. multinationals could enter into IP transfer arrangements, potentially including section 351 transfers of royalty-free licenses, and not have any deduction in their transferee foreign affiliate or any offsetting income in the United States related to the development or exploitation of the intangibles resulting from their R&D expenditures.[47]

That context clearly informed the debate over the allocation of R&D expenditures from 1973 through 1984 and beyond. The 1984 act applied section 367(d) to transfers of intangibles to foreign affiliates, putting an end to the ability of U.S. multinationals to transfer intangible property offshore without payment.[48] It generally applied prospectively to transfers of property after December 31, 1984. Thus, for many years after that, foreign affiliates of U.S. multinationals owned valuable intangible property rights resulting from U.S. R&D expenditures without any requirement for a payment to compensate the U.S. affiliate for the use of that intangible property. In this context, it is totally understandable that Congress and Treasury would focus on allocating R&D expenditures to foreign affiliate income generally (including dividends and subpart F inclusions) rather than to any more specific subset of that income.

Notwithstanding contrary tax policy arguments, Congress extended the 1981 moratorium in 1985 for that year.[49] As part of the Tax Reform Act of 1986 (but outside the code) Congress codified the 1977 regulations with three liberalizing provisions: The 30 percent automatic allocation was increased to 50 percent; it was applied to both the sales method and the gross

[43] Treasury, "The Impact of the Section 861-8 Regulations on U.S. Research and Development" (June 1983). *See also* James R. Hines Jr., "No Place Like Home: Tax Incentives and the Location of R&D by American Multinationals," in 8 *Tax Policy and the Economy* 79 (1994).

[44] P.L. 98-369, 98 Stat. 494, 648 (1984).

[45] *See, e.g.*, Gordon D. Henderson and Peter Miller of the New York State Bar Association, Committee on Deductions from Foreign Income, "Proposals for Improvement of Rules for Allocation of Deductions Between Foreign and U.S. Source Income: Report on Section 1.861-8 of the Proposed Regulations (Issued on June 18, 1973)," 29 *Tax Law Rev.* 598, 692-696 (1974); claim by William A. Raftery, president of the Motor and Equipment Manufacturers Association, that proposed regulations will "result in double taxation of foreign source income"; and letter from former Ways and Means Committee member Guy Vander Jagt to President Reagan regarding the section 1.861-8 R&D regulations.

[46] Rev. Proc. 68-23.

[47] Before 1982, U.S. multinationals could transfer U.S. intangibles to section 936 possessions corporations tax free, which, in combination with the Rev. Proc. 68-23 toll charge, led to a substantial increase in intangible-intensive manufacturing in Puerto Rico. *See Eli Lilly v. Commissioner*, 856 F.2d 855 (7th Cir. 1988).

[48] P.L. 98-369. Section 367(d) was originally enacted in 1982 but was limited to transfers of intangibles by section 936 possessions corporations.

[49] Consolidated Omnibus Budget Reconciliation Act of 1985, P.L. 99-272, 100 Stat. 82, 325 (1986).

income method (renamed from the regulations' gross-to-gross method); and the 50 percent of sales method allocation floor was removed from the gross income method.[50] That statute was extended in 1988 with two further changes: increasing the automatic allocation to 64 percent, and reinstituting a 30 percent sales method floor under the gross income method.[51] In 1989 Congress further extended the 1988 provision and included it in the code as section 864(f), later renumbered as section 864(g).[52] It ultimately was extended through 1994, when it expired and was replaced by the current 1995 regulations.[53]

Allocating R&D expenditures to broad classes of foreign income thus continued to attract repeated legislative attention until the early 1990s, even though after 1984 transfers of intangibles to foreign affiliates had to be compensated through royalty or similar payments. That leads to a question: In the 1990s, why didn't Treasury or other tax policy participants consider whether R&D expenditures should be allocated more narrowly to royalties or other similar payments for intangible property transfers rather than to all income within a product category? After all, by that time a substantial amount of intangible property had no doubt been transferred to foreign affiliates with royalties or other compensating payments owed back to U.S. affiliates.

The most obvious answer is that such a narrowing of the allocation metric would not have mattered. After the 1986 act, virtually all royalties and most other compensation for the use of intangible property were in the same FTC basket as other foreign-source active business income. Narrowing the framework of the 1977 regulations to treat R&D expenditures as definitely related to intangible income would not have materially changed the result under the sales method, and would likely have meant eliminating the gross income method, which at that time would have been politically impossible.

Indeed, by the early 1990s, Treasury and other tax policy participants came to understand that the rules putting royalties in the same FTC basket as high-taxed dividends and subpart F deemed dividends, combined with limited R&D expense allocation rules, created a favorable result for U.S. multinationals conducting R&D in the United States and licensing the resulting intangibles to foreign affiliates. In 1993, at the beginning of the Clinton administration, Treasury officials testified before both the House Ways and Means Committee and the Senate Finance Committee that the FTC basketing rules allowed taxpayers to shelter foreign-source royalty income by cross-crediting relatively high foreign income taxes attributable to dividends and subpart F inclusions in the same basket, while at the same time allocating relatively little R&D expenditures to that basket:

> When research expense deductions (and credits) are claimed on a current basis, as permitted under existing law, these expenses cannot be apportioned to income later generated by that intangible [property]. Under existing law, moreover, these expenses are often allocated substantially to *U.S. source* income earned in the year of deduction. As a result, foreign source royalty income generated by intangible property often is not reduced by an appropriate amount of related expense. These rules, in combination with the FTC rules, increase the potential for erosion of the U.S. tax base. Foreign source royalty income could be sheltered from U.S. tax through "cross-crediting," while related expense deductions (and credits) reduce tax on other, often U.S. source, income.[54] [Emphasis added.]

