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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Steven A. Musher
Branch Chief, CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum dated June 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

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Amount A	=
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Assembly	=
City A	=
Component 1	=
Component 2	=
Continent A	=
Contractor X	=
Country A	=
Country B	=
Country C	=
Country D	=
Date 1	=
Date 2	=
FSub	=
Industry X	=
Product Y	=
Product Z	=
Product Line 1	=
Product Line 2	=
Product Line 3	=
Product Line 4	=
State A	=
Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=
Test	=
USCorp	=
USGroup	=

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =

ISSUES:

1. Which section 482 Treasury Regulations govern the buy-in payment for Taxable Year 3 with regard to USGroup's Date 2 cost sharing arrangement.

2. Whether the buy-in payment from FSub to USGroup must be computed as a lump sum or as a royalty.

3. If the buy-in payment must be computed as a royalty, must a net present value of the intangibles nevertheless be estimated for that purpose as of the date of entry into the cost sharing arrangement.

4. If the buy-in payment must be computed as a royalty, over what period of time must the royalty extend.

CONCLUSIONS:

1. The 1994 final section 482 regulations, in particular Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6, govern the buy-in payment for Taxable Year 3.

2. The buy-in payment for Taxable Year 3 should be determined in the form of a royalty. The amount of such royalty for Taxable Year 3 is subject to adjustment in accordance with the section 482 regulations.

3. There is no general requirement that a transfer pricing methodology for determining a buy-in payment in relation to a given taxable year must estimate a net present value of the relevant intangibles. It is for Examination to determine, under the best method rule, which among competing applications of potential transfer pricing methodologies for computing the buy-in payment provides the most reliable measure of an arm's length result. Treas. Reg. § 1.482-1(c)(1). Any inconsistency of taxpayer's reported results with available market evidence of the present value of the intangibles is a

factor that should be taken into account in the best method analysis. See Treas. Reg. § 1.482-1(c)(2)(iii). This advice discusses some considerations which may tend to support Examination's conclusion that the purported application of the residual profit method under taxpayer's section 6662(e) penalty documentation does not provide as reliable a measure of an arm's length result as the transfer pricing methodologies that Examination is exploring as either primary, alternative, or confirming bases of proposed adjustments relating to the buy-in payment for Taxable Year 3.

4. The buy-in payment for Taxable Year 3 should generally be computed as what would be the royalty for such year in a stream of commensurate with income royalties, determined as of such year, extending over the remaining useful life of the Existing Technology and Work-In-Process Technology.

FACTS:

A. Background

USCorp is a publicly-held State A corporation headquartered in City A, State A, that is the common parent of USGroup, an affiliated group filing consolidated income tax returns. Since Year 1, USGroup has designed Product Y and Product Z, core components of Industry X technology. Product Y is a subcomponent of Product Z. USGroup operates worldwide through a number of wholly-owned foreign subsidiaries and foreign branches.

In Year 2, USGroup established FSub, a Country A corporation, which processes third party-manufactured Product Z and ships the processed Product Z to USGroup. In Year 3, FSub began manufacturing Product Z for USGroup.

1. USGroup - FSub Relationship Prior to the Date 2 Cost Sharing Agreement

Between Year 2 and Date 1, USGroup designed Product Y and Product Z. USGroup would then contract with Contractor X, an unrelated third party, to manufacture Component 1, which is a beginning stage component of Product Y. After Contractor X manufactured Component 1, either Contractor X or USGroup would Test Component 1.

After Component 1 was Tested, it was sent to an unrelated third party for Assembly. The final output was Product Y. The unrelated third party then sent Product Y to either USGroup or FSub for final testing.

If FSub performed the final testing, it was done on a consignment basis. Once FSub completed the final testing, FSub either attached Product Y to Component 2 to make Product Z that it had manufactured for USGroup, and then sent Product Z to original equipment manufacturers other customers such as wholesalers. Alternatively, FSub sent only Product Y to customers. In the former case, title in Product Y was transferred from USGroup to FSub at cost, FSub then resold the final Product Z to USGroup at cost plus profit, and USGroup subsequently sold Product Z to the customers. In the latter case where FSub sent only Product Y to customers, title in Product Y remained with USGroup.

After Date 1, Contractor X began to Test some Component 1 that it had manufactured for USGroup and FSub. Contractor X then sent the Tested Component 1 to a third party, who assembled Component 1 into Product Y. At this point, USGroup no longer held title to Product Y, and FSub bought Product Y from the third party to perform testing. FSub then either: sold Product Y directly to customers; sold Product Y to USGroup, which in turn resold Product Y to customers; or retained Product Y for use in final products manufactured at its site in Country A. For Taxable Year 3, which includes Date 2, A% of Product Y to which FSub took title was sold directly to USGroup, whereas FSub sold the remaining B% to other entities.

