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Corporate Taxation: Profit Shifting, Transfer Pricing, and Cost Sharing

Recent events have highlighted the issue of corporate profit shifting using transfer pricing and cost sharing methods. In its October 11, 2023, 8-K filing with the Securities and Exchange Commission, Microsoft indicated that it had received a notice of a $28.9 billion deficiency from the Internal Revenue Service (IRS). Microsoft communications indicated that the deficiency is related to the allocation of profits among countries using a transfer pricing method referred to as cost sharing. This deficiency refers to taxes during the 2004 to 2013 period. In a separate development, on October 20, 2023, the IRS announced a number of new initiatives, including a focus on large corporations' cross-border transactions and transfer pricing methods of U.S. subsidiaries of foreign corporations. Senator Ron Wyden, chairman of the Senate Finance Committee, has also proposed legislative changes to address transfer pricing following an investigation of multinational pharmaceutical companies by the committee.

This In Focus explains how transfer pricing, and specifically the cost sharing method, can be used to allocate profits from intangible assets out of the United States and into low-taxed jurisdictions.

What Is Transfer Pricing?

Transfer pricing is one of the two main methods, along with the allocation of debt, that affects how multinationals report profits across different countries. In general, profits are attributed to the country where the asset generating the profits is produced or acquired. When sales of goods or assets occur between related corporations, such as a U.S. parent and its foreign subsidiary, transfer pricing rules generally require that the transaction occur at arms-length prices, that is, prices that would occur between unrelated parties.

The Internal Revenue Code (IRC) section that governs transfer pricing, Section 482, is a brief section, general in nature, which consists of three sentences. The first sentence, which is long-standing in the tax code, allows the Secretary of the Treasury to adjust tax items to address tax evasion or to properly reflect income. The second sentence, added by the Tax Reform Act of 1986 (P.L. 99-514), provides that in the case of intangibles the payment for the transfer or license of an intangible must be commensurate with the income received from the intangible. The third sentence, added by a law commonly referred to as the Tax Cuts and Jobs Act of 2017 (P.L. 115-141), provides that intangible assets can be aggregated to determine valuation.

The details of rules regarding transfer pricing are contained in the Treasury regulations under Section 482, which are generally designed to reflect the arms-length standard. The best method for achieving arms-length prices is through prices in comparable uncontrolled transactions. For some goods and services, and particularly for intangible assets, such comparable prices are not available because of the unique nature of the commodity. Examples of intangibles likely to confront this problem are drug formulas and digital assets such as software.

Treasury regulations outline the basic methods for setting transfer prices for tangible property, intangible property, loans, and services. In the case of intangibles there are three methods:

- The comparable uncontrolled transactions method compares the payments between unrelated businesses to determine the transfer price (similar to comparison of sales prices for tangible goods).
- The comparable profits method, where profits of comparable firms as a share of assets, sales, or operating costs are used to determine the transfer price.
- The split-profits method, where profits are allocated based on the contribution of each firm (including functions performed, resources invested, and risks assumed). When a firm has ongoing research and development, the allocations are often determined by the split-profits method with cost sharing. A variation of the split-profits method is the residual split-profits method, where an amount of profit is assigned for routine functions and the residual is split between the corporations.

Cost Sharing Agreements and the Split-Profits Method

Cost sharing agreements (CSAs) are a common way to allocate profits derived from intangible assets between a parent and its subsidiary, usually by payments to the parent for the rights to exploit the intangible in a particular geographic area. Under a cost sharing arrangement there is an initial buy-in payment (sometimes called a platform contribution) to acquire a share of the existing intangible. After that point, the subsidiary firm makes a cost contribution to reflect its share of any ongoing profits from the original intangible. The buy-in payment could be an ongoing royalty that reflects the increased earnings due to the intangible or an upfront payment that would reflect the present value of those increased earnings. The buy-in payment is deductible to the subsidiary and is taxable to the parent.

After this initial buy-in payment, profits are divided based on cost sharing payments by the subsidiary to the parent,

again deductible by the subsidiary and taxable to the parent. The research and development often takes place solely in the United States and is managed by the U.S. parent.