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[50] P.L. 99-514, 100 Stat. 2085, 2549 (1986).

[51] Technical and Miscellaneous Revenue Reconciliation Act of 1988, P.L. 100-647, 102 Stat. 3342, 3653 (1988)

[52] Revenue Reconciliation Act of 1989, P.L. 101-239, 101st Cong., 1st Sess., section 7111.

[53] Revenue Reconciliation Act of 1993, P.L. 103-66, 103rd Cong., 1st Sess., section 13234(a). The provision technically expired in 1992, but the IRS issued Rev. Proc. 92-56, 1992-2 C.B. 409, allowing taxpayers to apply the provision for 1993.

[54] Administration's Tax Proposals: Hearings Before the Senate Finance Committee, Apr. 27, 1993, Prepared Statement of Samuel Y. Sessions (assistant secretary of treasury for tax policy), in Bernard D. Reams Jr., Legislative History of the Revenue Reconciliation Act of 1993 (Title XIII Omnibus Budget Reconciliation Act of 1993, P.L. 103-66) 457 (1993).

To end this shelter, Treasury proposed ending the look-through rule of section 904(d)(3) for royalties, placing royalty income in the passive FTC basket in which (particularly given the high-tax passive basket kick-out rule of section 904(d)(2)) it could not be sheltered by high-rate foreign taxes on dividends or subpart F inclusions. As part of that change, Treasury proposed to eliminate *any* allocation of U.S.-performed R&D expenditures to foreign-source income. In Treasury's view, once royalty income became fully subject to U.S. tax through the elimination of cross-crediting, there would be no sound basis for allocating R&D expenditures to any other category of foreign-source income.[55]

Thus, by 1993 Treasury understood that, as a tax policy matter, R&D expenditures should be seen as definitely related to royalty and other intangible income, rather than to all income of foreign affiliates. The 1993 Treasury proposal was rejected by both the House and Senate on the grounds that the sheltering of royalties through cross-crediting encouraged U.S. performance of R&D and thus was good economic policy if not good tax policy.[56] With that failure, Treasury acceded to Congress' viewpoint and finalized the 1995 regulations.

Over the next 20-plus years, foreign countries reduced their corporate tax rates substantially. That reduction, and the availability of check-the-box planning starting in 1997, caused many multinationals to switch tax planning strategies from focusing on using excess credits to focusing on reducing foreign tax and deferring low-taxed foreign-affiliate earnings. In that context, the basketing of royalties and the allocation of R&D expenditures to foreign-source income became a much less pressing issue because many more taxpayers found themselves with excess FTC limitation, rather than excess credits.

The issue was revived, however, in the TCJA, given the reduction of the corporate tax rate to 21 percent and the taxation of GILTI inclusions at a 10.5 percent rate. Those reduced rates caused many taxpayers to once again find themselves, potentially, in an excess credit position. Had royalties and GILTI inclusions been placed in the same FTC basket (as royalties and subpart F income and dividends generally were pre-TCJA), the issue of foreign taxes on GILTI sheltering royalties through cross-crediting, and the need to allocate substantial R&D expenditures to that basket, would have been front and center. For better or worse, that did not happen. Instead, much like the Treasury proposal 25 years earlier, the TCJA put royalties in a different basket than the bulk of taxable foreign affiliate earnings by creating a separate basket for GILTI inclusions.[57] Apparently, tax policy considerations outweighed economic policy arguments. In this context, the proper allocation of R&D expenditures becomes straightforward; it should be allocated, if at all, to the same FTC basket in which income from intangible property income arises.

D. Why the Proposed Regulations Got It Right

The foregoing discussion — summarizing the purpose of expense allocation under section 862(b), the underlying history of the R&D expense allocation rules, and the nature of the TCJA's changes to the section 904(d) FTC limitation regime (most notably adding the new GILTI basket but not revising the section 904(d)(3) royalty look-through rule for passive basket purposes) — clearly demonstrates why the 2019 proposed regulations represent an entirely sensible update to (and indeed improvement on) the rules governing R&D expense allocation.

Consistent with the purpose of section 862(b), the proposed regulations represent an attempt to match the relevant category of expense with the relevant categories of income that the expense is intended to generate (whether or not the taxpayer's business plan in fact pans out). As Shay et al. acknowledge, R&D expense is designed to give rise to intangible property. That property, in turn, is intended to give rise to income either from the sale or license of the resulting intangible property itself or from the sale of goods and services embodying that intangible property. The goal of the R&D expense allocation regulations, consistent with the mandate of section 862(b),

[55] *See* Treasury, "Summary of the Administration's Revenue Proposals," 57-59 (Feb. 1993).

