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The R & E Expense Allocation Rules

House Ways & Means Committee Testimony

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Introduction

Thank you, Chairman Johnson, Congressman Matsui, and Members of the Subcommittee on Oversight, for the opportunity to testify before you today. I am Tracy Kaye, an Associate Professor of Law at Seton Hall University School of Law. I appear before you today to comment on Treasury Regulation Section 1.861-8(e)(3), the research and experimentation expense allocation rules, often referred to as the "861 R&D allocation rules."

The reality of the global marketplace is that our tax system must interact with other countries' tax systems. Therefore, Congress should consider other nations' tax systems in designing our own.

I am here to urge Congress to take into consideration international economic policy and the effects of any proposals on the competitiveness of U.S. corporations. U.S. international tax policy needs to minimize tax deterrents to productive international economic activities and avoid creating a hostile tax environment.

Applying the United States income tax system to international transactions is inherently complex because cross-border transactions do not have a single geographic source. Thus, in order to avoid either double taxation or undertaxation of these transactions, a coherent set of rules for determining the geographical source of taxable income must be developed. To achieve a coherent system of international taxation, the United States should take note of how other countries tax international income.[1] The reality of the global marketplace is that our tax system must interact with other countries' tax systems. Therefore, Congress should consider other nations' tax systems in designing our own.

Historical Background

The United States taxes the worldwide income of its corporations and uses a foreign tax credit system to eliminate international double taxation. The foreign tax credit is limited to the United States tax liability on foreign source taxable income to ensure that the foreign tax credit does not reduce the U.S. corporation's taxes on its domestic income. To compute this limitation, sourcing of income and allocation of expense rules are necessary to determine

Endnotes

[1] Charles I. Kingson, The Coherence of International Taxation, 81 Colum. L. Rev. 1151, 1153 (1981).

[2] Department of the Treasury; International Tax Reform, An Interim Report (January 1993).

[3] Treasury Regulation Section 1.861-8(e)(3)(i)(A).

[4] Treasury Regulation Section 1.861-8(e)(3)(ii)(A).

[5] Treasury Regulation Section 1.861-8(e)(3)(ii)(B).

[6] Treasury Regulation Section 1.861-8(e)(3)(iii).

[7] Department of the Treasury, *supra* note 2 at 31.

[8] International Fiscal Association (IFA), *Rules for determining income and expenses as domestic or foreign*, LXVb Cahiers de droit fiscal international (1980).

[9] Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 Am. J. of Tax Policy 1, 57 (1991).

[10] Michael J. McIntyre, *The International Income Tax Rules of the United States*, 3-65 (Butterworth 1992).

[11] See Ernst & Young, *Worldwide Corporate Tax Guide* (1994).

[12] The counterargument made by some is that these expenses are recovered initially in the domestic market, and, as royalties or other payments represent the profits, no allocation should be made to foreign income.

[13] Double taxation only occurs for those taxpayers in an excess foreign tax credit position, i.e. those taxpayers whose foreign income taxes paid exceed their foreign tax credit limitation. It is generally assumed that the majority of multinational corporations are in an excess credit position.

[14] McIntyre, *supra* note 10.

[15] See generally, Tracy Kaye, *European Community Tax Harmonization and the Implications for U.S. Tax Policy*, Tax Foundation (1994).

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undertaxation; and 3) the distribution of tax jurisdiction over taxable income among sovereign governments in some mutually agreeable fashion.[10] The only solution that will simultaneously satisfy all three goals is international consensus on a set of rules for the sourcing of income and the allocation of expenses. Therefore, I urge Congress to encourage the Treasury Department to take the lead in the negotiation of such a harmonized set of rules.

Until such an international agreement is reached, I propose that the allocation of R&D expense to foreign source income should only occur where deductible in the foreign jurisdiction. The tax planning of multinationals focuses on the reduction of worldwide tax liability, not just U.S. tax liability. Therefore, given that U.S. corporate tax rates are often lower than most other jurisdictions,[11] there is already a built-in incentive to claim all allowable deductions against foreign source income aggressively so as to reduce the foreign tax burden. To the extent U.S. multinationals are operating in jurisdictions with a lower tax rate than that of the U.S., it will be necessary to develop a mechanism to allocate the greatest amount of R&D expense allowable as a deduction in the foreign jurisdiction.

The sourcing of income and expense allocation rules should be designed to achieve three goals: 1) the elimination of double taxation; 2) the elimination of undertaxation; and 3) the distribution of tax jurisdiction over taxable income among sovereign governments in some mutually agreeable fashion.

