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IRS Commensurate With Income Powers: Exploring Their Limits

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In this article, Brewer suggests that the periodic adjustment regulations under section 482 may be invalid to the extent that they override the statute of limitations for taxable transfers of intangible property.

The views expressed herein are those of the author and do not necessarily represent the views of Alvarez & Marsal Taxand.

In its recent decision in *Altera Corp. v. Commissioner*,[1] the Tax Court invalidated a rule the IRS adopted in its final regulations on qualified cost-sharing arrangements.

Shortly before the Tax Court's decision in *Altera*, the Supreme Court had an opportunity, in *King v. Burwell*,[2] to consider the validity of legislative regulations issued by the IRS. In *King*, the Supreme Court did not go so far as to declare the regulation in question invalid. But it did conclude that the regulation was not deserving of deference because Congress did not delegate to the IRS the authority to issue legislative regulations on the point of law in question.

Both of these recent cases have already received ample analysis in these pages[3] and therefore will not be discussed in detail here. What is relevant here is that both serve as reminders that Treasury regulations are not necessarily the final word on the points of law that they purport to establish or interpret.

The court in *Altera* chided the IRS for the *ipse dixit* basis for the rule in question. As James P. Fuller explained in his insightful analysis of *Altera*, *ipse dixit* is a Latin term that means, in essence, ''because I said so.''

In fairness to the IRS, the rule in question in *Altera* had somewhat more of a basis in law than simply ''because I [the IRS] said so.'' Actually, it was more like: ''because we [the IRS] have been delegated broad authority under the 'commensurate with income' (CWI) standard to say so'' (that is, to say what is arm's length in controlled transactions involving high-profit intangibles for which there is little, if any, public data on comparable transactions).

There is no question that Congress delegated broad regulatory powers to the IRS with the adoption of the CWI language in sections 367(d) and 482. But the *Altera* court flatly rejected the notion that this delegation gave the IRS the authority for the regulation at issue in that case. Thus, *Altera* stands for the proposition that there are limits on the powers delegated to the IRS under the CWI standard, even when the subject matter of the regulation in question relates to the kinds of high-profit intangibles to which Congress intended the CWI standard to apply.

The IRS has issued reams of regulations based on its delegation of authority under the CWI standard. Undoubtedly most of those CWI-based regulations find ample support in this delegation of authority. But there may be others, like the one at issue in *Altera*, that go beyond the penumbra of the IRS's CWI-based powers. The purpose of this article is to explore whether that is true regarding some aspects of the CWI-based regulations that arguably override section 6501, the statute of limitations for assessing deficiencies, in the case of taxable transfers of high-profit intangibles.[4]

A. Example to Illustrate the Issue

> **Facts:** In 1991 Mr. A, a U.S. citizen, obtained a patent on a product he had invented. He immediately sold the patent to a preexisting foreign corporation (ForCo), of which he owned 100 percent of the shares, in exchange

[1] 145 T.C. 3 (2015).

[2] 135 S.Ct. 2480 (2015).

[3] For an excellent analysis of *Altera*, see James P. Fuller, ''U.S. Tax Review,'' *Tax Notes Int'l*, Sept. 7, 2015, p. 871. For an excellent analysis of *King*, see Lee A. Sheppard, ''Recent Supreme Court Decisions and Judicial Deference,'' *Tax Notes*, July 6, 2015, p. 7.

[4] *See* Ken Brewer, ''Goodwill Hunting . . . Without a License: The IRS Takes Action,'' *Tax Notes*, Nov. 9, 2015, p. 803, for a discussion of the IRS's constitutional authority to make and change law by means of regulations and for a discussion of judicial deference to tax regulations issued by the IRS.

for a lump sum cash payment of $1 million, which was the best estimate at that time of the fair market value of the patent. Mr. A reported the $1 million of income on his tax return for 1991, which he filed on April 15, 1992.