[56] For examples of this argument see Ways and Means Committee Hearing on Clinton's Economic Proposals, Including Foreign Provisions (Apr. 1, 1993) (statement of John Young, former president and CEO for Hewlett-Packard Co.); *id.* (statement of Dr. J.D. Foster, chief economist and director, the Tax Foundation).

[57] Section 904(d)(1)(A).

therefore should be to attempt to match R&D expense with those types of income, which is precisely what the 2019 proposed regulations do in allocating that expense to the defined category of gross intangible income.

By contrast, the return on an equity investment in another corporation is not derivative of R&D expense. Rather, it derives from that corporation's investments, functions, activities, and risks. It thus defies the logic of section 862(b) to match R&D expense on one hand with dividends on the other. That rationale applies with equal force to both actual dividends and deemed dividends under the subpart F and GILTI regimes. The one exception to that logic would arise if a nontaxable investment in a subsidiary could be made in the form of the contribution of intangible property itself. But as discussed, section 367(d), which has been in effect since 1984, and which was expanded by the TCJA,[58] prevents the tax-free transfer of intangible property by a U.S. person to a foreign person. Instead, any such transaction is treated as a taxable contingent sale (or license) of that property, with the resulting return on that transferred property treated for U.S. tax purposes as income from the sale or license of the transferred intangible property, and with that income treated as gross intangible income to which R&D expenditures are allocable under the 2019 proposed regulations.

Thus, in the first instance, the proposed regulations provide a clear and sensible construct that tries to match — within certain broad strokes (for example, by grouping income and expense by relevant SIC codes rather than in any more targeted fashion) — R&D expense with the categories of income that arise, or are intended to arise, from that expense. Conversely, they carve out those categories of income — most notably returns on equity investments — that are not derivative of, and thus should not be matched with, R&D expense. In the parlance of section 862(b), the proposed regulations provide a sound construct for matching "the items of gross income . . . [with] the expenses, losses, and other deductions *properly* apportioned or allocated thereto." (Emphasis added.) Cutting through all the noise, the approach of the proposed regulations is precisely the approach that one would, a priori, expect would and should be taken when crafting a regime under section 862(b) for matching R&D expense and the types of income derived therefrom.

Based on the principles of section 862(b), an argument can be made that the proposed regulations should have apportioned R&D among categories of gross intangible income based on expected future receipts in each category rather than on current receipts, and should have limited the receipts taken into account to those more closely related to the specific intangibles intended to be developed. Such an apportionment could be more theoretically pure but difficult to administer. Indeed, under cost-sharing, when R&D expenditures are charged out based on expected future benefits, most taxpayers use relative current revenues to determine that charge-out as the most reliable measure of future benefit. Most importantly, given that few taxpayers will have excess FTCs in the general basket after the TCJA, the proposed regulations strike a reasonable balance between conceptual purity and administrative difficulty.

The question thus becomes whether there are any reasons — whether textual, historical, or policy-based — for departing from the approach of the 2019 proposed regulations. Shay et al. do not appear to posit a textual infirmity in the regulations. That is, they do not appear to argue that the express language of section 862(b) forecloses the approach of the proposed regulations.[59] Instead, they posit several arguments rooted in history and tax policy for

[58] TCJA section 14221.

[59] Section 862(b) provides for expenses to be properly allocated and apportioned to the relevant items of gross income, and otherwise for a ratable allocation of deductions, "which cannot definitely be allocated to some item or class of gross income." Shay et al., *supra* note 1, do not appear to suggest that R&D expense cannot (as opposed to should not) be allocable to specified items or classes of gross income, and thus do not appear to contend that the approach of the proposed regulations is foreclosed by the text of section 862(b). If that is their argument, it is clearly incorrect because that would imply that R&D expense would have to be ratably allocated to all classes of income, which would foreclose the SIC code approach of the prior regulations and the 2019 proposed regulations (an approach Shay et al. do not suggest) and would presumably require allocation to clearly unrelated forms of income such as interest income or income on portfolio investments. We thus read the argument by Shay et al. as one about the preferred implementation of the "properly apportioned or allocated" standard of section 862(b), which in turn is an argument rooted in history and tax policy.

abandoning the proposed regulations (and presumably returning to some form of the 1995 regulations). As discussed in the following section, none of those arguments withstands scrutiny or provides a compelling justification for abandoning the approach of the proposed regulations.

