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March 12, 2014

Mr. David Selig
Internal Revenue Service
CC:PA:LPD:PR (REG-159420-04)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC

RE: Proposed Regulations Under Section 41 of the Internal Revenue Code (REG-159420-04)

Dear Mr. Selig:

On behalf of the Semiconductor Industry Association ("SIA")[1] and the Information Technology Industry Council ("ITI")[2], Baker & McKenzie, LLP, respectfully submits the following comments on the proposed regulations REG-159420-04 (Credit for Increasing Research Activities: Intra-Group Gross Receipts) ("Proposed Regulations") issued by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") on December 13, 2013. The Proposed Regulations address the treatment of qualified research expenditures ("QREs") and gross receipts resulting from transactions between members of a controlled group of corporations or a group of trades or businesses under common control (collectively, "Intra-Group Transactions") for purposes of determining the credit for increasing research activities ("research credit") under section 41 of the Internal Revenue Code of 1986, as amended

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[1] SIA is the leading voice of the U.S. semiconductor industry. SIA represents U.S. companies involved in research, design, and manufacture of semiconductors. Semiconductors are a foundation of the information technology sector and essential to modern communications, entertainment, national defense, health care, transportation, and other aspects of the world's economy. SIA advocates public policy that maintains the global market leadership position of the U.S. semiconductor industry.

[2] ITI is the premier advocacy and policy organization for many of the world's leading innovation companies. ITI navigates the constantly changing relationships between policymakers, companies, and non-governmental organizations. ITI engages in policy advocacy and provides creative solutions that advance the development and use of technology around the world. ITI matches its members' breakthrough innovations with cutting-edge approaches to help people and governments better understand its members and the work they do.

("Code").[3] Treasury and the IRS requested that comments on all aspects of the Proposed Regulations be submitted to the IRS by March 13, 2014. For the reasons set forth below, SIA and ITI respectfully request that Treasury and the IRS withdraw the Proposed Regulations.

SIA and ITI also request the opportunity to have their representatives testify on their behalf at the hearing scheduled for April 23, 2014, at 10 a.m., regarding the topics discussed below, as well as any topics that other commentators may raise.

I. EXECUTIVE SUMMARY.

Proposed Treasury Regulation section 1.41-6(i)(2) (the "Proposed Rule") proposes a regulatory rule that would undermine the statutory rules mandated by Congress in two provisions of the Code. Specifically, the Proposed Rule requires the inclusion of gross receipts from Intra-Group Transactions in computing the research credit when a foreign affiliate engages in an external transaction that gives rise to gross receipts that are not effectively connected with the conduct of a trade or business within the United States ("US Trade or Business"). The Proposed Rule directly contradicts the plain and unambiguous language of section 41(f)(1), which treats all members of a controlled group – including foreign corporations – as a single taxpayer for purposes of computing the research credit, and section 41(c)(7), which provides that gross receipts of a foreign corporation are taken into account under section 41 only when they are effectively connected with the conduct of a US trade or business. In seeking to "harmonize" sections 41(f)(1) and 41(c)(7), the Proposed Rule does quite the opposite – it creates an exception to section 41(f)(1) that Congress did not intend and thereby takes into account (and includes in gross receipts a portion of) the very gross receipts that section 41(c)(7) expressly excludes from the computation of the research credit. The legislative history of section 41 confirms that Congress understood the complementary roles of sections 41(f)(1) and 41(c)(7), and intended that all Intra-Group Transactions, as well as receipts derived by a foreign corporation in a transaction not connected with a US Trade or Business, be disregarded in computing the research credit.

Treasury and the IRS attempt to justify the Proposed Rule by asserting that the interaction of sections 41(f)(1) and 41(c)(7) create a "distortive effect" by including QREs incurred by domestic members of a controlled group but not sales to foreign corporate members. This allegedly distortive effect, however, is illusory. Indeed, it is the Proposed Rule that creates distortive effects contrary to the statute by including in gross receipts for purposes of computing the research credit gross receipts from Intra-Group Transactions between domestic and foreign corporations that constitute part of the same taxpayer, and by including gross receipts that bear no relationship to the QREs that are included in the credit computation. The Proposed Rule effectively reduces the research credit by taking into account Intra-Group Transactions relating to external transactions with respect to which the taxpayer did not incur QREs. Congress drew a

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[3] Unless otherwise noted, all "section" references are to the corresponding section of the Code, and all "Treas. Reg. §," "Treasury Regulation section," and "regulations" references are to the Treasury regulations promulgated thereunder.

line at the US borders and completely excluded both QREs incurred outside of the United States and gross receipts from sales by foreign corporations that are not effectively connected with a US Trade or Business. Without any basis in the statute and without even acknowledging the applicable case law that holds otherwise, the Proposed Rule seeks to make an end run around this line and would pick up a substantial portion of the gross receipts from non-effectively connected sales by foreign corporations, which Congress clearly and unambiguously mandated should be excluded. Simply stated, the non-effectively connected gross receipts of foreign corporations cannot be taken into account in determining gross receipts under section 41(c)(7), and the Proposed Rule requires that such gross receipts be taken into account to determine which Intra-Group Transactions will be included in the research credit computation in violation of the single taxpayer rule in section 41(f)(1). Thus, the Proposed Rule is contrary to the plain language of the statute and should be withdrawn.

II. BACKGROUND.

A. Current Section 41 and Treasury Regulations.

Section 41 provides a tax credit as an incentive to encourage taxpayers to increase research and development activities. Under section 41(a), the research credit is equal to 20 percent of the excess of a taxpayer's QREs for the computation year (the "credit year") over its base amount ("R&D Credit"). Section 41(c)(1) defines the base amount as the product of the taxpayer's fixed-base percentage and the taxpayer's average annual gross receipts for the four taxable years immediately preceding the credit year. In general, the fixed-base percentage is computed by dividing the taxpayer's aggregate QREs by the taxpayer's aggregate gross receipts for the taxable years beginning after December 31, 1983, and before January 1, 1989. I.R.C. § 41(c)(3).

For purposes of calculating a controlled group's R&D Credit, section 41(f) establishes a single taxpayer rule that necessarily applies to all components taken into account in computing the group's R&D Credit, including QREs and gross receipts. Specifically, section 41(f)(1)(A)(i) provides that, in determining the amount of the R&D Credit, "all members of the same controlled group of corporations shall be treated as a single taxpayer" ("Single Taxpayer Rule"). Both domestic and foreign controlled corporations are members of the same controlled group for purposes of section 41. I.R.C. § 41(f)(5). Treasury Regulation section 1.41-6(i)(1) implements the statutory mandate by effectively treating transactions between members of the same controlled group as transactions between divisions of a single corporation. Such regulation provides that "[b]ecause all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded." (Emphasis added.)

In the case of a foreign corporation, section 41(c)(7) provides that only gross receipts which are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States (i.e., a US Trade or Business) are to be taken into account for purposes of computing the R&D Credit.

The current statutory and regulatory scheme make clear that Congress and Treasury, respectively, intended to exclude from the computation of a controlled group's R&D Credit gross receipts derived from Intra-Group Transactions with foreign members of such group. The only reported opinion that addresses this issue reached the same conclusion. In Procter & Gamble Co. & Subsidiaries v. United States, 733 F. Supp. 2d 857 (S.D. Ohio 2010), the court held that because all Intra-Group Transactions, whether with domestic or foreign controlled group members, are disregarded under the Single Taxpayer Rule, gross receipts derived from Intra-Group Transactions are excluded from the computation of the controlled group's R&D Credit. Cf. Hewlett-Packard Co. v. Commissioner, 139 T.C. 255, 256 (2012) (Commissioner conceded the same issue). The IRS litigating position was that the taxpayer's intercompany sales with foreign (but not domestic) members of its controlled group should be taken into account in calculating the R&D Credit. The court disagreed and concluded that the distinction advocated by the IRS between domestic and international Intra-Group Transactions "appears arbitrary given the lack of statutory support." Procter & Gamble, 733 F. Supp. 2d at 865 (emphasis added). The court explained that "the plain language of the statute and regulation is dispositive of this case," and "a discussion of the legislative history of Section 41 of the Internal Revenue Code reveals that P&G's decision to exclude intercompany transfers with its international members is consistent with the credit's intended incentive effect." Id.