2. USGroup - FSub Relationship After Date 2 Cost Sharing Agreement

On Date 2, a date after Year 3 but prior to January 1, 1996, USCorp and FSub entered into a cost sharing arrangement governing research and development of Industry X technology. The cost sharing arrangement was effective for the last Q months of USGroup's Taxable Year 3. USGroup stated in its section 6662(e) penalty documentation for Taxable Year 3[1] that research and development is "fundamental to [its worldwide operations] success." USGroup has a number of research and development centers in the United States which employ over L engineers total. Approximately I% of USGroup's employees worldwide engage in research and development. During Taxable Years 1, 2 and 3, USGroup spent $ Amount A (J% of net sales), $ Amount B (K% of net sales) and $ Amount C (K% of net sales), respectively, on research and development activities worldwide. Additionally, FSub maintained a development center in Country A since Year 6, a year prior to Date 2. In Taxable Year 3, this development center employed

[1] We have been provided with what appears to be the principal documents (or a part thereof) prepared by the taxpayer for Taxable Year 3. See Treas. Reg. § 1.6662-6(2)(iii)(B).

approximately M employees to focus on several areas of research and development.

On Date 2, the legal relationship between USGroup and FSub was memorialized in several agreements, including a Technology License Agreement ("License Agreement"), a Technology Research and Cost Sharing Agreement ("CSA"), a Trademark License Agreement ("Trademark Agreement") and a Corporate Agreement. This advice focuses mainly on the License Agreement and CSA, which covered three categories of technology: Existing Technology, Work-In-Process Technology and Developed Technology. The License Agreement covered "Existing Technology" (intangible property in existence as of Date 2 that related to or may have related to products in existence as of Date 2), whereas the CSA treated the sharing of the costs of development of the Developed Technology (intangible property that did not exist as of Date 2, and that was developed pursuant to the cost sharing arrangement) and, in that connection, addressed the buy-in for "Work-In-Process Technology" (intangible property contributed to the cost sharing arrangement by USCorp which existed as of Date 2, and related or may have related to products which did not yet exist as of Date 2). The consideration for Existing Technology and Work-In-Process Technology under the License Agreement and the CSA, respectively, were structured as two-year declining royalties payable from FSub to USCorp.[2]

a. License Agreement

The purpose of the Date 2 License Agreement between USCorp and FSub was to facilitate USCorp's license of certain rights to "Existing Technology" to FSub, thus permitting FSub to manufacture, assemble and sell "Licensed Products" which incorporated Existing Technology. USCorp granted FSub a "nonexclusive license to use Existing Technology for the sole purpose of manufacturing, testing, assembling, using, selling and marketing the Licensed Products anywhere in the world." License Agreement, § 2.1.

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[2] This advice uses the term "buy-in payment" to refer both to the consideration for Existing Technology and Work-In-Process Technology. Use of this terminology, however, is unrelated to whether Examination may decide to propose separate adjustments for Existing Technology and Work-In-Process Technology. Additionally, we note that although the taxpayer structured its legal agreements separately with "License Fees" for Existing Technology and "Buy-In Royalties" for Work-In-Process Technology, its application of the residual profit split method in its Taxable Year 3 section 6662(e) penalty documentation does not appear to distinguish between Existing Technology and Work-In-Process Technology. See infra Issue 3.

Although "Existing Technology" was not defined in the License Agreement, it was defined in the CSA as

> [A]ny and all patents, copyrights, trade secrets, and similar intellectual property rights (including without limitation any patent applications pending thereto), and any Know-How, which exist as of [Date 2] and which relate or may relate to the manufacturing, assembling or testing of products existing as of [Date 2] (the Existing Products) . . . [3]

CSA, § 1.6. Pursuant to the License Agreement, "Licensed Products" meant "those specific Existing Products which are listed on [an exhibit attached to the License Agreement], and other products which might be added to the list from time to time by [USCorp and FSub]." License Agreement, § 1.2.