This is a departure from traditional U.S. tax policy which requires that foreign source taxable income be computed according to U.S. concepts. It is probable that research expenses incurred in the U.S. produce not only domestic income but also foreign income,[12] therefore to the extent the amount of research expense deductible in the foreign jurisdiction is less than the amount properly allocable to the foreign source income, the United States would suffer a loss of revenue in favor of the foreign jurisdiction.

I believe this departure from U.S. tax policy is justified because of the unique income measurement problems that exist with respect to R&D expenses. The United States' unilateral resolution to this issue has led to double taxation for many U.S. multinationals.[13] In theory, these double taxation problems should be resolved through the negotiation of bilateral treaties and the competent authority mechanism.[14] However, given the limited treaty network of the United States, the lengthy treaty negotiation process, and the problems with the competent authority process, this is not realistic.

This is admittedly a second best, and should not be a permanent, solution. Once again, the only way to satisfy the international goals of designing a system that avoids overtaxation and undertaxation as well as providing for an equitable distribution of tax revenue among sovereign governments is to harmonize the rules for the sourcing of income and the allocation of expenses. It will be necessary to study the approaches taken by the various governments' tax systems and develop a system that is mutually agreeable. Note that these rules are of paramount importance whether administrating a territorial tax system or a foreign tax credit system.

As cross-border activity between Canada and Mexico increases because of the North American Free Trade Agreement, it will be necessary to attempt some harmonization of these respective tax systems, including the allocation of R&D expenses. The European Union, now comprised of fifteen countries, is already engaged in a similar exercise.[15] These efforts should pave the way for the negotiation of a coherent system for the sourcing of income and allocation of expenses of international transactions.

foreign source taxable income. The rules generally aim to ensure that income subjected to foreign tax is treated as foreign source. Any allocation of expense to foreign source gross income reduces foreign source taxable income and correspondingly the foreign tax credit limitation. Thus, too great an allocation to foreign source income leads

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to double taxation; too little leads to undertaxation of the cross-border income.[2]

The research and development (R&D) expense category has proven to be one of the most difficult to allocate, primarily because R&D expenses are capital in nature. Although these costs are incurred to earn future income, code section 174 permits a current deduction as an incentive for the performance of R&D. Most expenses are allocated to domestic or foreign source income on the basis of their factual relationship to the production of particular gross income. Because R&D deductions do not generally relate to gross income earned in the current period, the matching principle of Treasury regulation 1.861-8 is not helpful.

The Section 1.861-8 regulations, published in 1977, contain detailed rules for the allocation and apportionment of R&D expenses. These rules require government mandated R&D expenses to be allocated to the gross income arising in the country where the benefit is expected to be derived. The remaining R&D expenses must be allocated to the product categories to which they relate or to all categories if the expenses cannot be related to a particular product category.[3] Allocation is followed by an apportionment procedure whereby a fixed percentage of R&D (at present 30 percent) is apportioned to the geographic source where over half of the taxpayer's deductible research expenses are incurred.[4] The remaining expense is apportioned on the basis of gross sales.[5]

Alternatively, a taxpayer may use an optional gross income method to apportion the non-government mandated expenses on the basis of relative amounts of gross income from domestic and foreign sources.[6] Unfortunately, it is actually even more complicated than the above description. Since 1981, this regulation has been modified eight times by temporary legislation to permit an exclusive apportionment (ranging from 50 percent to 100 percent) to the actual place of performance of the R&D.

Problem

Conflicts between the sourcing of income and allocation of expense rules of the United States and foreign countries lead to economic double taxation. No foreign country grants a deduction for R&D performed in the U.S. on the basis of U.S. regulatory allocation of that expense to foreign source income. Many countries use a tracing approach, allocating expenses incurred within the residence country to domestic source income and expenses incurred outside the country to foreign source income. Other countries follow generally accepted accounting principles for attributing items of expense to categories of gross income.[7]

To my knowledge, no country has R&D allocation rules similar to those required by the United States. Generally, the allocation of expense rules of foreign countries are much less developed, often relying on a facts and circumstances determination.[8] This absence of sophisticated 861 allocations in foreign countries means that foreign-owned multinationals enjoy a tax advantage over the foreign activities of U.S. multinationals.[9]

Recommendation

The sourcing of income and expense allocation rules should be designed to achieve three goals: 1) the elimination of double taxation; 2) the elimination of