B. Proposed Regulations.

The Proposed Rule purports to override the Single Taxpayer Rule in section 41(f)(1) in a wide range of circumstances by taking into account gross receipts from Intra-Group Transactions for purposes of determining the amount of the R&D Credit when (i) a controlled group member that is a foreign corporation engages in a transaction with a party outside of the group (an external transaction) involving the same or a modified version of tangible or intangible property or of a service that was previously the subject of one or more Intra-Group Transactions (an internal transaction), and (ii) the external transaction does not give rise to gross receipts that are effectively connected with a US Trade or Business. The Proposed Rule provides that gross receipts from an Intra-Group Transaction subject to the rule are taken into account for purposes of calculating the R&D Credit in the year the external transaction occurs. Prop. Treas. Reg. § 1.41-6(i)(2)(ii). If there is more than one internal transaction, then only the last Intra-Group Transaction giving rise to gross receipts is taken into account in calculating the R&D Credit. Prop. Treas. Reg. § 1.41-6(i)(2)(iii).

C. Key Facts Pertinent to the Proposed Regulations.

The members of SIA and ITI, like most other multinational companies, each typically have numerous domestic and foreign corporations in an affiliated group that perform a wide range of activities, including research and development, marketing, manufacturing, selling, and other activities. Within the group, there are numerous types of Intra-Group Transactions that are undertaken so that domestic and foreign corporations can provide products, intangible property, and services to unrelated customers. Domestic corporations and foreign corporations engage in numerous Intra-Group Transactions relating to tangible property, intangible property, and

services, with transfers going in both directions. In many, if not most cases, a foreign corporation that is a member of an affiliated group will engage in a transaction with an unrelated third party that involves the same or a modified version of tangible or intangible property, or services that previously was the subject of an Intra-Group Transaction. Indeed, it would be unusual for a domestic corporation to provide tangible property, intangible property, or services to a foreign member of the group, and then for that foreign member not to engage in one or more transactions with unrelated third parties involving the same property or services (or modified versions of same). Moreover, it is not typical for foreign corporations in affiliated groups to engage in transactions with unrelated third parties that give rise to effectively connected income. Thus, Proposed Treasury Regulation section 1.41-6(i)(2)(i), which identifies the Intra-Group Transactions to which the Proposed Rule applies, would include most, if not substantially all, of the Intra-Group Transactions between domestic corporations and foreign corporations of an affiliated group.

Notwithstanding the foregoing, there is no necessary connection between an Intra-Group Transaction between a domestic corporation and a foreign corporation in a controlled group, and the conduct of qualified research by the domestic corporations in the group. The products sold, intangible property transferred, or services provided by a domestic corporation to a foreign corporation in the controlled group may or may not embody the results of any research activities performed by the domestic members of the group. Moreover, there are a variety of scenarios in which such property or services may reflect research and development activities performed outside of the United States, whether by a foreign corporation that is a member of the controlled group or otherwise.

III. ANALYSIS.

A. The Unambiguous Language of Section 41 Requires That All Gross Receipts Relating to Intra-Group Transactions and All Foreign Corporate Gross Receipts Not Effectively Connected with a US Trade or Business be Disregarded in Calculating the R&D Credit.

1. Treasury and the IRS Did Not Have the Authority to Issue the Proposed Rule Because the Statute is Clear and Congress Left No Gap for Treasury and the IRS to Fill.

An agency's authority is circumscribed by statute and it can act only insofar as empowered by Congress. La. Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986) (a federal agency "literally has no power to act . . . unless and until Congress confers power upon it"). Once such power is conferred, an agency can act only within the confines of delegated authority. City of Arlington v. FCC, 133 S. Ct. 1863, 1869 (2013) (For "agencies charged with administering congressional statutes," "[b]oth their power to act and how they are to act is authoritatively prescribed by Congress, so that when they act improperly, no less than when they act beyond their jurisdiction, what they do is ultra vires.").

The Proposed Rule must be withdrawn because Treasury and the IRS do not have the authority to issue it. In the Proposed Rule, Treasury and the IRS attempt to include in gross receipts income from Intra-Group Transactions in situations in which foreign corporate members of a controlled group sell certain goods or services to parties outside of the controlled group and in which such sales do not produce income that is effectively connected with a US Trade or Business. However, the statute adopted by Congress directly addresses both the treatment of gross receipts from Intra-Group Transactions and the treatment of foreign gross receipts not effectively connected with a US Trade or Business. Congress has directly spoken to the precise issues addressed in the Proposed Rule. Because Congress has made the policy choice, Treasury and the IRS have no policy gap to fill in administering those laws.

The statutory regime of section 41 provides clear and unambiguous rules relating both to the exclusion of Intra-Group Transactions and the exclusion of foreign gross receipts not effectively connected with a US Trade or Business in the computation of the R&D Credit. This plain language is controlling on Treasury and the IRS, just as it is controlling on taxpayers. Like any administrative agency, Treasury and the IRS must act within the bounds of the statute.

Section 41 provides an R&D Credit to incentivize and encourage taxpayers to increase their research and development activities. Section 41(a)(1) sets forth the method for determining the amount of R&D Credit for each taxable year. The operation of the statute is clear based on the plain statutory terms. Section 41(c)(7) expressly limits the gross receipts of a foreign corporation that may be taken into account in the R&D Credit computation to "only gross receipts which are effectively connected with the conduct of a trade or business within the United States." (Emphasis added.) Congress could not have more clearly expressed its intent that gross receipts relating to a foreign corporation that are not effectively connected with a US Trade or Business must not be taken into account in determining the gross receipts used to compute the R&D Credit. This bright-line statutory mandate hinges on whether gross receipts derived from sales by a foreign corporate member are effectively connected with a US Trade or Business. If the gross receipts are effectively connected with a US Trade or Business, then the gross receipts may enter into the R&D Credit computation. If the gross receipts of a foreign corporation are not effectively connected with a US Trade or Business, then they definitively must be excluded from the R&D Credit computation and may not otherwise be "taken into account" in determining the gross receipts of the taxpayer.

The language of the Single Taxpayer Rule in section 41(f)(1) is similarly simple and clear. By treating all members of the same controlled group of corporations as a single taxpayer, section 41(f)(1) eliminates all Intra-Group Transactions for purposes of determining the amount of the R&D Credit. Section 41(f)(1) expressly provides that the Single Taxpayer Rule applies for purposes of "determining the amount of the credit under [section 41]" and thus directly applies, *inter alia,* to the determination of gross receipts necessary to compute the R&D Credit. Section 41(f)(1) ensures that only third party transactions, and not Intra-Group Transactions, are taken into account for purposes of calculating the R&D Credit. The Single Taxpayer Rule operates to prevent distortions in the computation of the R&D Credit that could either overstate

or understate the R&D Credit if the computations arbitrarily included certain Intra-Group Transactions.

The Supreme Court has made it clear that when a statute is unambiguous, there is no statutory gap for any agency to fill and thus no room for agency discretion in the construction of the statute. United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1843 (2012); Lamie v. United States Trustee, 540 U.S. 526, 538 (2004) (quoting Mobil Oil Corp. v. Higginbotham, 436 U.S. 618, 625 (1978) ("There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted.")). Courts and agencies must give effect to the unambiguously expressed intent of Congress. See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843-44 (1984). When statutory rules directly address the treatment of an item, there is nothing further to be clarified or amplified in a regulation or ruling. See, e.g., Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992) ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'") (Internal citations omitted.); United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989) (quoting Caminetti v. United States, 242 U.S. 470, 485 (1917) ("[W]here, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'")); Microsoft Corp. v. Commissioner, 311 F.3d 1178, 1186 (9th Cir. 2002) (citing United States v. Lewis, 67 F.3d 225, 228 (9th Cir. 1995) ("When the plain language of a statute is clear, we need look no further to divine its meaning.")).