The License Agreement was effective for two years from Date 2, provided the CSA remained in effect, and was automatically renewed annually thereafter unless USCorp or FSub gave thirty days written notice of intent to terminate the License Agreement. License Agreement, § 5.1.[4] Additionally, FSub acknowledged that USCorp owned all Existing Technology and value associated with it, and that "[a]ll rights to Existing Technology not expressly or explicitly granted by USCorp to FSub

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[3] "Existing Products" referred to in the CSA are apparently the "Licensed Products" listed in an exhibit to the License Agreement. There are approximately N Existing Products licensed by USCorp to FSub. When combined with the O Work-In-Process technology projects contributed by USCorp to the CSA, this effectively constitutes a transfer of G% of USCorp's preexisting technology.

Additionally, we note that although the CSA and License Agreement both contain a clause explaining that each agreement constitutes the entire and exclusive agreement between the parties on the respective subject matters, the CSA and License Agreement cross reference each other in various sections, as noted above.

[4] Examination has learned that both the License Agreement and the CSA were renewed at least once upon the expiration of the initial two year term. Although the buy-in royalty rates for both the License Agreement and the CSA were decreased in the respective renewals, additional information about the methodology used to establish arm's length royalty rates for the additional years has not been otherwise obtained or reviewed.

in [the] License Agreement are expressly reserved to USCorp . . . " License Agreement, §§ 3.1 and 2.3.[5]

In consideration for the license of rights to Existing Technology, FSub agreed to pay USCorp a fee "equal to a percent[age] of FSub's Product Line Gross Revenues . . . " License Agreement, § 4.1.[6] Product Line Gross Revenues included intercompany transfer pricing, i.e., sales from FSub to USGroup, as well as third party sales. There were four Product Lines for which gross revenue percentages were determined for Year 4 and Year 5, the first two years of the CSA and License Agreement. The license fees specified in the License Agreement as a percentage of product line gross revenues were as follows: for Product Line 1, C% of FSub's Product Line Gross Revenues in Year 4, declining to D% in Year 5; for Product Line 2, C% of FSub's Product Line Gross Revenues in Year 4, declining to D% in Year 5; for Product Line 3, E% of FSub's Product Line Gross Revenues in Year 4, declining to F% in Year 5; for Product Line 4, D% of FSub's Product Line Gross Revenues in Year 4, declining to E% in Year 5. The License Agreement did not provide license fee percentages for years subsequent to Year 4 and Year 5.

b. CSA

On Date 2, USCorp and FSub entered into a two year cost sharing arrangement because they

> [C]onsider[ed] it beneficial that certain research and development activities concerning technology to be developed and incorporated in

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[5] FSub was given the right to grant a license or sublicense of its rights to use Existing Technology to third parties, contingent upon approval and consent of USCorp. License Agreement, § 2.2.

[6] "Product Line Gross Revenues" was defined as,

> [A]ll gross revenues accrued by FSub from the sale, lease or license of any Licensed Product within a specific Product Line, less sale or use, VAT, GST or similar taxes imposed on sales, transportation and insurance charges billed separately to customers, and credits, allowances and returns granted to customers in the fiscal quarter to which such credits, discounts, allowances or returns are actually allowed or granted.

License Agreement, § 1.3. "Product Lines" were groups of products divided by type, function, use or other criteria agreed upon by USCorp and FSub. License Agreement, § 1.4.

> [Industry X products] be conducted by [both parties] for the benefit of each party . . . [And] to pool their respective resources for the purpose of conducting research and development concerning such products by sharing the risks and costs of such research and development activities . . .

CSA, Recitals. The CSA was effective for two years beginning on Date 2, and automatically was renewed annually thereafter unless either USCorp or FSub gave thirty days written notice of intent to terminate the CSA. CSA, § 10.1. Upon termination of the CSA due to a breach by FSub, a buy-out payment was required based on the appraised values of the Developed Technology and the Work-In-Process Technology. Section 10.6(a) provided the following:

> [A]ll rights owned by [FSub] in the Work-In-Process Technology or in the Developed Technology as of the date of Termination and any beneficial ownership of any rights pertaining to the Developed Technology held by [FSub] hereunder shall be subject to a reasonable buy-out fee for [FSub's] rights both in the Work-In-Process Technology and in the Developed Technology, in an amount to be based on the appraised values of the Developed Technology and of the Work-In-Process Technology, and on [FSub's] total Cost Share under this [CSA], including the Buy-In Royalties paid by [FSub].

CSA, § 10.6(a). In the event of termination of the CSA pursuant to other circumstances,

> USCorp and FSub may decide to enter into a reasonable mutual buy-out agreement pursuant to which either Party may buy out the rights in the Work-In-Process Technology and/or in the Developed Technology of the other Party, or both, for a fee in an amount to be based on the appraised values of the Developed Technology and of the Work-In-Process Technology, and on the selling Party's total Cost Share under this [CSA], including any Buy-In Royalties paid by the Parties.

