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COMPARATIVE TAX ASPECTS OF TECHNOLOGICAL CHANGE IN
THE CANADA/U.S. CONTEXT: THE TOTAL TAX BURDEN ON
PEOPLE AND CORPORATIONS: U.S. VIS-À-VIS CANADA – A U.S.
PERSPECTIVE

*H. David Rosenbloom**

I am going to begin by offering some preliminary comments and observations on the comparative tax aspects of technological change. My topic here has a comparative slant to it, and I think I ought to introduce it by saying that I am quite skeptical about comparing tax systems, particularly about making comparisons from one particular bias or angle. These usually are offered in support of an agenda. In a purely intellectual sense, it is close to impossible to compare tax systems because there are so many variables in operation. For one thing, although I will speak about the research-specific provisions in U.S. law, it is clear to me that the biggest influences on taxation of any activity in the United States, and presumably in any other country, are the prevailing effective rates. In the case of the United States, we have a classical system of taxation, whereas Canada has a partially integrated system with only one level of taxation of corporate profits, which makes for huge differences in the non-research-specific areas of tax law. So, focusing on the research-specific areas is not a way to arrive at a proper comparison.

Nevertheless, given the subject matter today, I thought it would be interesting to outline for you what we do in the United States specifically with respect to the tax aspects of research. My presentation covers four separate regimes. It is interesting to me, from a U.S. perspective, that the most powerful stimulants that we have to research activity seem to be confined to the multinational arena. In other words, they appear to be most beneficial to taxpayers who are engaged in cross-border activities.

I want to go through the four regimes and explain to you in broad terms what we do and where I think each regime fits into the big picture. Two of these regimes are available across the board, meaning they are not specific to multinationals. One allows for the deductibility of certain research and experimental expenditures. That is under Section 174 of the Internal Revenue

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Code.¹ Our tax laws allow for a current deduction or, at the taxpayer's election, a five-year write-off for expenditures that qualify for R&D.² Those are defined broadly as expenditures incurred in connection with a trade or business in an experimental or laboratory sense.³ In general, the definition is fairly liberal.

This tax regime is old. It represents a substantial benefit because these types of expenditures would be expected to produce multi-year returns. Normally such expenditures would have to, under U.S. principles, be capitalized. Section 174 goes back to the 1954 Code. It has taken a bit of a twist lately because, outside the R&D area, the United States has been focusing on the dividing line between current deductibility and capitalization.

Mostly, this derives from a Supreme Court case, *Indopco, Inc. v. Commissioner of Internal Revenue*.⁴ We have had a number of follow-up decisions in U.S. case law which have encouraged the Internal Revenue Service to take a rather tough stand in regard to the requirements of capitalization.⁵ In that environment, Section 174 looks better than it did when there was not quite so much pressure on the issue. *Indopco* has nothing to do with R&D directly – it dealt with expenses of defending against a takeover⁶ – but it has generated a lot of activity generally relating to the subject of capitalizing expenses. So Section 174 is beneficial, but it is of relatively limited benefit. As I say, it covers expenditures for research in an experimental or laboratory sense. It has been extended, although not technically, by analogy to software development.⁷

The second general benefit regime is Section 41 of our Code, which provides for a twenty percent R&D credit against tax.⁸ Each dollar of credit, of course, is worth a dollar, whereas deductions in the United States are worth thirty-five cents. The R&D credit is available for the excess of qualified research expenses over a base amount. This is a much more recent provision in our law, and it has been amended several times. In its most recent incarnation, it has been a one-year credit. In other words, Congress rolls it forward from year to year. It then goes out of existence and Congress has to come up

¹ See I.R.C. § 174 (1998).

² See I.R.C. § 174 (b)(1)(C) (1998).

³ See 26 C.F.R. § 1.174-2.

⁴ 503 U.S. 79 (1992).

⁵ See generally *A.E. Staley Mfg. Co. & Subsidiaries v. Commissioner of Internal Revenue*, 119 F.3d 482 (7th Cir., 1997); *Norwest Corp. v. Commissioner of Internal Revenue*, 112 T.C. No. 9 (1999).

⁶ See *Indopco*, *supra* note 4.

⁷ See, e.g., *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. (Ill.) 1998); *Yellow Freight System of Delaware v. U.S.*, 24 Cl. Ct. 804 (1991); *Norwest Corp.*, *supra* note 5.

⁸ I.R.C. § 41 (1998).

with the budgetary funds to justify re-passing it. It is frustrating for people who would like to make long-term plans in the research area, but that is the way it has been. The credit is an expensive item in the budget, and Congress has never been willing to authorize it for more than a year, at least not recently. They may have intended for it to last for more than a year, but in recent years it has only been for a year at a time.

