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Discussion

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Discussion After the Speeches of Michael F. Solomon and Peter Kastner

QUESTION, *Mr. Faye*: Michael, you did not mention patents. I know a lot of companies have maybe 1200 patents for IBM, and they deduct them as an R&D expense. Even when there is just one patent, they deduct it.

Now, they can capitalize on it, and some initial public offerings do capitalize on it in order to make the cash flow look a little better. But at the same time, it is kind of six-of-one, half-dozen of another if you have a stream of income.

ANSWER, *Mr. Solomon*: Certainly under U.S. principles, the cost of obtaining a patent in the sense of having your researchers do the research, and then go out and obtain a patent for the results of the research is a deductible item for U.S. purposes. If I purchase someone else's patent, I do not get a deduction under U.S. tax rules. And the open area that has prompted much debate and disagreement lately with respect to the internal revenue service is how do you treat your internal patent department in a big, multinational corporation? Is that patent department something that you can get a credit on?

How do people need to develop their internal patent departments? They have to figure out how the internal patent department is helping the research effort. They are an integral part. The way the credit rules provide, if some other department of the company supports the research effort and it is direct support, then you can claim a credit on all of those expenses. If the patent department helps by telling us what other patents are out there so we can understand how our research has to be different, then those types of interactive efforts qualify the patent department for the research credit. It is something that lots of companies have been able to get. But once you get away from that, and all the department does is just process paper and handle disputes and third-party interferences, it becomes a much more difficult problem with respect to those expenses.

QUESTION, *Professor Entin*: I am not a tax person or a patent person, so I have a two-part question that may reflect my ignorance. First of all, how bad, in absolute terms, are the disincentives for research and development in the U.S. tax code at this point? To what extent are we not really encouraging research and development through the tax system. And in comparative terms, how badly are we doing? Then, Mr. Kastner, you said that Canada has some feeling that it needs to have the best incentives it can because the climate is not particularly favorable in a variety of ways. In the United States, when you have incentives for state and local governments to provide tax incen-

tives for attracting economic development and other sorts of activities, you tend to have a kind of a race to the bottom. So my question is, to what extent does Canada feel itself in that kind of race, and how has that affected the tax structure for R&D?

ANSWER, *Mr. Solomon*: Let me just answer the domestic part of your question. There has been a very recent study out by the United States that shows that, for every dollar of credit that a U.S. firm actually gets, it will spend two dollars on research on a current basis and two dollars worth of down-stream research. So that sounds to me like a pretty good incentive. The problem in the United States is, fifteen to twenty percent of all research will get a credit and is effectively subsidized by the government. In the United States, the number is much lower than that. In many instances, it is no more than five percent. The reason is because of the incremental nature of that. That really created a disincentive; you just do not get the credit. The aerospace association in this country recently went into Congress and said, look, scrap this twenty percent credit nonsense. The most anybody ever gets is ten percent. The reason you get only ten percent is that you can never get credit incrementally for more than half of your current yearly expenses. They set a base up at half of that. So if you get a twenty percent credit on half, it is only a ten percent credit on your total R&D expense. They said, we are already at ten maximum. Cut that in half and just give us five of everything that we spend, and we will be happy.

That is just one industry. But if one industry said they will be happy with five percent and for everybody else, the most they get is ten percent, that is not a big range relative to the fifteen or twenty percent there is in Canada.

ANSWER, *Mr. Kastner*: I will answer the regional, jurisdictional issue first. The federal government certainly has an awareness of regional expansion, and certainly there is a diversity in the Canadian economy by region. That tends to be addressed much more through specific grant and retraining programs through government-funded industry. It is like the job that costs \$50,000.00 a year forever and really does not generate a lot except it provides local economic stability.

The provinces, though, are in the game of buying business growth and business expansion. One of the problems that we are very familiar with in our industry is that New Brunswick is trying to become call center to North America; if not the world. The best salesman that New Brunswick Telephone has is the premier of the province who promotes it vigorously. Ontario and Quebec compete particularly in the automotive industry. The Ontario government, which is as far left as words allow me to describe in a conference like this in the People's Democratic Republic of Ontario. Even a socialist government at the provincial level competed with the other provinces to get a large expansion with one of the automotive companies. At the federal level, the incen-

tive is indeed richer. And I think it is precisely on point with what Michael said.

If the incentive is not great enough to influence your decision before you commit your capital to it, it is arguably not a good incentive. If it is a wind-fall or it is a reward afterwards from a fiscal and social policy point-of-view, it is maybe not that good. So I guess my point would be that it has to be rich enough to influence your behavior for or against something that you would otherwise do.

QUESTION, Professor King: The thrust of the U.S. tax code seems to be that, if you deduct here, and it benefits your overseas operation, then you ought to get recompense from the licensees to use that technology, particularly for subsidiaries and foreign affiliates. This is hazardous and difficult in certain areas. Brazil, for example, never allowed royalty payments until fairly recently. I assume there may be other countries where you are prevented from it.