IV. Why Shay et al. Are Wrong

Shay et al. essentially make one historical and three tax policy arguments in support of their conclusion that R&D expense should be allocated and apportioned to dividends and deemed dividends under the subpart F and GILTI regimes. On the historical front, they claim that R&D expenditures have always (since 1977) been allocable to dividends and subpart F income and that the changes in the TCJA do not warrant a departure from that long-standing approach. On the policy front, they argue that R&D expenditures should be allocable to dividends (real and deemed) because (1) the categories of gross intangible income do not reflect the costs of unsuccessful R&D; (2) some companies do not enforce their intangible rights and thus are not compensated for their R&D expense in the form of gross intangible income; and (3) related-party royalties (real and deemed) are determined by transfer pricing rules under section 482, which cannot be trusted. Each of these arguments is flawed and results in a proposal that turns the FTC limitation system on its head — from one that attempts to mitigate double taxation by properly ceding primary taxing jurisdiction over foreign-source income, to one that by design inflicts double taxation by formulaically asserting primary taxing jurisdiction over foreign-source income. The result of the 2019 proposed regulations is a proper measurement of net foreign-source income within each foreign-source income basket that appropriately allocates primary taxing jurisdiction over each such category to the proper jurisdiction (that is, to the foreign jurisdictions to the extent of the net foreign-source income in each basket, and otherwise to the United States). The result of the approach by Shay et al., in contrast, is to automatically reduce net foreign-source income in the GILTI basket, and thereby effectively recharacterize a portion of GILTI as U.S.-source income, without regard to whether the relevant foreign jurisdiction is or even should be ceding its primary taxation claim to that income. The result is the double taxation of that GILTI in a manner that is inconsistent with the text and logic of sections 862(b), 904(d), 960, and when relevant, our tax treaty obligations.

A. The Historical Argument

Shay et al. argue that the R&D expense allocation regulations have consistently — since 1977 — allocated and apportioned R&D expense to dividend (and deemed dividend) income and that nothing in the TCJA warrants a change to that approach. The historical and contextual discussion earlier reveals the fundamental flaws in that argument.

First, as discussed earlier, at the time of the promulgation of the 1977 regulations, section 367(d) had not been enacted and taxpayers thus could make an equity investment in an affiliate in the form of a tax-free contribution of foreign intangible property. In such a world, the allocation and apportionment of R&D expense to (at least certain) dividends and deemed dividends from affiliates made sense within the confines of section 862(b).

Of course, by the time of the promulgation of the 1995 regulations, section 367(d) was already in place, and thus arguably allocation and apportionment to dividends should not have been retained. But, as noted above, under the 1995 regulations, the function and relevance of allocation and apportionment of R&D expense to dividends was exceedingly narrow and effectively elective, such that a rethinking of allocation and apportionment to dividends was not particularly important. While it is true that the 1995 regulations provided for the allocation of R&D expense to dividend, subpart F, and royalty income, those categories of income were generally in the same foreign-source income basket (typically general basket income) under the look-through rules of section 904(d)(3). The allocation to dividend and royalty income versus only royalty income generally did not matter; in either event the expense would be allocated to the same foreign-source income basket.

When inclusion of dividends *could* matter was at the apportionment stage of the process. But under the 1995 regulations (as under the 1977 regulations) apportionment could be done on one of two bases — sales or gross income. Under the sales method, dividends (and subpart F inclusions) were irrelevant for apportionment purposes because apportionment depended on the relative sales — within and outside the United States — of the goods in the relevant product category. Whether a controlled foreign corporation paid a dividend or earned subpart F income had no effect on the apportionment of R&D expense.

Apportionment to dividends only mattered under the gross income method because dividends and subpart F income were included in the gross income of the U.S. shareholder that was used for the apportionment calculation. But the gross income method was an optional method; the receipt of dividends and subpart F income was effectively optional (because the amount and timing of actual dividends could be controlled and subpart F income generally could be avoided through supply chain structuring); and perhaps most importantly, the gross income method was generally a highly taxpayer-favorable method that overall tended to reduce apportionment of R&D expenditures to foreign-source income. So much so that, as noted, its benefits relative to the results of the sales method were generally limited. Put simply, allocation of R&D expense to dividends and subpart F income under the prior regulations was largely irrelevant, while apportionment to those categories of income was the result of a political compromise allowing limited use of a taxpayer-favorable method of apportionment.

Which brings us to the current proposed regulations and the relevance of both the changes made by the TCJA and other changes made in the proposed regulations. When those other changes are properly understood, the approach of the 2019 proposed regulations is actually properly viewed as consistent with — rather than a break from — the 1995 regulations.

First, the 2019 proposed regulations removed the gross income method, leaving only the sales method (now called the gross receipts method). Thus, the only method under which apportionment to dividends and subpart F income actually mattered under the prior regulations no longer exists. There is no sense in which historical continuity calls for preserving apportionment to dividends and subpart F income when the relevant and generally favorable apportionment method has been excised altogether.

Second, regarding allocation, the introduction of a new and separate foreign-source income basket for GILTI fundamentally changed the calculus regarding the proper allocation of R&D expense to dividends and deemed dividends under subpart F and now GILTI. While previously, the 904(d)(3) look-through rules generally caused dividends and royalty income to be placed in the same foreign-source income basket with the relevant underlying CFC income (including subpart F income), the TCJA, by creating a separate basket for GILTI, has now segregated royalty income and subpart F income, on one hand, and GILTI on the other.[60] That segregation — which puts the income earned by a U.S. person from its intangible property in one basket, and CFC income taxable under the GILTI regime in another — makes allocation to that latter category of income critically important in a manner that it simply wasn't under prior law. Again, historical continuity does not demand continued allocation to all forms of dividends and deemed dividend income when that allocation simply did not matter under the prior law. The fact that the TCJA created a new species of deemed dividend income in the form of the GILTI regime, and placed that new species of income in a separate foreign-source income basket from the ones that previously included dividends, subpart F, and royalty income, is certainly sufficient statutory change to warrant a regulatory rethinking of the proper approach for allocating R&D expenditures.[61]