By 2001 it became apparent that the profits of ForCo from exploiting the patent were far in excess of what could have reasonably been foreseen in 1991. An IRS agent discovered this in 2004 while auditing Mr. A's 2001 tax return. Armed with that information, the IRS agent asserted a deficiency in 2004 for Mr. A's 2001 tax year based on the amount of income ForCo earned in 2001 from exploiting the patent.

The resulting controversy: Mr. A's tax adviser informed the IRS agent that the income from the sale of the patent was properly reportable by Mr. A on his 1991 tax return and that section 6501 (the statute of limitations for the assessment of deficiencies) prevents the IRS from assessing a deficiency regarding Mr. A's 1991 tax return any time after April 15, 1995. The agent pointed out to Mr. A's tax adviser the following language in reg. section 1.482-4(f)(2):

> A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent tax year without regard to whether the tax year of the original transfer remains open for statute of limitations purposes.

B. The Commensurate With Income Principle

Congress added the CWI principle to the tax code in 1986 in the second sentence of section 482 (dealing with related-party transfer pricing) and in the last sentence of section 367(d)(2)(A) (dealing with transfers of intangible property by U.S. persons to foreign corporations). The stated purpose of the CWI principle is to prevent taxpayers from shifting taxable income outside the United States by transferring unique, high-value intangible property, the valuation of which is based on industry norms that do not reflect the property's real earnings potential. With that in mind, the CWI principle shifts the valuation focus away from third-party "comparables" and directs it toward the income that is actually generated or is reasonably expected to be generated by the intangible property in question.

Section 367(d) recasts the outbound transfer of intangible property in an otherwise tax-free exchange under section 351 or 361 as a sale of property in exchange for a hypothetical stream of payments over the useful life of the property that are contingent upon the productivity, use, or disposition of the property. The hypothetical amounts taken into account under section 367(d) are required to be "commensurate with the income attributable to the intangible."

The first sentence of section 482 was in effect long before the enactment of the CWI principle. That first sentence authorizes the IRS to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such [controlled] organizations, trades or businesses, if . . . necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." It is important to note that this language speaks only of distributing, apportioning, etc., between or among business units, not between or among tax years (unlike section 367(d)).

The second sentence of section 482 goes on to say: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." In contrast to section 367(d), section 482 does not recast the form of the transaction, nor does it expressly authorize the IRS to recast the form of the transaction by regulation. So, unlike the language in section 367(d), the language in section 482 does not alter the timing for the recognition of income on a taxable transfer of intangible property.

A precise meaning for the phrase "commensurate with the income attributable to the intangible" has never been provided by statute, regulation, case law, or ruling. But there is fairly universal agreement that the CWI principle provides the IRS with at least some ability to use hindsight to determine the value of the intangible property based on the results (whether actual or projected) of exploiting the intangible property after its transfer.

C. Statute Override Based on CWI Powers

The regulations under section 367(d) do not purport to extend the statute of limitations for assessing deficiencies regarding amounts of hypothetical income imputed under section 367(d). Regulatory extension is not necessary because the statutory language of section 367(d) itself causes the hypothetical income amounts to be taken into account in years after the actual transfer. Thus the application of the statute of limitations in section 6501 naturally flows from the year in which the hypothetical income amounts are required by statute to be included in the taxable income of the transferor.

In contrast, the periodic adjustment regulations under section 482 do purport to override section 6501. As discussed above, the statutory language of section 482 does not alter the timing for the recognition of income, nor does it authorize the IRS to alter the timing. Nonetheless, the periodic adjustment regulations in section 1.482-4 and -7 provide that transfer pricing adjustments may be made for one or more tax years after the tax year in which the income in question was required to be taken into account for tax purposes. Those regulations go on to provide that periodic adjustments under the CWI requirement of section 482 may be made in those subsequent tax years without regard to whether the tax year in which the income was required to be recognized remains open for statute of limitations purposes.[5]

The notion that this may represent an unauthorized override of section 6501 is less apparent in the context of transfers made in exchange for a stream of contingent royalty payments over a period of years. So to illustrate how this aspect of the periodic adjustment regulations arguably overrides section 6501, we will focus on the case of an upfront, lump sum payment for an irrevocable, fully paid-up license (or sale) of intangible property, as illustrated in the above example.