The Proposed Rule attempts to make policy judgments in an area where Congress has clearly spoken by statute and left no policy question unresolved. Section 41(c)(7) excludes gross receipts derived from sales by foreign corporate members to customers if those sales do not generate income that is effectively connected with a US Trade or Business. Section 41(f)(1) excludes from the R&D Credit computation all QREs and gross receipts relating to Intra-Group Transactions of all members of the group. These separate yet complementary statutory rules operate in harmony and interact in a simple and straightforward way. There is no conflict, disharmony, or overlap between these two provisions. Each provision works independently to serve the specific purpose for which it was designed. Read together by their plain terms, the provisions include only those QREs and gross receipts that Congress intended to be included in the computation of the R&D Credit. Because Congress has fully provided the policy in this area, and because there is no ambiguity in the statute, the Proposed Rule is outside of the authority of the statute and must be withdrawn.

2. The Proposed Rule is Contrary to the Plain Language of Section 41.

Treasury and the IRS assert that they issued the Proposed Rule to "address how the interaction of section 41(f)(1) (relating to the treatment of controlled groups as a single taxpayer) and section 41(c)(7) (relating to the exclusion from gross receipts of amounts received by a foreign corporation that are not effectively connected to a United States trade or business) affects the computation of gross receipts resulting from intra-group transactions between domestic

controlled group members (domestic members) and foreign corporate members of the controlled group (foreign corporate members)." Notice of Proposed Rulemaking and Notice of Public Hearing regarding "Credit for Increasing Research Activities: Intra-Group Gross Receipts," 78 Fed. Reg. 75,905 (Dec. 13, 2013). As demonstrated above, the plain terms of section 41 provide clear and straightforward rules relating to the exclusion of all gross receipts associated with both Intra-Group Transactions and a foreign corporation's gross receipts not effectively connected with a US Trade or Business. Through the Proposed Rule, however, Treasury and the IRS violate both statutory mandates under the guise of addressing how these otherwise unambiguous statutory provisions interact. The Proposed Rule also would create ambiguity where none exists in the statute.

The Proposed Rule is based on an incorrect premise. As explained above, there currently is no conflict between sections 41(f)(1) and 41(c)(7) that needs to be harmonized. See, e.g., Procter & Gamble Co. & Subsidiaries v. United States, 733 F. Supp. 2d 857 (S.D. OH 2010) (holding that disregarding all intercompany transactions under section 41(f)(1) is proper and consistent with section 41(c)(7)). Each of sections 41(f)(1) and 41(c)(7) has independent significance. Each stands on its own. Each is part of a harmonious statutory framework that operates pursuant to the plain terms of the statute.

The Proposed Rule would not "harmonize" sections 41(f)(1) and 41(c)(7), but rather would circumvent both statutory provisions by including a portion of the very gross receipts that section 41(c)(7) expressly excludes from the computation of the R&D Credit through the inclusion of the very same Intra-Group Transactions that section 41(f)(1) is designed to disregard. On this ground alone, the Proposed Rule is per se contrary to the statute. Treasury and the IRS do not have the authority to read two provisions together in a way that eviscerates both, which is the precise effect of the Proposed Rule.

Ultimately, the Proposed Rule is nothing more than a transparent attempt by Treasury and the IRS to reject the express policy judgment made by Congress in favor of their own policy preferences. This is not permissible or warranted. If Congress had intended to produce the policy result preferred by Treasury and the IRS, it would have enacted specific statutory language to achieve that result in sections 41(f)(1) and 41(c)(7). Congress did not take this approach. Congress, in fact, did the opposite of what Treasury and the IRS seek to do with the Proposed Rule. Congress chose in section 41(f)(1) to treat all members of an affiliated group – including all foreign corporations in the group – as a single taxpayer, and did not create any exception to that rule. Congress certainly did not create an exception in section 41(c)(7), or elsewhere in section 41, relating to Intra-Group Transactions connected with an external transaction in which the foreign corporate member generates non-effectively connected gross receipts. Rather, Congress preserved and applied the more straightforward Single Taxpayer Rule that excluded <u>all</u> QREs and gross receipts arising from Intra-Group Transactions for purposes of computing the R&D Credit.

Similarly, Congress expressly chose in section 41(c)(7) the rule that non-effectively connected gross receipts of a foreign corporation shall not be "taken into account" in determining

the taxpayer's gross receipts, and did not create (or allow for) any exception to that rule. This rule not only excludes from gross receipts all income derived from sales by foreign corporate members that were not effectively connected with a US Trade or Business, but also precludes such gross receipts from otherwise being taken into account in determining the gross receipts of the taxpayer for purposes of computing the R&D Credit. Thus, Congress did not provide for any exception that might allow non-effectively connected gross receipts of a foreign corporation to be taken into account in determining whether, and to what extent, to include the gross receipts from Intra-Group Transactions connected with such foreign corporation's gross receipts. If Congress had adopted the policy choice advocated by Treasury and the IRS, the second sentence of section 41(c)(7) would have provided for such an exception. The statute, however, does not embrace or allow for that policy choice, and the plain language of the statute controls.

The Proposed Rule should not be adopted because it would establish a regulatory rule that is directly contrary to two statutory rules adopted by Congress. A regulation that is contrary to a statute's plain language is invalid and will not be given effect. Microsoft, 311 F.3d at 1189 ("Because we conclude that the statute clearly expresses Congress's intent, we do not defer to the conflicting regulation. . . . Moreover, because [the regulation] conflicts with the plain meaning of [the statute] the regulation is invalid."); Loving v. IRS, No. 13-5061, slip op. (D.C. Cir. Feb. 11, 2014) (affirming the permanent enjoinment of an IRS regulation when the interpretation reflected in the regulation was foreclosed by the statute).

The Proposed Rule is contrary to both sections 41(f)(1) and 41(c)(7). The Proposed Rule is contrary to section 41(f)(1) because it contravenes the Congressionally mandated requirement that members of a controlled group be treated as a single taxpayer for purposes of determining the R&D Credit. The sole purpose of the Proposed Rule is to include in such gross receipts the gross receipts of a domestic member of a controlled group with respect to Intra-Group Transactions with foreign members of the same group (i.e., transactions among members of the same taxpayer). Indeed, the Proposed Rule does precisely what the statute prohibits by requiring taxpayers to treat foreign corporations as separate and distinct from the single taxpayer and to include gross receipts arising from Intra-Group Transactions with such foreign corporations in the R&D Credit computation. The preamble to the Proposed Regulations and the Proposed Rule itself recognize that Intra-Group Transactions "are generally disregarded in determining the QREs and gross receipts of a member for purposes of the research credit," and characterize the Proposed Rule as an "exception." Notice of Proposed Rulemaking and Notice of Public Hearing regarding "Credit for Increasing Research Activities: Intra-Group Gross Receipts," 78 Fed. Reg. 75,905 (Dec. 13, 2013).

By recognizing that this new rule is an "exception" to the statutory mandate of section 41(f)(1), Treasury and the IRS concede that the Proposed Rule is inconsistent with, and contradicts, the plain language of section 41(f)(1). Id. Treasury and the IRS are not permitted to create their own "exception" to an unambiguous statute. Moreover, this exception is by no means a narrow exception, as represented by Treasury and the IRS. Virtually all Intra-Group Transactions with a foreign member of a controlled group will give rise to, or facilitate, an "external" transaction between that foreign member and an unrelated third party. Thus, the

Proposed Rule would include in gross receipts for purposes of the R&D Credit virtually all gross receipts of domestic members arising from Intra-Group Transactions with foreign members. By arbitrarily eliminating the Single Taxpayer Rule for such a broad group of Intra-Group Transactions, Treasury and the IRS effectively would eliminate in the vast majority of circumstances the single taxpayer treatment mandated by Congress. As a result, the Proposed Rule effectively writes section 41(f)(1) out of the Code as it is supposed to apply with respect to foreign corporations that are members of a controlled group.