Also, there is a provision in the code that says if you set a royalty rate with a foreign subsidiary overseas, and then suddenly the income of the foreign subsidiary explodes, you have got to re-negotiate that rate despite the fact that the books might be closed on the foreign subsidiary for the tax authorities of the other countries. It seems to me that these are penalties that are built into our system. I wanted to know whether you had any comments on that.

ANSWER, Mr. Solomon: Certainly you mentioned two of the most notable areas of dispute there. The first is what goes under the umbrella in transfer pricing in 482, and the second goes under the umbrella of the 1986 Act, the commensurate with income standard.

They are both part of the same ball of wax. That is, how much of a total return with respect to an effort should the United States subject to tax, and the how much of the income is associated with the foreign jurisdiction? There is no good answer, and I think the fact that there has been so much litigation on these points over the past twenty years just exemplifies how difficult this whole compliance problem is.

The commensurate with income standard, which was the 1986 Act proposal, had some sense to it because what people said is, if I had a very good intangible, I would never license that to a third party. Therefore, if I could never have an arms' length price for that intangible, which is the notion that is here currently in the United States, that the arms' length price is what you need to develop even between interaffiliate types of transactions, could I ever develop an arms' length price where these types of intangibles, these very valuable things, never trade?

The theory is that there is a lot of sense there. Since they really never do trade or ought not to trade, maybe we ought to see how much income they develop and then divide it up on some basis. But it throws you back into the question of, what is really right for worldwide

groups?

That is why I suggested to everyone to take a look at cost sharing, because one of the things that cost sharing does is it avoids the necessity for ever having inner-company disputes. Basically the internal revenue service has said in its regulations that companies that cost share will not face 482 exposure with respect to transfer price, because in effect they will say that they own the intangible. So whatever they develop from that is their own, and no piece of that has to come back to the United States or go the other way. If you do not cost share, then you obviously have to worry about these things.

COMMENT, *Professor King*: It is a tough one.

QUESTION, *Mr. Korester*: To what extent do you find multinationals entering into the advanced pricing agreements in order to minimize the difficulties of controversy with both jurisdictions where the parent is licensed to a sub and where the parent is either foreign or domestic?

ANSWER, *Mr. Solomon*: You raise a word hopefully other people know. Advanced pricing agreements, the service tried to come up with an administrative response to all of these controversies. What is the right price for goods and services, intangibles, and what have you. And with these advanced pricing agreements, you go in, you bear your soul, you show all of your finances, you show everything else, and then you and the service negotiate a fair price with respect to a transfer or with respect to a sale between related parties.

My general opinion of these is that they are quite good in certain industries. And, in fact, if you can develop sufficient information, they tend to be a great audit saver. They take a lot of time. They are very expensive. And I think the service is becoming more reasonable.

The first few were very difficult, but I am now seeing a number of them. In fact, I think that they are a good alternative to just flying by the "seat of the pants" and worrying about fighting with the service when they come in. But as I said, you have got to be prepared to commit an awful lot of money, so most of the time, it is only the major multinationals that face hundreds and millions of dollars of these types of transactions. They can afford to do it.

I have seen none that have been accomplished at less than a million dollars, probably two million dollars worth of expense by the time you pay all of the experts, pay the law firms, pay your accountants, and you take into account all of your internal time. It is just extremely expensive.

ANSWER, *Mr. Kastner*: Maybe to get a Canadian perspective on the APA's, it is certainly better than playing the audit lottery parceling things off to a competent authority, and waiting sometimes for your successor to hear what the resolution is. But it is expensive, and it is slow.

One of the things that I think both governments have not been able to react to is that very few of us are in a static business environment where you can forecast a three to five year plan for inter-company trade, and this is how our agreements will work. So it is better than the bad old days, but I do not think it is getting as much positive reception as maybe Revenue Canada and the IRS thought it would.

QUESTION, *Professor Jensen*: Mr. Kastner, could you comment on the sorts of R&D that qualifies for the credit in Canada? And also could both of you comment on the treatment of computer software development costs?

ANSWER, *Mr. Kastner*: I will try to give you a broad brush look on it. One of the things that is similar to the United States' provisions is that the social sciences generally do not qualify. There has been some flexibility from Revenue Canada on things like psychological research. In our industry, what are colors that people will not use, colors that people will use, ergonomics. So we have had some success in that. But generally, the social sciences do not qualify.

Computer software is a hot issue. The whole information technology issue is what qualifies because of the core of the language that is in the Canadian law and regulation. It dates from the mid-1950s. They deliberately kept the language brief and somewhat ambiguous in order to allow Revenue Canada administratively to come to grips with it.

The general answer is the computer software development will qualify if it represents state-of-the-art rather than routine industrial practice, if it has got new algorithms, if it has got new compression techniques, if it has a marrying of technologies and hardware that did not exist before. I think that is the same issue as the one Michael mentioned.