The other thing to say about the R&D credit is that it is incremental. That is to say, if you perform a base level of research from year to year, you will not be entitled to the credit. The credit is available for twenty percent of the increment above a base. Computation of the base is very interesting and quite complex, involving various elections. The most important observation here, however, is that the credit is incremental, it is not just for engaging in R&D, and that it is on a year-to-year basis.

The definitions of R&D credit are much more carefully hedged linguistically than the Section 174 deduction definitions. There are four basic tests to qualify for the credit. First of all, there has to be a Section 174-type of expenditure. It has to be technological in nature, meaning that it must be hard science as opposed to soft science. It has to be an expense undertaken for the purpose of discovering information whose application will be useful in the development of a new or improved business component. Finally, substantially all of the activities have to constitute elements of a process of experimentation.⁹

Each of these four tests has its own individual role, and there were proposed regulations issued in early December 1998, which explain the tests. All of the tests deal with fairly imprecise language, and therefore they are all subject to interpretation. The Internal Revenue Service has shown itself to be prepared to engage in controversies all along the spectrum of potential interpretive doubt. Congress has provided for a broad benefit in the sense of a credit, even if it is only for one year and it is incremental, but the benefit is couched in language that is susceptible to dispute. There has been considerable litigation in this area.

One thing the IRS has tended to do has been to break down research activities into very small pieces and argue that those small pieces are not really innovative and do not qualify for the credit. Any research activity can be broken down into pieces which, on their own seem trivial, and our tax administrators have tended to do that. Also, in order to qualify for the credit, there is a separate set of rules for internal-use software, which became a big issue in the United States in 1986. The Revenue Service was very concerned about internal-use software. A typical case, in which my firm participated,

⁹ See I.R.C. § 41 (d)(1)(A)-(C) (1998).

involved Norwest, a bank in the United States.¹⁰ They developed software for internal use, and a number of U.S. accounting firms had convinced financial institutions and others that these qualified for the R&D credit. Congress passed a statute in 1986 which said that, in order for this internal-use software to qualify, it had to be innovative, had to entail significant economic risk, and could not be commercially available.¹¹ Regulations interpreting those tests came out in 1997.¹²

What is "innovation"? What is "significant economic risk?" These issues are subject to dispute by the IRS, and they can take a fairly tough and niggling attitude. They are not particularly receptive to creative arguments. One of the unique problems in the United States that always mystifies Canadians derives from the concept that a partnership in U.S. tax law is a residual category. In other words, a partnership is not only an entity described in a piece of paper that says "partnership" on it. It is any kind of venture where people come together for a common interest and where expenses and income are shared. A group of people could easily form a partnership inadvertently, and there is plenty of case law on that.¹³ The tests for the R&D credit are applied at the partnership level as opposed to the partner level, which is a pretty sure way, if you have one of these inadvertent partnerships, to be kicked out of the credit. In addition to the terminology of the statute and the partnership problem, the IRS has been very tough about requiring records. Basically, the credit is there as an incentive, but it is very, very circumscribed in application, and people claim it at their peril. There is a great deal of litigation in the pipeline in this area.¹⁴

The more interesting benefits for research in the United States are international, which means that they are probably of only marginal benefit to the start-up companies about which we were talking in prior sessions. One of the benefits appears in the cost-sharing regulations under our transfer pricing rules. Transfer pricing encompasses the rules for supervising transfers of value between controlled corporations. In the United States, where there is a consolidated return regime, most affiliated companies file one return. Therefore, there is no domestic application of transfer pricing, or it is very limited.

¹⁰ See *Norwest*, *supra* note 5.

¹¹ See Tax Reform Act of 1986, Pub. L. No. 99-514, § 41(d)(4)(E), 100 Stat. 2085 (1986) (codified at I.R.C. § 41(d)(4)(E)).

¹² See 62 Fed. Reg. 81 (1997).

¹³ See, e.g., *Madison Gas & Elec. Co. v. Commissioner of Internal Revenue*, 7 L.T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

¹⁴ See generally Proposed IRS Coordinated Issue Paper on Qualified Research for Research Tax Credit, Tax, Budget & Accounting (BNA) No. 145 (July 27, 1999).