[60] It is worth noting that throughout their article, Shay et al., *supra* note 1, refer to the allocation of R&D expense to subpart F income and GILTI. But subpart F income is not a separate category of income for section 904(d) purposes — instead foreign-source subpart F income is basketed as either general or passive basket income, just as royalty income is. Thus, allocation to subpart F income is irrelevant today much as it was under the prior regulations, and subpart F income is likewise irrelevant for apportionment under the sales/gross receipts method. The only relevant change in the proposed regulations — and presumably the true driver of the critique by Shay et al. — is the non-allocation of R&D expenditures to GILTI.

[61] The proposed legislative changes put forth by Treasury in 1993 recognized the relationship between the separate basketing of royalty income on one hand and the non-allocation of R&D expenditures to residual CFC income on the other, and thereby presaged the approach of the TCJA and the 2019 proposed regulations.

Ultimately, the depiction by Shay et al. of the proposed regulations' discontinuity with the prior regulations is greatly overblown. If there is a clear discontinuity, it is in the proposed regulations' elimination of the gross income method, a change to which Shay et al. do not appear to object. Once that change is accepted as legitimate, the relevance of dividend and subpart F-based allocation and apportionment under the prior regulations is rendered null. As a result, a rethinking of the allocation of R&D expense to dividend and deemed dividend income — in particular to the new, and separately basketed species of GILTI — is more than justified.[62]

B. The Policy Arguments

1. What About Unsuccessful R&D?

Shay et al. argue that R&D expenditures should to be allocated to all types of income because R&D by its nature is a speculative activity, may be unsuccessful, and therefore must be allocated to all types of income and not just the types of income that the R&D expense in fact generates.[63]

That argument misunderstands the nature of expense allocation under section 862(b). That section seeks to match categories of expense with the categories of income that the expense is intended to generate. It is irrelevant whether an expense in fact gives rise to income. Many if not most types of business expenses by their nature are speculative and may prove unsuccessful. R&D expenditures are not unique in that respect. The point of the allocation system is to allocate expenses to the types of income that the expenses are intended to generate, without regard to whether they in fact prove successful in doing so. A taxpayer may incur expenses in pitching for, negotiating, and entering into a services contract, and that services contract may prove loss-generating (or may never be successfully negotiated, so may not yield any gross income altogether). Nonetheless, those expenses are allocable to the category of gross income that the services contract was intended to generate. The same is true for costs incurred to manufacture a good. The fact that a business expense may prove unprofitable should not, and as a general matter does not, alter the allocation of that expense. R&D expenditures should be no different in that regard.

Further, while royalties earned on any particular item of intangible property rights may not directly reflect the costs of unsuccessful R&D, transfer pricing methods do in fact take into account the costs of unsuccessful R&D in determining arm's-length royalties or other payments under section 482.[64] And more broadly, any business model that intends to be successful in the long run must earn a positive return on its investments, including its investments in R&D.

To be sure, timing mismatches between the incurrence of R&D expenditures and the realization of a return on that investment may result in companies incurring R&D expenditures that are not presently fully compensated for by gross intangible income. For example, start-up companies may have R&D expenditures and no income at all. In that case, if they ultimately fail, the lack of an allocation is meaningless because they will never have income that needs to be offset via FTCs. And if they ultimately succeed, R&D is only allocated to any foreign-source income once they generate sales or licensing income, both under the 2019 proposed regulations and the prior 1995 and 1977 regulations. If that timing mismatch is a flaw in the system, it applies equally to the proposed regulations and all prior

[62] Shay et al., *supra* note 1, suggest that the TCJA's mere introduction of the new GILTI basket under section 904(d) does not justify any change to the expense allocation rules because the TCJA did not amend section 862(b) and the legislative history does not suggest any desire to eliminate expense allocation to the GILTI basket. Putting aside the well-noted language in the legislative history stating that GILTI subject to a local tax rate of at least 13.125 percent would not be subject to residual U.S. tax (calling into question the second premise by Shay et al.), see H.R. Conf. Rep. No. 115-446, at 626-627, the first premise by Shay et al. does not withstand scrutiny. Even if as a general matter expenses should be allocated to the GILTI basket, the introduction of new baskets necessitates a consideration of *which* expenses are properly allocable to those new baskets. Those new baskets are new subspecies of foreign-source income that did not exist pre-TCJA. How then could pre-TCJA law automatically dictate which expenses should be allocated to these new categories of income?

[63] It is not clear how far Shay et al., *supra* note 1, would take this argument. If R&D expense should truly be allocable to all forms of income because of its speculative (and often unsuccessful) nature, then why accept the SIC code-based groupings under the prior and proposed regulations? And why not allocate and apportion to other forms of income, like interest income. Clearly the R&D expense allocation regulations have never accepted that approach, because they always purported to match the expense with income "reasonably connected with the relevant broad product category."