CSAs are widely used by multinationals with intangible assets such as software, search algorithms, and other digital assets, as well as large pharmaceutical companies. These arrangements are generally with subsidiaries in tax havens which have low or no taxes, such as Bermuda, the Cayman Islands, Ireland, Switzerland, Singapore, or, in the Microsoft case and others, Puerto Rico, which is not subject to the U.S. tax and often offers tax reductions and holidays. Puerto Rico is treated the same as a foreign country for allocating income. The arrangements can allow exploitation of the intangible in a particular area (such as Europe or Asia) but can also involve selling back to the United States.

A case can be made that cost sharing agreements are not consistent with arms-length prices for several reasons. While a wholly owned subsidiary can contribute to the cost of research, it cannot assume the risk. A Government Accountability Office (GAO) study pointed out that any loss of the subsidiary will be reflected in the market value of the parent so that any loss to the subsidiary is a loss to the parent. Thus, related corporations do not have the same ability to transfer risk as do unrelated corporations.

Moreover, for a company whose ongoing profitability exceeds normal or competitive returns (for example, because of its unique status in the market), a company would not likely contract with an unrelated corporation for an ongoing share of its profits based on the share of costs contributed.

A University of Michigan law professor, Reuven Avi-Yonah, has argued that the cost sharing method should be eliminated.

Another issue that arises with the CSA is that the buy-in payment may be structured as a royalty that is relevant to current profits, but which declines and disappears as the technology decays. For many intangibles (e.g., the Microsoft Windows code), each new development is layered on top of the existing technology so the original intangible has an indefinite life.

Another issue is that CSAs allocate a disproportionate amount of profits to the subsidiary even though the subsidiary has no active role in the management and oversight of the research, which is carried out in the United States under the complete control of the U.S. parent.

The Commensurate With Income Standard and Period Adjustments

The IRS regulations include a provision to make periodic adjustments to transfer prices to reflect profitability. These regulations are based on the commensurate with income standard for the transfer of intangibles (the second sentence of Section 482) added by the Tax Reform Act of 1986.

In an extensive article in *Tax Notes* discussing cost sharing arrangements in general and Microsoft in particular, Steven Curtis and Reuven Avi-Yonah indicate that the IRS has not invoked periodic adjustments but that it would be a tool to enforce what they consider gaping holes in the cost-sharing approach.

There is some debate about whether periodic adjustments conflict with the arms-length standard, which has been the underlying focus of regulations reflecting the first and long-standing sentence of Section 482. One issue might be whether periodic adjustments reflect the ex post realization of profits that was not expected at the time of the buy-in or whether ex post realization of profits is evidence that the payments were originally understated. However, the arms-length standard is a regulatory concept while the commensurate with income measure is in the statute, with the latter taking precedence in defining IRS authority.

Other Measures to Challenge Cost Sharing

While the periodic adjustments rule could be used to adjust transfer prices under the cost sharing method, there are other parts of the tax code that might be used to challenge these prices. These options are discussed in the Curtis and Avi-Yonah article on Microsoft and also in an earlier related study by Steven Curtis and Richard Chamberlain. These alternatives include treating the income as effectively connected with U.S. source income, or challenging the agreement as lacking economic substance or as a sham transaction.

From a legislative perspective there are changes in the tax law that could capture some of the profits allocated to tax havens through CSAs as contained in the House version of the Build Back Better Act (H.R. 5376) in the 117th Congress, and as recently proposed by Chairman Wyden. This proposal related to the Senate Finance Committee's study of multinational pharmaceutical companies. Under current law, a U.S. tax is imposed on foreign source income from intangibles (the tax on Global Intangible Low Taxed Income, or GILTI), but the tax rate is lower than the U.S. rate and can be reduced by the use of unused foreign tax credits from non-tax haven countries. These revisions would raise the GILTI rate and apply credits against the tax only for foreign taxes paid to the country. (See CRS In Focus IF11943, *GILTI: Proposed Changes in the Taxation of Global Intangible Low-Taxed Income*, by Jane G. Gravelle for a discussion of these proposals.)

The ability to shift profits to low-tax jurisdictions could also change if a global minimum tax (Pillar 2) proposed by the OECD/G20 is widely adopted. (See CRS In Focus IF11874, *International Tax Proposals Addressing Profit Shifting: Pillars 1 and 2*, by Jane G. Gravelle for an explanation.) Many countries have already begun the process of adopting this minimum tax.

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