This form of transaction and payment is sometimes used in connection with buy-in payments for research and development cost-sharing arrangements (now referred to as "platform contribution transactions" in the cost-sharing regulations). But they are also common in intellectual property licenses that are not associated with cost-sharing arrangements, both in related-party and unrelated-party transactions. Thus, many related-party intellectual property transfers involve lump sum, paid-up licenses that give rise to this issue.

The analysis herein will address the rules in reg. section 1.482-4, which apply to transfers that are not made in connection with qualified cost-sharing arrangements. But the analysis is virtually the same under reg. section 1.482-7 for lump sum payments in exchange for platform contributions in connection with qualified cost-sharing arrangements.

D. The Transaction Form and Payment Form

It might be relevant to note a critical distinction between a lump sum payment for an irrevocable paid-up license and a lump sum payment serving as a prepayment of an uncertain amount of royalties to be determined later on the basis of future events (such as the productivity or use of the intellectual property). The argument that the override of section 6501 by the periodic adjustment regulations is invalid is somewhat more compelling in the former case. But the argument may also have merit in the latter case.

When the lump sum serves as a prepayment, the licensor is entitled to additional royalties if the intellectual property turns out to be more productive than expected. In that case, the licensor has the right to exclude the licensee(s) from continued use of the intellectual property for failure to pay any additional royalties required (and possibly for other types of contractual breaches). Thus, a contingent royalty-bearing license might be viewed as an open transaction involving the possibility of ongoing and continuous taxable events.

In contrast, a fully paid-up, irrevocable license (or sale) involves a closed and completed transaction under which the licensor generally does not retain the right to exclude the licensee from using the transferred rights. The licensee's ongoing use of rights under a fully paid-up license in years after the transfer does not amount to a taxable event for the licensor in those subsequent years. The taxable event for the licensor is the transfer itself.

As a general rule, the statute of limitations for the assessment of a deficiency relating to income from a closed and completed transaction undertaken by a taxpayer runs from the point when the taxpayer files its return for the tax year in which the income from the transaction is properly includable.[6] The determination of the year or years in which the income is properly includable is based on the nature and timing of the transaction giving rise to the income (the taxable event) and on the proper application of the taxpayer's accounting method for the income in question. For the IRS to have the authority to assess a deficiency for any given tax year, there must have been a taxable event to which that deficiency relates that was properly reportable for that tax year.

For purposes of analyzing the statute of limitations implications, a fully paid-up, irrevocable license might be best analogized to the grant of an easement over a parcel of land in exchange for an upfront lump sum payment. An easement is a nonpossessory interest in another's land that entitles the holder only to use the land in a specified manner. After an easement is conveyed or otherwise arises, there are no ongoing transfers of rights. The conveyance of an easement is the relevant taxable event. The exercise of rights under an easement is not a taxable event. The statute of limitations for assessing a deficiency relating to the lump sum consideration received in exchange for the conveyance of an easement would run from the tax year in which the easement was conveyed, not from the tax years in which the easement is enjoyed by its beneficiary.

[5]Reg. section 1.482-4(f)(2)(i) (last sentence) and -7(i)(6).

[6]Section 6501.

E. The Regulations in Question

The periodic adjustment regulations provide a special rule for lump sum payments in reg. section 1.482-4(f)(6), which was added to those regulations in 1994. While the special rule may seem consistent with the spirit of the CWI principle of section 482, it appears to conflict directly with the operation of section 6501, at least in the case of irrevocable paid-up licenses (or sales).

The conceptual approach of reg. section 1.482-4(f)(6) in determining whether a lump sum payment satisfies the arm's-length principle is to compute a hypothetical stream of annual royalty payments over the estimated useful life of the intangible that have a present value equal to the lump sum payment. Each of these hypothetical payments is referred to as the "equivalent royalty amount" for the year to which it pertains. For any given year during the life of the intangible property, the determination of whether the lump sum payment in the initial year of the license satisfies the arm's-length principle is done by comparing the equivalent royalty amount for the later year with an arm's-length royalty amount for that later year, determined on the basis of the actual results for that year.