Transfer pricing is really a multinational concern, where income or expenses cross borders. The benefit of a cost-sharing agreement is that, if controlled companies get together and contribute to the costs of research in proportions that meet the terms of a qualified cost-sharing agreement, then the product of the research will be owned, in part, by each of the participating companies. If you can qualify, it is a wonderful thing because, at the end of the day, the intangible property developed through the research is owned throughout the corporate group in the various countries where it is supposed to be exploited. There is no reason to worry about the correct transfer price for the use of a related company's intangible property, which is a constant problem in international taxation in the United States.

The problem with the cost-sharing rules is that their requirements are difficult to meet. They require arm's-length participation in the agreement in accordance with the benefits to be obtained by the participants, and the rules are rather strict. Fortunately, the United States and Canada have both developed a process called the advance pricing agreement process by which companies can attempt to have their transfer pricing practices approved in advance.¹⁵ The process is somewhat long and arduous, but it can be a real help to taxpayers. There have been, I think, 150 advance pricing agreements issued, of which I would guess no more than twenty involve cost-sharing agreements. But a cost-sharing agreement is a substantial benefit for anyone who is going to be engaged in an international business. Without cost-sharing, transfers of intangible property are subject to re-examination by the IRS, and for that matter, by the tax administrations of other countries, and the cost of dealing with those examinations can be rather onerous.

The final incentive is also a multinational incentive, namely our rules for allocating and apportioning deductions. Normally, discussion of this subject is incomprehensible to people who are not involved in international taxation. However, this issue involves large sums of tax dollars. Entities in the United States avoid double taxation by claiming foreign tax credits for income taxes and taxes in lieu of income taxes imposed by other countries on foreign source income.¹⁶ That is the way our credit works. Canada has a completely different system. We only have a foreign tax credit system, and no exemption system. One of the ways to maximize benefits in our system is to have as much foreign source income as possible. The foreign source income concept is a net concept. You want to maximize your gross foreign source income, and you want to minimize the deductions that are associated with that gross

¹⁵ See Advanced Pricing Agreement Procedure, Rev. Proc. 96-53, 1996-2 C.B. 375.

¹⁶ See Treas. Reg. § 1.861-17.

income. Every multinational company in the United States knows these rules backwards and forwards.

The rules with respect to R&D expenses in the United States have been an incredible (and seemingly unlikely) political battleground, given a subject matter that is so difficult to understand. This is another area where Congress brought forward the law on a year-by-year basis rather than enacting anything permanent. The story really has antecedents going back to 1976, when the U.S. Treasury put out regulations saying that R&D expenses have to be apportioned, generally speaking, in accordance with sales.¹⁷ U.S. companies found that rule quite onerous because it would send a large amount of those expenses against foreign income, thereby reducing the amount of foreign source income and reducing the amount of foreign tax credits that could be claimed. There was such a political battle that, after a few years, many U.S. multinationals came to the Treasury and said that if the regulations were not changed, they were going to move all of their research from the United States to Switzerland or Chad or somewhere else.

In fact, Congress stepped in, overrode the regulations, and began tinkering with the process of allocating and apportioning the deductions. And after a number of years, the regulation was rewritten. We now have Section 1.861-17, which is an extremely generous allocation and apportionment rule. What it basically does is to carve a slice of these deductions off the top and associate them with the geographical locus where the research takes place.¹⁸ So a U.S. company can have anywhere from twenty-five to fifty percent of their total expenses associated with where the research is – generally speaking, we are essentially talking about the United States – and the rest can be apportioned under fairly liberal rules either on the basis of sales or on the basis of gross income. This is a much more favorable way of apportioning deductions, because income, unlike sales, is very much under a company's control.

The two multinational provisions in our law, the cost-sharing and the R&D expense allocation, are both very valuable to U.S. companies engaged in research if they have multinational operations and are concerned about transfer pricing. For the expense allocation rules to be meaningful, the companies have to have a concern about the foreign tax credit, which presupposes that they are paying foreign taxes in some other country.

On balance, in regard to our R&D-specific rules, we in the United States are not particularly hospitable to R&D in our tax system. The R&D credit is favorable in name, but the way in which it has been conferred, the language in which it has been couched, and the attitude of the tax administration in

¹⁷ *See id.*

¹⁸ *See id.*

applying it have been such to make it a highly problematic benefit. It is there if a taxpayer turns square corners, but turning those square corners takes a great deal of effort. Many people have tried to take advantage of this credit, but the IRS is out there willing to take them to court.

On the other hand, in the multinational arena our rules have been generous. They are a much bigger benefit to the large companies which are operating not only in the United States, but also abroad – other companies that can really take advantage of the expense allocation rules and that are facing or would otherwise face major transfer pricing concerns.