This result is particularly egregious because the Proposed Rule would determine when, and to what extent, to invoke this violation of section 41(f)(1) by applying a rule that also is directly contrary to section 41(c)(7). Because gross receipts of a domestic corporation from an Intra-Group Transaction would be included in the taxpayer's gross receipts whenever the foreign member engages in a related external transaction that generates non-effectively connected gross receipts, such gross receipts of the foreign member necessarily are "taken into account" in the computation of the R&D Credit in violation of section 41(c)(7). Thus, whenever the Code does not operate to include the gross receipts of a foreign corporation in the taxpayer's gross receipts (because the gross receipts are not effectively connected with a US Trade or Business), the Proposed Rule would treat the foreign corporation as separate from the taxpayer and would include in the R&D Credit calculation the gross receipts of a domestic member from Intra-Group Transactions with that foreign member. As a result, the Proposed Rule has the ultimate effect of including foreign gross receipts that are not effectively connected with a US Trade or Business into the R&D Credit computation. Given that most Intra-Group Transactions give rise to gross receipts of the foreign member from an external transaction that are not effectively connected a US Trade or Business, the Proposed Rule is not a narrow exception to section 41(c)(7). It is an "exception" that literally swallows the rule. For many taxpayers, the Proposed Rule would have the effect of "tak[ing] into account" a substantial percentage of the foreign gross receipts that section 41(c)(7) was designed to exclude from the R&D Credit computation. This is directly contrary to the second sentence of section 41(c)(7) and would effectively read that provision out of the statute.

Ironically, the Proposed Rule would allow the operation of the statutory Single Taxpayer Rule in section 41(f)(1) with respect to a foreign member of a controlled group only when the gross receipts derived by that foreign member from an external transaction are effectively connected with a US Trade or Business. Otherwise, the Proposed Rule would ignore the statutory requirement to treat the foreign member as part of the same taxpayer as the domestic corporation in an Intra-Group Transaction, and would ignore the prohibition against taking into account the non-effectively connected gross receipts of the foreign corporation. Moreover, although the Proposed Rule is silent with respect to the treatment of Intra-Group Transactions between two foreign members of the group, an example in the Proposed Regulations apparently recognizes that it would be a violation of section 41(c)(7) to include in gross receipts the gross receipts of a foreign corporation with respect to an Intra-Group Transaction with another foreign member of the group. See Prop. Treas. Reg. § 1.41-6(i)(2)(iv), Example 3. For the same reason,

the operation of the Proposed Rule with respect to an Intra-Group Transaction between a domestic member and a foreign member also violates section 41(c)(7).

It is not necessary to develop hypotheticals to illustrate how the Proposed Rule is contrary to the statute because the examples in the Proposed Regulations already do so. Proposed Treasury Regulation section 1.41-6(i)(2)(iv), Example 1, is as follows:

> D and F are members of the same controlled group. D is a domestic corporation. F is a foreign corporation that is organized under the laws of Country. F does not conduct a trade or business within the United States, Puerto Rico, or any U.S. possession. In Year 1, D sells Product to F for $8x. In Year 2, F sells Product to F's unrelated customer for $10x. Because the Product that F sells outside the group is the same Product that was the subject of an internal transaction (i.e., the sale from D to F), and the $10x that F receives upon sale of Product outside the group is not effectively connected with a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States, the $8x that D receives from F is included in D's gross receipts for purposes of computing the amount of the group credit. The $8x of gross receipts is taken into account in Year 2, the year of the external transaction. See paragraph (i)(2) of this section. The $10x that F receives from F's customer is excluded from gross receipts under section 41(c)(7) because it is not effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

The total gross receipts to the controlled group in the example is $10x. These gross receipts were realized by F, a foreign corporation, in a sale that was not part of a US Trade or Business. Section 41(c)(7) clearly and unequivocally mandates that these gross receipts be excluded from the R&D Credit calculation, and must not otherwise be taken into account in that calculation. Yet, without any justification in the statute itself, the Proposed Rule improperly disregards the mandates of sections 41(f)(1) and 41(c)(7) and picks up 80% of the non-effectively connected receipts for purposes of the R&D Credit calculation. Under the Proposed Rule, F's gross receipts are directly "taken into account" in determining whether to include the "internal" gross receipts of another member, in direct violation of the unambiguous language of section 41(c)(7). Because F's gross receipts of $10x enter into the computation of the R&D Credit and are taken into account under the Proposed Rule, F is not treated as part of the single taxpayer (with D) as required by section 41(f)(1).

The plain language of sections 41(f)(1) and 41(c)(7) simply does not allow any room for this result. The only court that has addressed this issue rejected the position embodied in the Proposed Rule as contrary to section 41. See Procter & Gamble Co. & Subsidiaries v. United States, 733 F. Supp. 2d 857, 864 (S.D. Ohio 2010) (rejecting the position that Intra-Group Transactions with foreign subsidiaries should be included in gross receipts for purposes of the R&D Credit computation because the language of section 41(f)(1)(A) was plain and unambiguous and both QREs and gross receipts must be determined on a "single taxpayer"

basis). In that case, the court rejected the Commissioner's attempt to make arbitrary distinctions to include some intercompany transfers, but not others, and held that the plain terms of the statute "militate[] in favor of disregarding all forms of intercompany transfers from the Gross Receipts calculation." Id. at 865. The holding in Procter & Gamble further confirms that the statute is clear on its face and that the Proposed Rule is contrary to the plain terms of section 41. Indeed, the Proposed Rule seeks to achieve the same result advocated by the IRS, and rejected by the court, in Procter & Gamble. If the Proposed Rule had been part of the regulatory regime at the time of the litigation, the court would have disregarded the rule as an invalid rule for the same reason that it rejected the IRS litigating position – it is contrary to the plain language of the statute. 5 U.S.C. § 706(2)(A), (C), and (D); Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 34 (1983) (courts must set aside an agency rule or agency action if it is arbitrary or capricious in substance or contrary to the statute).

The statute is clear and unambiguous and there is no room to create the opposite result through administrative fiat because Treasury and the IRS "believe" that the line that Congress has drawn is "distortive." Congress has made the policy choice as to what is "distortive" in the R&D Credit computation and arrived at a policy choice far different from Treasury and the IRS. It is up to Congress, and not Treasury and the IRS, to change the statute to the extent that it deems it necessary. The Proposed Rule conflicts with the plain language of sections 41(f)(1) and 41(c)(7) and thus would be invalid if finalized. See, e.g., Procter & Gamble, 733 F. Supp. 2d 857 (2010). As a result, the Proposed Rule should be withdrawn.

B. Congress Intended to Disregard All Intra-Group Transactions in Computing the R&D Credit.

When the language of a statute is unambiguous, as is the case with the Single Taxpayer Rule in section 41(f)(1) and the rule relating to foreign corporations in section 41(c)(7), it is not necessary to resort to the legislative history of the statute to determine Congress's intent. United States v. Woods, No. 12-562, slip op. at 15 n.5 (U.S. Dec. 3, 2013). Nonetheless, the legislative history of section 41 confirms that Congress intended, through the language of the Single Taxpayer Rule, to require all transactions between members of a controlled group of corporations to be disregarded for purposes of calculating the group's R&D Credit.

In the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 241, Congress first enacted a tax credit to provide businesses an incentive to increase their private research and development activities. In its original form, the R&D Credit was based solely on the incremental increases in the QREs of the controlled group. The original statute established special rules for calculating the credit of a controlled group. Former section 44F(f)(1)(A)(i) provided that, in computing the credit, "all members of the same controlled group of corporations shall be treated as a single taxpayer." Accordingly, a taxpayer computed a single credit amount for the entire controlled group by aggregating the QREs of each member of the controlled group for the credit year (and reflecting any eliminations relating to intra-company transactions) and comparing that amount to the base period QREs (which generally covered the prior three years).