CSA, § 10.6(b).

All research and development activities, termed "Research Program," were identified and administered by a Cost Sharing Committee comprised of representatives from USCorp and FSub. CSA, § 2. USCorp and FSub agreed to share the costs of the Research Program "in accordance with the reasonably anticipated benefits to be derived by each . . . from selling Developed

Products[7] within Product Lines." CSA, § 3.2. Additionally, USCorp and FSub determined that the most reliable measure of reasonably anticipated benefits to be derived from the cost sharing arrangement for the purpose of sharing costs was the relative gross profit of each party derived from the sale of Developed Products. Id. USCorp and FSub agreed to share costs of research and development on an E% and G% basis, respectively. CSA, § 3.3.

The CSA included a provision that permitted the Cost Sharing Committee to review and determine adjustments to the E% and G% cost sharing ratio, respectively. CSA, § 3.4. Such periodic adjustments were permitted

> From time-to-time and at least annually . . . . If it is determined by the Cost Sharing Committee that a modification of the Cost Sharing Ratio is appropriate in order to ensure that the Cost Sharing Ratio accurately reflects the benefits each Party derives from using Developed Technology, the Parties will negotiate with each other in good faith to modify the Cost Sharing Ratio on a prospective basis.

CSA, § 3.4.

1. Rights and Ownership of Developed Technology and Work-In-Process Technology

Pursuant to the terms of the CSA, USCorp was the owner of Existing Technology (as covered by the License Agreement, supra) and "Work-In-Process Technology" which was to be used as the basis for developing the "Developed Technology." Specifically, the CSA stated,

> USCorp is the owner of certain Work-In-Process Technology being developed in connection with the manufacturing, assembling, testing, promotion and distribution of future [Industry X products], and both USCorp and FSub agree that this Work-In-Process Technology should be used as the basis for further developing the Developed Technology . . .

CSA, Recitals.

"Work-In-Process Technology," identified in an exhibit attached to the CSA, meant

[7] "Developed Products" were defined as products utilizing or incorporating Developed Technology. CSA, § 1.5.

> [A]ny and all patents, copyrights, trade secrets, and similar intellectual property rights (including without limitation any patent applications pertaining thereto) and any know-how [sic] which exists as of [Date 2], but which relate or may relate to the manufacturing, assembling or testing of products which do not exist as of [Date 2] . . .

CSA, § 1.16. Whereas FSub made a buy-in payment (in the form of declining royalties) for the Existing Technology pursuant to the terms of the License Agreement, FSub also agreed to pay USCorp Buy-In Royalties[8] under the CSA in an amount equal to percentages of FSub's "New Product Line Gross Revenues," which were based on the sale, lease or license of products that did not exist as of Date 2, and which incorporated Work-In-Process Technology or Developed Technology ("New Products"). CSA, §§ 3.1, 1.9, and 1.8. The buy-in royalties specified in the CSA as a percentage of New Product Line Gross Revenues were as follows: for Product Line 1, C% of FSub's Product Line Gross Revenues in Year 4, declining to D% in Year 5; for Product Line 2, C% of FSub's Product Line Gross Revenues in Year 4, declining to D% in Year 5; for Product Line 3, E% of FSub's Product Line Gross Revenues in Year 4, declining to F% in Year 5; for Product Line 4, D% of FSub's Product Line Gross Revenues in Year 4, declining to E% in Year 5.

"Developed Technology" was defined as

> [A]ny and all patents, copyrights, trade secrets, and similar intellectual property rights (including, without limitation, any patent applications pertaining thereto) and any know-how [sic] which does not exist as of [Date 2], which relate or may relate to the manufacturing, assembling or testing of products which do not exist as of the [Date 2] and were developed in the Research Program.

CSA, § 1.5.

USCorp was the beneficial owner and retained the exclusive rights to manufacture, have manufactured, assemble and test, and have assembled and tested Developed Products and products incorporating Work-In-Process Technology in North America. CSA, §§ 5.1(a) and 5.2(a). FSub retained the exclusive rights to manufacture, have manufactured, assemble and test, and have assembled and tested Developed Products and products incorporating Work-In-Process Technology outside North America. CSA, §§ 5.1(b) and 5.2(b). With reference to the division of selling and use rights, both USCorp and FSub were

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[8] Neither the CSA nor License Agreement define "Buy-In Royalties."