If you can demonstrate technological uncertainty, either that you cannot get there or that you cannot get there in a particular time, or that you cannot get there at a particular cost, you would probably be successful with it. Doing a general ledger package that runs off Windows probably does not, and probably should not, fall under it.

Mr Solomon: In the United States, even today as we sit here, computer software development is not R&D. That is the services' published position. However, having said that, it is also their published position that computer software development expense will be treated exactly like R&D if the taxpayer elects. So it is kind of a distinction without a difference. And no one really understands why they are taking that, but I guess there must be some historical point. They published a ruling they never revoked in 1962 that takes that position. And even with that, again, there is a disconnect here, but section 41, which provides the credit, provides a credit for software development. And only 174 expenses qualify for the credit under section 41.

So you scratch your head, and you say, how can your service have

a rule out there that says software development is not 174, but yet Congress gives credit for it? So you just do not know how it got where it is. But basically, you do get a credit for software development. You do get to treat that as 174 expense if you so elect, or as a quasi 174.

Then there are special rules that came into the code in 1986. With respect to software development, general software development of the type that Peter mentioned always qualifies as a creditable type of an expense. But if you develop software for internal use in your business, and you do not sell it to third parties or you do not incorporate it into other hardware efforts, internal-use software is subjected to crediting on a much tougher and much more restrictive basis. It has to do with basically being able to show that the software is necessary and is part of a production process that you are developing or is necessary with respect to some product that you are developing, or — and they say by regulations you can get a credit for this internal use software if you can show it is of the novel type that Peter mentioned.

It is nowhere else available in the world. It is very, very difficult to do. You have to commit an awful lot of research and time to it. Then we might give you a credit for it. So that is really the U.S. rules.

QUESTION, *Professor Shanker*: I would like to get back to the basic theme of this conference. That is, do tax policies encourage or bring about innovation? Our Canadian audience guest made a point that there is no sense having an incentive unless it is really an incentive. They have a very generous one; twenty percent.

Let me comment on the weather. I think Toronto's weather is just as fine as Cleveland's weather, a heck of a lot better than Buffalo's weather, and I am not sure I would just as soon live in Vancouver than Seattle. The point I am making, of course, is that this is a very generous approach you have to R&D expenses in Canada compared to that in the United States. Has it worked? To put it another way, why have we not had that giant sucking sound for all the American research people to say, let us go up to Canada and get the advantage of this for R&D if, as you say, you are going to spend the money. The question is where do you spend it?

What I am wondering, does this suggest that the tax incentives are really only marginal to the decision to where the R&D expenses will be spent?

Here are two countries so close together, so common. How come we are not getting a lot more research in Canada that is now being done south of the border?

ANSWER, *Mr. Kastner*: Like I said, the corporate incentive is deliberately richer than any place else in the G7, and it reflects some of the concerns you mentioned. Researchers, like lawyers and accountants, do not like to pay personal tax at a marginal rate of fifty-five percent.

If you want to do R&D in Ontario, that is what your staff pays in taxes, a seven percent goods and services tax at the federal level, an eight percent goods and services tax at the provincial level. We are struggling a lot with services and what we can afford to deliver.

So in isolation, the R&D credit argument is a very clear one. But I think it is when all of those other things are built in, that is why I would argue, and I think the Canadian government should recognize, its incentive needs to be significantly greater than the U.S. incentive.

It also recognizes the difference in market. The Canadian inventor that comes up with a product that absolutely everybody in the country will buy has a market of twenty-six million people. Sales to a market of twenty-six million people will not support a project. In our industry it is in multiples of hundreds of millions of dollars.

Some of our competition, people with very deep pockets, got out of the electronic telecommunications switching business because they could not afford it. I take your point. It is good enough to maintain it and attract some of it. There are some Canadian industries, foreign-owned, who have had considerable success with what I referred to as the world product mandate.

Is there a giant sucking noise north? No, I do not think so. Some of the argument I made from a policy point of view is, if it was not as good as it is from Canadian incentives, you would hear a giant sucking sound.

COMMENT, *Mr. Solomon*: Really I have nothing to add except, for the companies I do work with in this area, I do not see anyone weighing research projects as to whether or not they are going to get a tax credit from them. And, in fact, most of the work I have done in the last ten years in this area is basically coming in on an audit and finding them money, because they fail to even claim the research credit on half of the research they had. What is research for the eye shade engineers is not the limit of what is research for the tax code. Believe it or not, that is one area where the tax code has more that is research and development for purposes of getting a credit than what your engineers will tell you is hands-on research. They did the research without even thinking about these things. It is this kind of thing, as you said. It is really found money. It did not give them an incentive here, and maybe it is wrong policy. So all I can tell you is that all of the people in the United States do research because they want to sell more widgets, not because Uncle Sam is giving them a credit for some small piece of it.