In the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110(b), 103 Stat. 2106, 2323-24 (the "1989 Act"), Congress changed the formula for calculating the R&D Credit to allow a credit only to the extent that a controlled group increased its research spending as a percentage of gross receipts. As revised by Congress, the R&D Credit was calculated (as it is today) based on both the QREs and the gross receipts of the controlled group. Notwithstanding the changes to the calculation of the R&D Credit in 1989, Congress maintained that the Single Taxpayer Rule applied to the entire R&D Credit calculation. Thus, after the change to incorporate gross receipts into the R&D Credit computation, the Single Taxpayer Rule continued to require (as it does today), without limitation, that "[i]n determining the amount of the credit . . . all members of the same controlled group of corporations shall be treated as a single taxpayer." Further, in the "Explanation of Provisions" section titled "Aggregation rules and changes in business ownership" of a House report related to the 1989 Act, Congress reaffirmed the Single Taxpayer Rule under the revised statue, and explained:

> The rules relating to aggregation of related persons and changes in business ownership are the same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

H.R. Rep. No. 101-247, at 1202-03 (1989).

That same House report shows the Congressional intent with respect to the interaction between the Single Taxpayer Rule in section 41(f)(1) and the rule relating to gross receipts of foreign corporations in section 41(c)(7). Specifically, the House report continues:

> In addition, . . . <u>a foreign affiliate's gross receipts which are not effectively connected with the conduct of a trade or business in the United States do not enter into the computation of the credit</u>.

<u>Id.</u> (Emphasis added.) It is apparent that in addition to the exclusion of Intra-Group Transactions under the Single Taxpayer Rule, Congress intended that the non-effectively connected gross receipts of foreign corporations should "not enter into the computation of the credit" in any manner.

Finally, when Congress extended the R&D Credit provisions in 1996 (and through other reenactments), Congress again reaffirmed, with great clarity, that the Single Taxpayer Rule applies to both QREs and gross receipts. Congress explained that "research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit [under the Single Taxpayer Rule]." S. Rep. No. 104-281, at 38-39 (1996).

Cont ary to the statement in the preamble to the Proposed Regulations that Congress did not make clear how the Single Taxpayer Rule in section 41(f)(1) and section 41(c)(7) should interact (see 78 Fed. Reg. 75,906), the legislative history confirms that Congress understood the interaction between these provisions and intended to treat a controlled group as a single taxpayer for purposes of calculating the group's entire R&D Credit, including QREs and gross receipts. Congress did not, however, intend to create any distinction between Intra-Group Transactions with domestic affiliates and Intra-Group Transactions with foreign affiliates. Rather than harmonize these rules, the Proposed Rule creates an unsupported exception to the plain language of the statute by including a portion of the gross receipts that section 41(c)(7) expressly excludes. The legislative history further confirms that the Proposed Rule is contrary to the purpose of the Single Taxpayer Rule and section 41(c)(7) because Congress intended that the Single Taxpayer Rule apply, as originally enacted, to the entire R&D Credit calculation and to exclude from such calculation a foreign affiliate's gross receipts which are not effectively connected with a US Trade or Business. The Proposed Rule is also contrary to the fundamental purpose of section 41 because it arbitrarily reduces the amount of the R&D Credit in certain circumstances and thereby interferes with the incentives that Congress intended under section 41. Because the Proposed Rule as written is contrary to section 41 and its purpose, it should be withdrawn.

C. The Proposed Rule's Application to Some, But Not All, Intra-Group Transactions is Arbitrary, Capricious, and Unreasonable.

1. The Proposed Rule Arbitrarily Produces Different Results for Some Intra-Group Transactions, But Not Others, Without Any Statutory Basis for Doing So.

Like the current Treasury regulations under section 41, Proposed Treasury Regulation section 1.41-6(i)(1) makes clear that all Intra-Group Transactions "are generally disregarded in determining the QREs and gross receipts of a member for purposes of the research credit." Proposed Treasury Regulation section 1.41-6(i)(2) would erect a new exception that covers only Intra-Group Transactions with a foreign corporate affiliate when the foreign corporate affiliate later engages in an external transaction and such transaction does not give rise to effectively connected income. The Proposed Rule thereby draws arbitrary lines as to when the Single Taxpayer Rule of section 41(f)(1) applies to disregard Intra-Group Transactions from the computation of the R&D Credit. These arbitrary lines are not permissible because they have no basis in the statute.

As explained above, the Single Taxpayer Rule applies a bright-line rule that excludes all Intra-Group Transactions for purposes of computing QREs and gross receipts. Instead of applying this blanket statutory prohibition, the Proposed Rule makes arbitrary distinctions between, *inter alia*, QREs and gross receipts and between domestic and international Intra-Group Transactions. Section 41(f)(1) (like section 41(c)(7)), however, does not provide any statutory basis for these distinctions. Indeed, these distinctions are not found within any provision of section 41.

Both domestic and foreign controlled corporations are treated as members of the same controlled group (and the same taxpayer) pursuant to the Single Taxpayer Rule and nothing in that rule distinguishes between Intra-Group Transactions involving foreign affiliates and Intra-Group Transactions involving solely domestic affiliates. Instead, the statute makes plain that all members of the same controlled group of corporations, whether foreign or domestic, are to be treated as a single taxpayer. The court addressed this issue in Procter & Gamble, 733 F. Supp. 2d at 865, and held that "[t]here is no basis for distinguishing, in the manner that the IRS attempts, between intercompany transactions with foreign subsidiaries and intercompany transactions with domestic subsidiaries." The court explained that the IRS's distinction "between domestic and international intercompany transfers appears arbitrary given the lack of statutory support for it, and militates in favor of disregarding all forms of intercompany transfers from the Gross Receipts calculation." Id.

Similarly, there is no statutory basis to apply the Single Taxpayer Rule of section 41(f)(1) differently to the computation of gross receipts in contrast to the computation of QREs. The court in Procter & Gamble, 733 F. Supp. 2d at 864, also addressed this issue and held that the Single Taxpayer Rule applies in the same way to the computation of gross receipts as it does to the computation of QREs.

2. By Circumventing the Prohibition on the Inclusion of "Intra-Group Transactions" Set Forth in Section 41(f)(1), It Is the Proposed Rule, Not the Statute, That Produces Arbitrary Distortions in the R&D Credit Computation.

The Proposed Rule is based on the premise that the exclusion of all Intra-Group Transactions from the computation of gross receipts creates a distortion in the R&D Credit computation. This premise is precisely backwards. By enacting the Single Taxpayer Rule of section 41(f)(1), Congress imposed a blanket prohibition on the inclusion of all Intra-Group Transactions for purposes of computing the R&D Credit to avoid improper distortions in the R&D Credit amount. By setting forth a clear, comprehensive rule that excludes all Intra-Group Transactions, Congress made a reasonable policy choice that ensures that QREs and gross receipts are untainted by Intra-Group Transactions. This ensures that gross receipts are based on the actual gross receipts of the controlled group with respect to third-party sales because taxpayers generally compute R&D budgets as a percentage of gross receipts.

As the court in Procter & Gamble, 733 F. Supp. 2d at 866, noted, the inclusion of receipts from Intra-Group Transactions in the gross receipts computation is contrary to the intent of Congress. The court explained:

> [T]he intent of the research credit is to reward research expenditures by measuring these expenditures against a relevant and determinate comparator: Gross Receipts. Including international intercompany transfers is inconsistent with this rationale because it would double count (at least) transactions which are merely administrative or legal in nature, thereby highlighting an irrelevant measurement.

> Businesses do not "determine their research budgets" as a percentage of intercompany sales receipts, and including intercompany transfers in the research tax credit would introduce a factor wholly unrelated both to research expenditure decisions and the credit's incentive effect.

Id. (Emphasis added.)

As the court notes, receipts relating to Intra-Group Transactions are "an irrelevant measurement" under section 41 because gross receipts are intended to be "a relevant and determinate comparator" and "including international intercompany transfers is inconsistent with [the intent of the R&D Credit]" because it "would introduce a factor wholly unrelated both to research expenditure decisions and the credit's incentive effect." Id. For these reasons, the exclusion of all Intra-Group Transactions is necessary to ensure the proper measurement of gross receipts and to prevent any distortions in the R&D Credit computation.