[64] *See*, *e.g.*, reg. section 1.482-6.

regulations, and could be corrected by allocating based on some measure of intended future benefit.

That R&D expenditures may not generate current income and may never generate income is not a basis for departing from the basic principles of section 862(b), which is that expense should be allocated to the type of income that the expense is intended to generate. Shay et al. do not provide an explanation for why R&D — of all the types of speculative business expenses — should be treated differently in that regard.

2. R&D That Gives Rise to Unprotected Intangibles

Shay et al. next argue that R&D expenditures must be allocated to a broader class of income because some R&D expenditures are designed to generate intangible property that the taxpayer makes freely available, and therefore the expenditure does not give rise to intangible, or perhaps any, income. They offer as examples companies like Google, Apple, Facebook, and Red Hat that allow developers to use their software in ways that expand their platforms and customer bases.

Of course, as an argument for an allocation of all R&D expenditures to all classes of income, it misses its mark regarding the broad spectrum of R&D expenditures that are designed to give rise to protected intangibles (whether statutorily protected property like patents and copyrights or contractually protected items like trade secrets and know-how).

Even within the confines of the class of R&D to which their argument could apply, the fact that some aspects of a taxpayer's technology is made publicly available does not mean that affiliates that benefit from the ability to combine that technology with other proprietary intangibles do not need to pay for that benefit under section 482.[65] If a taxpayer were to license its platform to a foreign affiliate, surely an arm's-length royalty would include the full value of the licensed intangible property even if the foreign affiliate could allow its customers to use the platform for specific purposes without any charge.

That is not to say that it is a simple exercise to determine what does and does not need to be compensated for, under arm's-length principles, between affiliates operating under some complex business strategies. That very complexity may be why many companies operating those business models often adopt cost-sharing arrangements whereby they share the costs of the development of the relevant technology platforms, and thereby avoid complex questions of determining the magnitude and character of payments that would otherwise be owed between affiliates for the use of any resulting technology. Indeed, from publicly available materials it is apparent that most, if not all, of the companies cited by Shay et al. are in fact cost-sharers. As discussed, for all those taxpayers, there has been a long-standing exception to R&D expense allocation for costs that are incurred within the scope of a cost-sharing arrangement. Under both the prior regulations and the 2019 proposed regulations, a U.S. taxpayer's R&D expenses that are within the scope of a cost-sharing arrangement are not subject to allocation and apportionment to income derived from the other cost-sharing participants at all.[66]

Ultimately, this second policy argument made by Shay et al. is an act of throwing out the baby with the bathwater. No doubt there are some instances in which it is challenging to precisely trace the nature and amount of compensation that is due from a foreign corporation to a domestic affiliate when the domestic affiliate develops a mixture of proprietary and nonproprietary technology. That does not mean we should just

[65] The same issue arises in more traditional transfer pricing settings when, for example, consumer goods sellers allow retailers to use their trademarks to promote the products without charging them a royalty. That has not meant that a U.S. company licensing its trademark to a CFC does not deserve a royalty when the CFC is using the trademark to sell its own products. Clearly section 482 requires the CFC to pay for that benefit even though it does not charge its own customers for the use of that intangible.

[66] The long-standing exception from allocation for cost-shared R&D expense also significantly undercuts the core premise of Shay et al., *supra* note 1, discussed further below, that R&D expense apportionment to GILTI is needed to serve as a backstop to section 482. If R&D apportionment is inappropriate in the context of cost sharing, it must be because section 482 and the cost-sharing regulations thereunder can be trusted to properly divide R&D costs among controlled participants in a manner consistent with the reasonably anticipated benefits from those costs such that it can be determined that there is no CFC income that can be reasonably connected to the U.S. affiliate's R&D expense. If section 482 can properly police the sharing of R&D costs for purposes of turning off R&D expense allocation, why can it not be trusted to police the allocation of income from those same types of costs for purposes of R&D expense allocation?

throw up our hands and treat all R&D expense as allocable to all forms of gross income.

3. The FTC Limitation as a Backstop to 482

Which brings us to the heart of the argument by Shay et al. — that section 482 cannot be trusted to police arm's-length dealing between cross-border affiliates (at least regarding intangible property), and that the FTC limitation and expense allocation rules should serve as a backstop to the section 482 and 367(d) regimes.[67]

Shay et al. offer several sub-arguments in defense of this position. First, they argue that the IRS does not have an incentive to apply sections 482 and 367(d) to change the character, rather than the amount, of a taxpayer's income, and that the IRS would therefore not apply sections 482 and 367(d) to cause a taxpayer to recognize additional royalty income when that income is already subject to taxation under the CFC regime in all events. That argument collapses when applied to the category of income that is actually relevant to the expense allocation rules: GILTI. That income is eligible for a 50 percent deduction and is thus subject to an effective U.S. tax rate of 10.5 percent, and is foreign-source income in the GILTI basket in which many taxpayers will have excess FTCs. Royalty income — whether actual royalty income or deemed royalty income under section 367(d) — is subject to full U.S. taxation at the current 21 percent rate, typically with little potential for FTC offset. Surely the IRS has the authority, and an incentive, to apply sections 482 and 367(d) when it results in subjecting the income to (at least) double the rate of taxation.