The regulations illustrate how this approach works with the following example:

> FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for five years, and payment takes the form of a single lump sum charge of $500,000, paid at the beginning of the period.
>
> The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be 10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

Year	Projected Sales (dollars)
1	$2,500,000
2	$2,600,000
3	$2,700,000
4	$2,700,000
5	$2,750,000

> Based on this information, the present discounted value of the projected whopperchopper sales is approximately $10 million, yielding an equivalent royalty rate of approximately 5 percent. Thus, the equivalent royalty amounts for each year are as follows:

Year	Projected Sales (dollars)	Equivalent Royalty Amount (dollars)
1	$2,500,000	$125,000
2	$2,600,000	$130,000
3	$2,700,000	$135,000
4	$2,700,000	$135,000
5	$2,750,000	$137,500

> If in any of the five tax years, the equivalent royalty amount is determined not to be an arm's-length amount, a periodic adjustment may be made under reg. section 1.482-4(f)(2)(i). The adjustment would equal the difference between the equivalent royalty amount and the arm's-length royalty in that tax year.

In the above example, if the actual sales for year 5 were $5 million and the arm's-length royalty rate was determined to be 5 percent, the royalty would be $250,000 if the transaction had been structured in the form of a contingent royalty-bearing license. Thus, under the approach of reg. section 1.482-4(f)(6), the IRS would be authorized to assess a deficiency for year 5 based on a hypothetical understatement of income of $112,500 for that year, even though the income from the actual transaction in question was properly includable in year 1 (and only in year 1).

As discussed above, reg. section 1.482-4(f)(2) provides (among other things) as follows:

> A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent tax year without regard to whether the tax year of the original transfer remains open for statute of limitations purposes.

Thus, even though the income from the transaction in the above example was required to be reported in year 1 and the statute of limitations for the assessment of a deficiency for year 1 expired sometime in year 5, reg. section 1.482-4(f)(2) purports to allow the IRS to assess a deficiency that relates to the taxable event that occurred in year 1 until sometime in year 9.

Here again, one might argue that it is consistent with the CWI principle enacted by Congress to extend the statute of limitations for the year in which the income from a lump sum payment is required to be included. In that regard, one might also argue that it is consistent with the CWI principle to recast contractual terms and the payment form chosen by the parties. Thus, it would seem possible that a delegation of authority to the IRS to override section 6501 and to recast contractual terms for transfers of high-value intangibles could satisfy the "necessary and proper" condition imposed by the Constitution (on delegations of legislative authority by Congress to the executive branch). Therefore, it would seem that such a delegation would be permissible under the Constitution — if such a delegation was in fact made by Congress and if the IRS's actions were consistent with that delegation.

F. Constitutional Implications

The statutory language of section 482 does not say that it overrides section 6501 or that the IRS is authorized to override section 6501 or recast the contractual terms chosen by the parties. Nor did Congress amend the language of section 6501 to include an exception for periodic adjustments under section 482. A somewhat less than exhaustive (but reasonably diligent) search of the legislative history of the second sentence of section 482 did not reveal any statements suggesting congressional intent to override section 6501. Also, there is nothing in the statutory language of section 367(d) or its legislative history suggesting that the CWI language in section 367 provides the IRS with this authority.

It is a fundamental principle of American constitutional law that statutory provisions enacted by Congress take precedence over conflicting administrative regulations.[7] Thus, to be effective, a delegation to the IRS of the authority to override a statute would have to be clear and unambiguous.

G. If You Like Your Payment Form, You Can . . .

The periodic adjustment regulations permit taxpayers to keep their chosen payment form. Admittedly, authority for the IRS to recast contractual terms can be found outside section 482, in the economic substance doctrine, but only for cases in which the contractual terms are not consistent with the economic substance of the transaction. The statutory language of section 482 does not appear to authorize the IRS to recast transaction forms beyond what is permissible under existing judicial doctrine or other statutory provisions; nor does the legislative history of section 482 appear to authorize this action. That might explain the approach taken by the IRS in the periodic adjustment regulations regarding the lump sum payment form.