Thus, the alleged "distortion" that Treasury and the IRS highlight is illusory. It was a legitimate policy choice made by Congress to exclude all Intra-Group Transactions and all foreign gross receipts not effectively connected with a US Trade or Business. The preamble to the Proposed Regulations erroneously asserts that the situation in the following example distorts the aggregate amount of gross receipts for purposes of determining the R&D Credit:

> For example, assume that a domestic corporation incurs research expenditures and sells a product that it produced to a foreign corporate member, and the foreign corporate member then sells the product to a customer in a transaction that does not give rise to gross receipts effectively connected with a trade or business in the United States, the Commonwealth of Puerto Rico, or any possession of the United States. If gross receipts from the sales transactions are excluded because the intra-group transaction is disregarded under § 1.41-6 and the foreign corporate member's gross receipts are excluded under section 41(c)(7) for the second transaction, the aggregate amount of gross receipts for purposes of determining the research credit is distorted. The distortion results because the QREs of the domestic member are included, but its gross receipts from the sale to the foreign corporate member are not.

78 Fed. Reg. 75,905, 75,906 (Dec. 13, 2013).

Contrary to this assertion in the Preamble, the exclusion of a foreign affiliate's gross receipts from the R&D Credit calculation is undoubtedly appropriate because section 41(d)(4)(F) also excludes foreign research (i.e., any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States) from a taxpayer's QREs. Thus, Congress has effectively drawn a line at the United States borders and provided that QREs incurred outside of the United States and gross receipts of a foreign corporation that are not effectively connected with a US Trade or Business are excluded, without exceptions. Because

Congress has drawn this line, Treasury and the IRS must abide by it. If it is to be changed, it is up to Congress, not Treasury and the IRS.

Conversely, the Proposed Rule would create distortions in the R&D Credit computation that are not permitted or contemplated by the statute. The Proposed Rule fails to recognize that the line drawn by Congress cuts both ways. If the roles in the example from the preamble were reversed, such that the foreign affiliate incurred research expenditures outside the United States and then sold the product it produced to a domestic affiliate, which sold the product to a third party, the gross receipts from the domestic affiliate's sale would be taken into account in computing the R&D Credit, even though the research expenses incurred by the foreign affiliate would not. The Proposed Rule fails to address or even acknowledge this situation, which creates the potential for an arbitrary distortion in the gross receipts computation. Because the statute works both ways, any perceived distortive effect is not limited to situations in which a domestic affiliate provides a product or service to a foreign affiliate.

There are numerous scenarios in which the Proposed Rule would lead to anomalous results that are contrary to the statute and the intent of Congress. For example, it is a common business paradigm for a foreign corporation to develop intangible property and license it to a domestic affiliate, then the domestic affiliate manufactures products using the intangible property and sells the products to various foreign sales affiliates, which then sell the products to unrelated customers within their respective foreign jurisdictions. Under the statute, the intra-company gross receipts of the domestic affiliate's sales to the foreign affiliates, and the gross receipts from the sales by the foreign affiliates, would not be taken into account. But under the Proposed Rule, the domestic affiliate's gross receipts from sales to foreign affiliates would be included in the computation of the R&D Credit, contrary to the statute. And this result would obtain under the Proposed Rule even though the products were produced using intangible property developed by a foreign affiliate outside of the United States.

Another common business paradigm involves property manufactured outside of the United States that a foreign affiliate sells to a domestic affiliate for quality control testing or other minor modifications, after which the domestic affiliate sells the property to other foreign affiliates (or even back to the same foreign affiliate). In such a situation, the costs incurred by the domestic affiliate may be only a small fraction of the total cost (and value) of the product, but the entire amount of the gross receipts of the domestic affiliate, including the cost and value of the product attributable to the original manufacture of the product by the foreign affiliate, would be included in the R&D Credit computation under the Proposed Rule.

A similar anomaly would arise when a domestic affiliate sells raw materials to a foreign corporation, which then manufactures those materials into a finished product using technology developed by an entity other than the domestic affiliate. The foreign corporation then sells the finished product to its unrelated customers. In this routine scenario, the Proposed Rule again would include in the R&D Credit calculation the gross receipts relating to the domestic affiliate's sales of raw materials to the foreign corporation. There is no basis under the Code for including such gross receipts, without regard to the source of the technology used by the foreign affiliate to

manufacture the products that it sells to unrelated customers. While the statute does not purport to link the inclusion of gross receipts with the place where related intangible property was developed, it would be particularly egregious to include such gross receipts in the R&D Credit computation when there is no relationship of the finished product to any research and development activity in the United States.

Yet another example involves services performed by a domestic corporation for both its domestic and foreign affiliates, which the domestic and foreign affiliates then incorporate in whole or in part into products or services provided to their unrelated customers. In this typical fact pattern, the Proposed Rule would arbitrarily include the gross receipts relating to the services provided to foreign affiliates, but would exclude the gross receipts relating to the same services provided to domestic affiliates. Moreover, if a foreign corporation generated third party gross receipts relating to similar services that were effectively connected with a US Trade or Business, the domestic corporation's gross receipts from services to that foreign corporation would not be included in the gross receipts computation. Such arbitrary distinctions find no support in the statutory language or otherwise.

Finally, the following example further highlights the arbitrary distortion caused by the Proposed Rule. Assume that D, a domestic corporation, sells property, to F, a foreign corporate affiliate, for $20,000. F then sells the same property to a third party for $30,000. The $30,000 is excluded from gross receipts under section 41(c)(7) because it is not effectively connected with a US Trade or Business. In a separate transaction relating to separate property, F licenses intangible property to D for a royalty of $20,000. D then sublicenses the same intangible property to a third-party customer for $30,000. D and F both incur $10,000 of research expenses. D's research expenses constitute QREs, while F's research expenses constitute research outside of the United States and thus do not qualify as QREs under section 41.

	D	F
Qualified Research	10,000	
Foreign Research		10,000
Third-Party Gross Receipts	30,000	30,000
Intra-Group Revenue	20,000	20,000
Total Gross Receipts Under Proposed Rule	50,000	30,000
Total Gross Receipts Under Statute	30,000	30,000

The example illustrates that the total gross receipts becomes arbitrarily inflated under the Proposed Rule because the Proposed Rule operates to include foreign gross receipts in the computation of total gross receipts, but excludes related foreign research expenses in the computation of total QREs.

Moreover, the Proposed Rule's underlying, implicit premise is incorrect. Section 41 does not apply a statutory regime that requires taxpayers to trace gross receipts to any specific

research activity. Rather, the statute provides a rough equivalency by excluding both foreign research expenses and foreign gross receipts not effectively connected with a US Trade or Business from the R&D Credit calculation. The statute creates a bright-line rule that does not seek to align research expenditures with the gross receipts that are ultimately derived from transactions with third parties (it should be noted that the Proposed Rule also does not effectively match QREs to gross receipts despite its stated rationale for the rule). As long as taxpayers are consistent across the base and multiplier years in calculating the R&D Credit, no unusual or unintended distortion is created by the exclusion of a domestic affiliate's intra-group gross receipts from transactions with foreign affiliates that engage in transactions that generate non-effectively connected income.

The neutral and non-distortive nature of the statute, and its operation to both benefit and burden taxpayers in various scenarios, dispel the sole concern raised by Treasury and the IRS with respect to the interaction between the Single Taxpayer Rule and section 41(c)(7). Even if Treasury and the IRS remain concerned with the application of the Single Taxpayer Rule to Intra-Group Transactions with foreign affiliates, there is still no statutory basis for the creation of an exception that would distinguish between Intra-Group Transactions with foreign corporate affiliates that subsequently engage in transactions with third parties outside of the United States and Intra-Group Transactions with all other affiliates.

D. Treasury and the IRS Did Not Set Forth in the Preamble any Reasoned Explanation for the Premise of the Proposed Rule.

1. Treasury and the IRS Arbitrarily Changed Their Regulatory Position on Intra-Group Transactions Without Explanation of the Statutory Authority or Other Basis for That Change.