Second, they argue that section 482 potentially allows taxpayers to set off some transfer pricing adjustments against others in a manner that can lead to a net-neutral taxable income result, but that nonetheless skews the measure of gross intangible income and thus R&D expense allocation. That premise, too, is incorrect as a matter of law. The setoff rules of section 482 do not permit setoff (or they require adjustments to setoffs) when a setoff results in a taxpayer-favorable collateral consequence arising, for example, from a change in the character of the taxpayer's income.[68] The IRS has expressly deployed that authority in the FTC context, using section 482 to police the FTC rules of section 901.[69] A taxpayer who underpays a royalty that would be due from a CFC to a U.S. affiliate under section 482, and thereby increases the amount of foreign tax paid by the CFC, cannot simply count on being able to claim a credit against that additional foreign tax, even if the CFC's income is otherwise subject to full current U.S. taxation under the subpart F regime. (And of course, if the income is subpart F income rather than GILTI, it would generally be in the same basket as royalty income in any event.) The rules of section 901 themselves prevent a taxpayer from claiming a credit against that tax, and section 482 can certainly be used to adjust the royalty in that circumstance to reduce the allowable credit. Further, if Shay et al. are concerned about section 482 setoffs being done across SIC code categories of income, then that was an issue under the prior regulations no less than the proposed regulations (and arguably less of an issue now given the elimination of the gross income method of apportionment).

Third, and most crucially, Shay et al. contend that the proposed regulations flip the relationship between sections 482 and 367(d) on one hand and the subpart F and GILTI regimes on the other — turning sections 482 and 367(d) into backstops to subpart F and GILTI, rather than the other way around. They contend that sections 482 and 367(d) cannot be trusted to police cross-border income allocation (at least as it relates to income from intangible property), and that the FTC limitation mechanism, via R&D expense allocation, should backstop those provisions.

Whatever one thinks of the premise that subpart F and GILTI are designed to serve as

[67] Shay et al., *supra* note 1, repeatedly mention that section 482 is a discretionary enforcement tool given to the IRS and not a rule of accounting. Putting aside that section 482 is in fact found in subchapter E of the code, which contains the rules for "Accounting Periods and Methods of Accounting," surely the hundreds of pages of regulations under section 482 governing the pricing of related-party transactions involving intangibles, the mandatory contemporaneous transfer pricing documentation requirements governing those arrangements, and the special penalties applicable to taxpayers that fail to comply with section 482 makes the section into something more than a discretionary enforcement tool. *See* section 6662(e).

[68] *See* reg. section 1.482-1(g)(4) ("If the effect of a setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions.").

[69] *See, e.g.*, ILM 201349015.

backstops to section 482, the argument by Shay et al. depends on going yet a step further and concluding that the FTC limitation rules are intended to serve as a backstop to the income allocation rules of section 482. Put differently, in the view of Shay et al., the GILTI and subpart F regimes should serve not only to ensure U.S. inclusion of the relevant categories of income, but that the FTC limitation system should further be used to grant the United States primary taxing jurisdiction over portions of that income, without regard to whether that income is properly measured, is foreign-source, and is subject to full taxation in a foreign jurisdiction (including a jurisdiction with which we have a tax treaty).

As a matter of sound tax policy, their argument fails. If, as they believe, there is a section 482/367(d) problem at play, then we should be searching for a section 482/367(d) solution. To the extent one believes that the IRS does not do a good job in determining transfer prices for royalties and other payments for intangible rights, the appropriate response is to consider proposals to improve transfer pricing rules (and potentially enforcement), not to formulaically allocate R&D expenditures to unrelated categories of income without regard to whether a taxpayer has complied with the transfer pricing rules.

Without actually doing the work of reallocating intangible income (through sections 482 and 367(d) and tax treaty processes as applicable), the preferred R&D expense allocation system of Shay et al. either accomplishes nothing (in the case of taxpayers earning income in low-tax jurisdictions in which case FTC limitations don't bite) or targets precisely the wrong people (those earning income in higher tax jurisdictions, which often coincides with jurisdictions that are our treaty partners). By necessity Shay et al.'s approach depends on combating income shifting by subjecting foreign income to double taxation. Surely the relevant foreign jurisdiction will not give a deduction for R&D performed by another entity, and likewise that foreign jurisdiction appropriately claims primary taxing rights over its entity's income (net of any arm's-length royalties paid for intangibles used in producing that income). Under the approach used by Shay et al., the United States would also claim primary taxing rights to a portion of that income, *sub silentio*, through the section 904 limitation mechanism, without ever having to prove any transfer pricing infirmities and without giving the taxpayer (or the foreign jurisdiction if a treaty is involved) the opportunity to prove its case. A system that targets precisely the wrong people (those paying relatively higher foreign tax rates) and gives them no opportunity to prove their innocence, is neither fair nor well-grounded in sound tax policy.