The regulations do not purport to recast the lump sum payment form, except in cases in which that payment form is inconsistent with the economic substance of the transaction. Rather, they simply permit the IRS to assess a deficiency that relates to the year of the transfer, long after the expiration of the statute of limitations for that year, based on a hypothetical calculation of what would have been due in later years if the taxpayer had chosen a contingent payment form or if the IRS had successfully recast the chosen payment form under the authority of the economic substance doctrine.

It seems difficult to justify an administrative override of the statute of limitations under the authority of the second sentence of section 482 when nothing in the language of that section, or in its legislative history (or that of section 367(d)), appears to delegate any authority to the IRS to override other sections of the code.

H. Possible IRS Counterarguments

1. The later-in-time argument. The IRS might conceivably respond to the override problem with an argument applying the following logic:

- The CWI language in the second sentence of section 482 imposes an affirmative obligation on the IRS to determine the income for a transfer of intangible property by referring to the income attributable to the intangible. It does not limit that determination to income earned before the expiration of the statute of limitations for the year of the transfer. Thus, it is mandatory for the IRS to make any adjustments required by this sentence whenever the income attributable to the intangible indicates that the income reported in the year of the transfer was inadequate, regardless of when that income was earned.
- The second sentence of section 482 was added in 1986.
- The statute of limitations provision was in existence before 1986.
- Federal case law indicates that if there is a conflict between two statutes, the statute that is later in time prevails.[8]
- Thus, section 482 prevails over the conflicting statute of limitations code provision because the second sentence of section 482 was enacted later in time.

It is relevant to note that a similar later-in-time argument was made by the secretary of the interior and rejected by the Supreme Court in *Watt v. Alaska*.[9] The following language from *Watt v. Alaska* should be instructive on at least two levels here:

> The Secretary invokes the maxim of construction that the more recent of two irreconcilably conflicting statutes governs. Without depreciating this general rule, we decline to read the

[7] *Supra* note 4.

[8] *See, e.g., District of Columbia v. Hutton*, 143 U.S. 18 (1892).

[9] 451 U.S. 259 (1981).

statutes as being in irreconcilable conflict without seeking to ascertain the actual intent of Congress. Our examination of the legislative history is guided by another maxim: '''repeals by implication are not favored,''' *Morton v. Mancari*, 417 U.S., at 549, quoting *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936). ''The intention of the legislature to repeal must be 'clear and manifest.''' *United States v. Borden Co.*, 308 U.S. 188, 198 (1939), quoting *Red Rock v. Henry*, 106 U.S. 596, 602 (1883). We must read the statutes to give effect to each if we can do so while preserving their sense and purpose. *Mancari*, *supra*, at 551; see *Haggar Co. v. Helvering*, 308 U.S. 389, 394 (1940).

That language is instructive first in that it shows that for the later-in-time principle to apply, there must be an irreconcilable conflict between the two statutory provisions in question. The second sentence of section 482 could easily be interpreted as being not in conflict with the statute of limitations, thereby precluding the application of the later-in-time principle.

The *Watts* opinion is also instructive in citing the maxim ''repeals by implication are not favored.'' As discussed above, there does not appear to be anything explicit in the statutory language of section 482 or its legislative history that indicates an intention to override the statute of limitations.

It is important to note that some intangibles may retain (or even grow in) value and may therefore generate income for many decades or even centuries.[10] Thus, when taken to its logical extreme, the later-in-time argument would establish the patently absurd mandate that the IRS must require CWI adjustments until the last dollar of income is earned on the transferred intangible, even if that last dollar is earned more than 100 years after the year of the transfer.

2. The statute override is essential to accomplishing the policy objective of the CWI principle. Without an override of the statute of limitations, the IRS would have less than four years from the tax year of the transfer to assess a deficiency regarding the value claimed by the taxpayer for the transferred intangible. In some industries, such as the biotech and pharmaceutical industries, it may take much more than four years before the value of an intangible can be reliably determined. In light of that, the IRS might argue that the authority to override the statute of limitations should be implied from the enactment of the CWI standard; otherwise, it would be impossible to accomplish the CWI standard's intended purpose.