"Sudden and unexplained change [in an agency's position], see, e.g., Motor Vehicle Mfrs. Ass'n. of United States, Inc. v. State Farm Mut. Automobile Ins. Co., 463 U. S. 29, 46-57 (1983), or change that does not take account of legitimate reliance on prior interpretation, see, e.g., United States v. Pennsylvania Industrial Chemical Corp., 411 U.S. 655, 670-675 (1973); NLRB v. Bell Aerospace Co., 416 U.S. 267, 295 (1974), may be 'arbitrary, capricious [or] an abuse of discretion,' 5 U.S.C. § 706(2)(A)." Smiley v. Citibank (South Dakota), NA, 517 U.S. 735, 742 (1996). "Unexplained inconsistency is" a "reason for holding an interpretation to be an arbitrary and capricious change from agency practice under the Administrative Procedure Act." Nat'l Cable & Telecomms. Ass'n. v. Brand X Internet Sers., 545 U.S. 967, 981 (2005). Courts routinely invalidate agency rules on this basis. See, e.g., CBS Corp. v. FCC, 663 F.3d 122 (3d Cir. 2011) (vacating FCC rule due to agency's arbitrary and capricious departure from prior policy); Honeywell Int'l, Inc. v. NRC, 628 F.3d 568, 579 (D.C. Cir. 2010) (''An agency may change its policy only if it provides a reasoned analysis indicating that prior policies and standards are deliberately changed, not casually ignored.'') (internal quotation marks and citations omitted); Ramaprakash v. FAA, 346 F.3d 1121, 1124 (D.C. Cir. 2003) (an agency must "provide a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored") (internal quotation marks and citations omitted).

Since 1981, when Congress first enacted the R&D Credit, the statute has required that "all members of the same controlled group of corporations shall be treated as a single taxpayer." I.R.C. § 41(f)(1)(A)(i). Congress did not at any time thereafter change the scope of application of that Single Taxpayer Rule. In the introductory language to subsection (f), Congress provided that the rules in subsection (f) apply "[f]or purposes of this section" (emphasis added), and the introductory language to subparagraph (f)(1)(A) reiterates that the Single Taxpayer Rule applies "[i]n determining the amount of the credit under this section." (Emphasis added.) As previously described, Congress intended the Single Taxpayer Rule to apply to all parts of section 41 and not to apply selectively to only a few parts of section 41 in a narrow range of factual scenarios.

For more than 30 years Treasury and the IRS have maintained a consistent regulatory position with respect to Intra-Group Transactions. From 1983, when Treasury first promulgated regulations pertaining to the R&D Credit, until the present, the Treasury regulations under section 41 have set forth the general rule currently contained in Treasury Regulation section 1.41-6(i): "Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded." See Prop. Treas. Reg. § 1.44F-6(e), 48 Fed. Reg. 2798 (Jan. 21, 1983) (initially promulgated in final form at Treasury Regulation section 1.41-8(e) (1989) via T.D. 8251). The provision has been renumbered over time, but despite numerous other regulatory changes, it has never been substantively altered. See, e.g., Procter & Gamble, 733 F. Supp. 2d at 863 n.9.

The text and scope of section 41(f) did not change in 1989, when Congress added the provision currently contained in section 41(c)(7), which provides that, in the case of a foreign corporation, "only gross receipts which are effectively connected with" a US Trade or Business are included in gross receipts for purposes of section 41. And just as section 41(f) did not change, neither did the pertinent Treasury regulations under section 41.

For more than two decades, the IRS's interpretation of the statute and the regulation was consistent. In 2002, in Chief Counsel Advice (CCA 200233011) (the "2002 Chief Counsel Advice"), the IRS concluded that the taxpayer should exclude gross receipts relating to Intra-Group Transactions with its foreign subsidiaries (which generated gross receipts from sales to unrelated third parties that were not effectively connected with a US Trade or Business). The IRS specified that it did not see any conflict (or absence of "harmony") between the rules currently contained in sections 41(f)(1) and 41(c)(7).[4] In particular, the IRS recognized that Congress modified section 41 in 1989 and clarified that gross receipts derived from sales by foreign corporations (that were not effectively connected with a US Trade or Business) were not included in gross receipts for purposes of section 41. There was not (and is not) any lack of statutory clarity on the scope of this provision. The IRS said as much in the 2002 Chief Counsel Advice:

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[4] The 2002 CCA considered the statutory provision currently set forth in section 41(c)(7), which was at that time set forth in section 41(c)(6).

> Congress specifically indicated what gross receipts should be disregarded for purposes of determining the base amount under section 41(c) when it enacted section 41(c)(6). Section 41(c)(6) provides that in the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade or business within the United States. [Emphasis added.]

The 2002 Chief Counsel Advice did not rely on any "exception" to the Single Taxpayer Rule to reach a different result.

In 2006, in Chief Counsel Advice (CCA 200620023) (the "2006 Chief Counsel Advice"), which involved facts similar to the 2002 Chief Counsel Advice but did not reference that prior advice, the IRS reached a different conclusion without identifying any basis or otherwise explaining the rationale for, such change. In its statement of the "Undisputed Facts" of the case, the court in Procter & Gamble highlighted this same unexplained change in agency position. 733 F. Supp. 2d at 860, Undisputed Fact 7 ("the 2006 Chief Counsel Advice does not cite, or otherwise acknowledge, the 2002 Chief Counsel Advice—CCA 200233011"). Despite this clear judicial recognition of the unexplained change in agency position, and despite acknowledging that the IRS was aware of the unexplained change (described in footnote 1 of Procter & Gamble), Treasury and the IRS did not provide any reasoned explanation for this apparent change in the agency position.

At no point in the preamble to the Proposed Regulations do Treasury and the IRS explain, or even acknowledge, this change in position. Moreover, Treasury and the IRS do not explain:

a. How the unchanged statutory scheme under section 41 suddenly (after decades of statutory and regulatory consistency) necessitates a change in agency position.

b. How the Proposed Rule comports with the plain language of section 41(f)(1), which mandates that "all members of the same controlled group of corporations shall be treated as a single taxpayer."

c. How the Proposed Rule comports with the plain language of section 41(c)(7), which, in the case of foreign corporations, contains the sole amounts that are to be included in gross receipts (i.e., "only gross receipts which are effectively connected with the conduct of" a US Trade or Business). (Emphasis added.)

d. How sections 41(f)(1) and 41(c)(7) are not in harmony.

e. How the Proposed Rule is necessary to effectuate Congressional intent.

f. How, and on what statutory basis, Congress provided authority to Treasury and the IRS to promulgate regulations that include in gross receipts Intra-Group Transactions

with foreign affiliates in situations in which the foreign affiliates derive non-effectively connected income through sales of products to third parties.

g. What specific statutory language in section 41 they are interpreting (if any).

h. How that interpretation (if any) is consistent with the language of section 41.

i. How Congress provided any authority to make a policy change of the sort contemplated by the Proposed Rule.

j. Why the conclusion in the 2002 Chief Counsel Advice with respect to the interpretation of the rules currently set forth in sections 41(f)(1) and 41(c)(7) was incorrect.

k. Why the conclusion in the 2002 Chief Counsel Advice, that Intra-Group Transactions with foreign subsidiaries (that derive non-effectively connected income through sales of the products to third parties) should be excluded from gross receipts for purposes of section 41, was incorrect.

Treasury and the IRS must, at a minimum, answer these specific questions. Otherwise, their unexplained change in position will render the regulation invalid ab initio.

2. Treasury and the IRS Did Not Explain Either Their Authority to Issue the Proposed Rule or How the Statute Is Ambiguous.

A basic tenet of informal rulemaking under the Administrative Procedure Act is that the agency must provide notice of the legal authority under which the rule is imposed. 5 U.S.C. § 553(b)(2). In this respect, as described above, a key threshold question is whether Congress has granted to Treasury and the IRS the authority to make policy of the type reflected in the Proposed Rule. "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984).

Here, Congress has directly spoken to the precise question at issue – specifically, whether gross receipts derived from an Intra-Group Transaction that is followed by a transaction between a foreign corporate member and a party outside of the controlled group involving the same or a modified version of tangible or intangible property or services that was the subject of the Intra-Group Transaction should be included in gross receipts for purposes of section 41 when the transaction between the foreign corporate member and the party outside of the controlled group generate income that is not effectively connected with a US Trade or Business.