A simple numerical example illustrates the point. Assume a CFC in-licenses IP from its U.S. shareholder, pays a royalty, and earns $100 of net foreign-source income after that royalty. If the local tax rate is 20 percent, the CFC will pay $20 of local tax. Assuming that same $100 is tested income within the meaning of section 951A, the U.S. shareholder of the CFC includes that $100 in income under the GILTI regime (subject to adjustments for qualified business asset investment of that CFC and tested losses of other CFCs). The U.S. shareholder is subject to full taxation on the royalty it receives from the CFC, and none of the $20 of tax paid by that CFC can offset the U.S. tax on the royalty income because the royalty income and the GILTI (and the taxes thereon) are in separate baskets under section 904(d) — that is, no cross-crediting is available to shield U.S. tax on that royalty income.

Absent R&D expense allocation, the U.S. shareholder would include the $100 of GILTI, and all else equal, would have $16 of FTCs (taking into account the 80 percent FTC haircut under section 960(d)), which would fully mitigate the $10.50 of pre-credit U.S. tax otherwise due on that GILTI inclusion ($100 * 50 percent section 250 deduction * 21 percent corporate tax rate). The U.S. taxpayer's GILTI basket FTC limitation would be $10.50, which equals its U.S. tax due on that income, leaving no residual tax due — as is appropriate.

If the royalty paid by the CFC to its U.S. shareholder is too low, it is subject to adjustment under section 482, and any such adjustment would properly increase the royalty income — and the resulting U.S. tax liability — of the U.S. shareholder.

But if the royalty is not too low, and R&D expense is formulaically allocated and apportioned to the properly measured GILTI, then for each $1 of expense so allocated, the U.S. shareholder would owe an additional $0.21 of

U.S. tax. The $49 of post-expense-allocation foreign-source GILTI basket income, multiplied by the 21 percent tax rate, yields a GILTI-basket FTC limitation of $10.29, such that the $10.50 of pre-credit tax due for the $100 of GILTI can only be reduced by $10.29, leaving a $0.21 residual U.S. tax. The allocation of that $1 of R&D expense to GILTI yields double taxation of that $1 of income.

Of course, the local jurisdiction would not offer any reduction in its tax levy because the $100 of taxable income of the CFC is already calculated net of the deductible royalty it pays for the use of the relevant technology. Nor, absent an actual transfer pricing adjustment, should it. The result of the R&D expense allocation to that after-royalty CFC income is thus the double taxation of that foreign-source income in clear violation of the purpose of the FTC system.

Further, when a treaty-partner jurisdiction is involved, the United States is supposed to provide a tax credit for foreign income so as to alleviate the potential double taxation of that income. To be sure, our tax treaties provide that the obligation to grant an FTC is subject to otherwise applicable domestic law limitations. But to design those limitations so as to per se impose double taxation without offering an avenue for relief through the traditional competent authority mechanism, surely strains the spirit, if not the letter, of those treaty obligations.

The same example, with only a different foreign tax rate, in turn demonstrates why Shay et al.'s proposal has no effect at all on a taxpayer earning low-taxed foreign income. If, in the above example, the CFC's income was subject to a 10 percent rate of tax, the allocation of that additional $1 of R&D expense to that GILTI would not alter the U.S. shareholder's tax liability at all. In all events, a residual tax of $2.50 would be owed for that income (the $10.50 of pre-credit U.S. tax minus the $8 of credits that are available for the $10 of foreign taxes paid). The reduced GILTI basket FTC limitation arising from the allocation of R&D expense to that income is of no consequence.

The allocation of R&D expense to GILTI basket income thus of necessity either has no effect in the case of taxpayers earning low-taxed foreign income, or imposes double taxation on those earning high-taxed foreign income. And because that double taxation, under Shay et al.'s proposal, would be imposed through the formulaic mechanism of expense allocation, taxpayers would be unable to use the traditional defenses under section 482 or applicable tax treaties to overcome that double taxation. Taxpayers' only available self-help mechanisms would be to (1) earn more foreign income in lower-tax jurisdictions or (2) shift R&D expense (and potentially activities) to the relevant foreign locations. Neither of these is a worthwhile goal of sound tax policy. Shay et al.'s proposal — ill-conceived in the first instance in its use of the FTC limitation to combat income shifting — actually threatens to achieve the opposite of its intended goal.

V. Conclusion

There are plenty of problems with the FTC system under the TCJA. But the taxation of royalties (actual and deemed) received from CFCs, and the allocation of R&D expense to those royalties (and not to residual foreign affiliate income) is a clear improvement over prior law, or more precisely, an improved alignment of the expense allocation regulations with the new terrain of the post-TCJA section 904 FTC limitation system. It represents an appropriate matching of income and expense so as to achieve a proper measure of net foreign-source income within the relevant categories. It eliminates the subsidy from royalties being sheltered by excess FTCs. It properly limits the double taxation of foreign-source GILTI by ensuring that the U.S. retains only a secondary taxation right over that foreign-source income. And, for most taxpayers, it eliminates any disincentive that the allocation of R&D expenditures to foreign-source income can create for taxpayers in an excess credit position. The 2019 proposed regulations thus represent a sensible implementation of section 862(b) and a highly justified update to the regulations in light of the TCJA's changes to the section 904(d) foreign-source income categories. ■