As a policy matter, this concern would seem to have merit. But in those situations when four years is not enough to determine the value of an intangible based on actual results, the CWI principle — even without an extended statute of limitations — still gives the IRS almost four more years of information after the year of the transfer, which should allow for more reliable projections of the future results than were available at the time of the transfer. So even for intangibles for which the development period is well over four years, the application of the CWI principle should allow the IRS significant hindsight. And, as discussed above, the authority of the executive branch to override legislation should not be implied in the absence of statutory language to that effect; at minimum there should be a clear indication in the legislative history (neither of which appears to exist here).

I. Does Tenure Apply to Agency Overrides?

If a regulation has been ''on the books'' for almost 20 years, there is a natural tendency to assume that it must be valid. That is undoubtedly the case with reg. section 1.482-4(f).[11] But the concept of tenure does not insulate a regulation, however longstanding, from being invalidated if it conflicts with a statutory provision.[12]

J. Potential Application to Periodic Royalties

As mentioned above, the potential constitutional shortcomings of the override of the statute of limitations are more apparent in the case of upfront, lump sum payments for irrevocable paid-up licenses (or sales). But the same issue could apply to transfers in exchange for a series of contingent

[10]Consider, for example, the Jack Daniel's whiskey brand, which dates back to sometime before the 1904 St. Louis World's Fair, where it won the gold medal for the world's finest whiskey.

[11]For evidence that this type of assumption about reg. section 1.482-4(f) is prevalent among highly respected experts, see ''U.S. Officials Urge Taxpayers to Comment on BEPS, Now in 'Brainstorming Phase,''' BNA's *DTR*, Dec. 13, 2013 (account provided of discussion between Rocco Femia of Miller & Chevalier Chartered and Christopher J. Bello, branch 6 chief, IRS Office of Associate Chief Counsel (International)).

[12]It is a fundamental principle of American constitutional law that statutory provisions enacted by Congress take precedence over conflicting administrative regulations. *See, e.g.*, *Caldera v. J.S. Alberici Constr. Co.*, 153 F.3d 1381, 1383 (Fed. Cir. 1998) (''Statutes trump conflicting regulations''); *Wolf Creek Collieries v. Robinson*, 872 F.2d 1264, 1267 (6th Cir. 1989) (''statutory language . . . prevail[s] over inconsistent regulatory language''); *Pacific Gas and Electric Co. v. United States*, 664 F.2d 1133, 1136 (9th Cir. 1981) (''a regulation which operates to create a rule out of harmony with the statute, is a mere nullity'') (citing *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936)); *United States v. Gordon*, 638 F.2d 886, 888 (5th Cir. 1981) (''Whatever effect the agency regulation may have under other circumstances, it cannot supersede a statute applicable to those present here'').

payments. To illustrate that possibility, let's assume we have a license of an intangible by a U.S. parent to a controlled foreign corporation that calls for royalty payments equal to 8 percent of sales (by the CFC) over a 10-year period. Based on that chosen form of transaction and payment, the resulting taxable events would take place during those 10 years. Nonetheless, under the periodic adjustment regulations, the IRS could require an adjustment decades (or even centuries) later if the intangible is still generating income.

K. Concluding Remarks

The IRS and Treasury are charged with the daunting task of crafting the huge volume of regulations required to accomplish the actions properly delegated to them by the Congress. But as the *King* and *Altera* cases demonstrate, sometimes in their efforts to craft rules in line with their views of the appropriate policy objectives, these agencies may exceed the scope of that delegated authority.

The question here is not whether the override of section 6501 makes sense as a matter of tax policy. The question is whether it represents a valid exercise of executive branch power under the separation of powers principle of the Constitution. Brushing aside the relevance of constitutional requirements could create (or enhance existing) precedent for doing so on other matters that are far more important than taxes.