Through the complementary rules set forth in sections 41(f)(1) and 41(c)(7), Congress answered that precise question. Specifically, Congress made clear in section 41(f)(1) that the gross receipts derived from the Intra-Group Transaction are to be disregarded for purposes of determining the amount of the R&D Credit. And, in the case of the transaction between the foreign corporate party and the party outside of the controlled group, Congress made equally clear that "only gross receipts which are effectively connected with" a US Trade or Business are to be taken into account for purposes of determining gross receipts under section 41. I.R.C. § 41(c)(7) (emphasis added). Thus, because Congress has fully addressed the precise question at issue, Treasury and the IRS "must give effect to the unambiguously expressed intent of Congress."

The Proposed Rule, however, reflects an attempt to replace decades of statutory clarity with new regulatory ambiguity. For more than 30 years, the section 41 regulations did not reflect or recognize any ambiguity on the precise matter addressed by the Proposed Rule. In the preamble to the Proposed Rule, Treasury and the IRS attempted to create ambiguity where none exists. Specifically, they imagine that sections 41(f)(1) and 41(c)(7) are not in "harmony." Without support in section 41 or the legislative history thereunder, and contrary to pertinent case law, Treasury and the IRS concluded: "Congress, however, did not make clear how the two provisions should interact and did not provide any additional indication regarding the consequences of being treated as a single taxpayer, including when the deemed single taxpayer is comprised of both domestic and foreign controlled group members." 78 Fed. Reg. at 75,906 (Dec. 13, 2013).

Without articulating how the plain language of sections 41(f)(1) and 41(c)(7) compel their belief, Treasury and the IRS posit an ipse dixit "belie[f]" that "an interpretation of section 41(f)(1) that completely excludes gross receipts associated with certain transactions is inconsistent with Congressional intent." 78 Fed. Reg. at 75,906 (Dec. 13, 2013). In the Proposed Rule, Treasury and the IRS essentially attempt to circumvent the clear Congressional mandates that (i) Intra-Group Transactions are disregarded and (ii) income from sales by foreign corporate members of a controlled group to parties outside of the group are included in gross receipts only if the income derived is effectively connected with a US Trade or Business. That is, the Proposed Rule attempts to include in gross receipts income that (i) is derived from Intra-Group Transactions and (ii) is not effectively connected with a US Trade or Business. The unsupported, unexplained, ipse dixit belief of Treasury and the IRS is not sufficient to override the plain language of section 41 and the unambiguous intent of Congress.

The best indicator of Congressional intent is the plain language of the statute. United States v. Am. Trucking Ass'ns, 310 U.S. 534, 543 (1940) ("There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation."). In section 41, Congress has fully established the policies of excluding Intra-Group Transactions from gross receipts and excluding from gross receipts income that is not effectively connected with a US Trade or Business.

As such, the Proposed Rule reflects a change in the position of Treasury and the IRS, and not a change in Congressional policy. As described above, there is no room for Treasury and the IRS to make any contrary policy choice. Treasury and the IRS did not (and likely could not) explain how the Proposed Rule followed from and was consistent with the plain language of sections 41(f)(1) and 41(c)(7). Moreover, in the Proposed Rule, Treasury and the IRS did not interpret any statutory language, and they did not explain which statutory language they purported to interpret.

Treasury and the IRS posit in the preamble to the Proposed Rule that they "believe that the single taxpayer concept should be interpreted consistently with the purpose the statute is intended to advance." 78 Fed. Reg. 75,905 (Dec. 13, 2013). As described above, the purpose of section 41 is to create an incentive to encourage taxpayers to increase their research and development activities. Treasury and the IRS, however, invoke a statutory purpose that is at odds with the plain language of section 41 and its fundamental purpose. They do so by hypothesizing a "distortion" that arises in a scenario in which a domestic corporation incurs research expenditures and then sells a product to a foreign corporate member, which in turn sells the product to a customer in a transaction that does not give rise to gross receipts effectively connected with a US Trade or Business. Notably, Treasury and the IRS did not (and could not) explain the basis for their unsupported belief by reference to any statutory text, any legislative history, or the overall legislative scheme. Instead, they imagine a distortion based on their own position – which is wholly at odds with the Congressional policy embodied in the statutory text, the legislative history, the statutory scheme, and the holding of the only court to address the matter. Accordingly, Treasury and the IRS fail to explain (i) the legislative basis for their unsupported belief, and (ii) how their position is consistent with the actual policy of the statute.

Ultimately, the "distortion" and lack of "harmony" that Treasury and the IRS imagine do not exist and do not have any basis in the text, context, structure, purpose, or history of section 41. By ignoring the plain language of the statute, and by failing to explain their departure from the plain language of section 41 and the fundamental purpose of the statute, Treasury and the IRS highlight the arbitrariness of the Proposed Rule. Treasury and the IRS should recognize that the Proposed Rule is arbitrary and withdraw it.

E. The Proposed Rule Would Introduce Unnecessary Ambiguity and Would Lead to More Disputes, Rather than Resolving any Open Questions.

The Proposed Rule would generate ambiguity where none exists now, and would create even more tension and disputes between taxpayers and the IRS with respect to the R&D Credit than exists to date. The Proposed Rule will introduce questions as to whether a transaction between a foreign affiliate and an unrelated third party involves "the same or a modified version of tangible or intangible property or a service that was previously the subject of one or more intra-group transactions." If the foreign affiliate purchases raw materials or a component from a domestic affiliate and incorporates it into a finished product, does the finished product involve "the same or a modified version" of the raw materials or component? If the foreign affiliate uses intangible property licensed from a domestic affiliate to produce a product that it sells, is the

tangible property a "modified version" of the intangible property licensed in the Intra-Group Transaction? Numerous other similar issues would further complicate, rather than simplify, IRS audits relating to the R&D Credit.

Similarly, the Proposed Rule would introduce complexities as to the timing of inclusion of certain gross receipts, and would require tracing of external transactions back to the relevant internal transactions. It frequently is not easy to determine when a particular material, part, component, intangible, or service acquired from a domestic affiliate was incorporated into a finished product that a foreign corporation sold to unrelated customers. Taxpayers would be obliged to develop means to trace and link external transactions with specific internal transactions in order to effectuate the timing provision of the Proposed Rule. This would create added complexity and potential for disputes, without enhancing the operation of the statute.

Finally, the Proposed Rule would create a myriad of issues and complexities relating to the determination of gross receipts with respect to the base period. Based on the consistency requirement, taxpayers would be obliged to redetermine their gross receipts for all base period years using the anomalous Proposed Rule. This would lead to further uncertainty and issues relating to data and information gaps, and certainly would proliferate the disputes associated with the Proposed Rule. The preamble to the Proposed Regulations acknowledges this troubling aspect of the Proposed Rule, including the "unique burden" on taxpayers that lack records necessary to apply the Proposed Rule. The preamble suggests that the Proposed Regulations are intended merely to capture "some measure of intra-group gross receipts," but the Proposed Regulations and the related preamble are silent as to what constitutes "some measure" and how the IRS will apply the Proposed Rule to base periods. Most likely, there will be rampant disputes between taxpayers and the IRS regarding the computation of intra-group gross receipts under the Proposed Rule, particularly when there are uncertainties or ambiguities in the data that is available to render such computations.

While the preamble invites taxpayers to comment regarding the need for a rule or safe harbor in applying the consistency rule in connection with the Proposed Rule, there is no compelling reason for taxpayers to devote time and effort to develop any such a rule or safe harbor because the underlying Proposed Rule is contrary to the statute and Congressional intent. Instead, Treasury and the IRS should mitigate the waste of time and energy with the many disputes that would arise from the ambiguities of the Proposed Rule by withdrawing the Proposed Regulations and allowing the unambiguous statute to apply as it has for many years.

IV. CONCLUSION.

The Proposed Regulations should be withdrawn.

Respectfully submitted,

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