> [T]he beneficial owner[s] of the perpetual and non-exclusive right to sell Developed Products and products incorporating Work-In-Process Technology worldwide, and the right to use any of the Developed Technology and Work-In-Process Technology worldwide.

CSA, §§ 5.3(a) and (b).[9] Both USCorp and FSub retained the right to license any rights to Developed Technology or Work-In-Process Technology without consultation or approval of the other party. CSA, § 5.7.

2. Legal Title to and Protection of Developed Technology and Work-In-Process Technology

USCorp retained bare legal title to the Developed and Work-In-Process Technology because it was best able to protect intellectual property rights associated with the technologies. CSA, § 5.5. Additionally, USCorp was required to perform all actions and incur all costs necessary to protect the Developed Technology and Work-In-Process Technology in any jurisdiction worldwide. CSA, § 5.6. Such costs incurred by USCorp were to be shared by USCorp and FSub based on the E% and G% cost share ratio, respectively. Id.

c. Trademark License Agreement

On Date 2, USCorp and FSub entered into a Trademark License Agreement ("Trademark Agreement"), pursuant to which USCorp licensed certain "Existing [USCorp] Trademarks" to FSub, enabling FSub to manufacture, assemble, test and sell Licensed and Developed Products or products incorporating Work-In-Process Technology anywhere in the world by using the "Licensed Trademarks." Trademark Agreement, Recitals and § 2.1. "Existing [USCorp] Trademarks" was defined to mean,

> [A]ll trade names, trademarks, service marks, logos, trade dress and other trade designations adopted and owned exclusively by [USCorp] prior to [Date 2].

Trademark Agreement, § 1.1. "Licensed Trademarks" meant Existing [USCorp] Trademarks and any other trademarks added to the list by USCorp and FSub.

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[9] We note that FSub's worldwide use rights, described in CSA section 5.3, imply a right to use Developed Technology and Work-In-Process Technology worldwide, which is in apparent contradiction to USCorp's exclusive right to manufacture Developed Products and products incorporating Work-In-Process Technology in North America.

Trademark Agreement, § 1.3. Pursuant to the Trademark Agreement, USCorp retained ownership of and goodwill associated with the Licensed Trademarks. Trademark Agreement, § 3.1. In consideration of the grant of the license, FSub agreed to pay USCorp H% of its “Third-party Gross Revenues,” meaning any gross revenues accrued by FSub from the sale, lease or license of any product incorporating a Licensed Trademark to any party other than USCorp. Trademark Agreement, § 1.2. The initial term of the Trademark Agreement was two years from Date 2, provided that the CSA remained in effect, and was automatically renewed for additional one year terms thereafter, unless either USCorp or FSub provided thirty days written notice of intent to terminate the agreement. Trademark Agreement, § 5.1.

d. Corporate Agreement

The Date 2 Corporate Agreement between USGroup and FSub governed USGroup’s purchase of products that were manufactured, finished, tested, packaged and shipped by FSub to USGroup; FSub’s ability to provide certain logistical services[10] to USGroup throughout the “Service Territory;[11] and USGroup’s ability to provide Support Services[12] to FSub throughout the “Service Territory.” Corporate Agreement, Recitals. With reference to the pricing of products purchased by USGroup from FSub, prices were “based on an arms-length [sic] basis in compliance with the regulations under Section 482 of the Internal Revenue Code . . . . ” Corporate Agreement, § 3.2. Service fees were accrued for services provided by USGroup to FSub, and by FSub to USGroup, and were computed as

[10] FSub was responsible for providing the following services to USGroup: assisting with distribution, marketing, selling and servicing of USGroup’s Products in Country A; coordination of activities with third party distributors and sales representatives, direct sales coverage for USGroup’s major customers in Country A; providing marketing support and training for USGroup’s third party distributors and sales representatives; participation in trade shows and exhibitions; business planning and product demand “forecasting” in Country A. Corporate Agreement, Exhibit D.

[11] “Service Territory” was defined to mean “All of Continent A except Country B including Country C and Country D.” Corporate Agreement, Exhibits A and D.

[12] “Support Services” provided by USGroup to FSub were mainly financial management, and included the following: cash management, investment management, risk management, advice regarding insurance coverage for business risks, Management Information services and support, the power to deposit or withdraw FSub funds to meet obligations incurred by FSub. Corporate Agreement, Exhibit A.

costs incurred in provision of the services without mark-up. Corporate Agreement, Exhibits A and D.

The initial period of the Corporate Agreement was for two years from Date 2, and was automatically renewable for two year terms thereafter, unless either USGroup or FSub gave written notice of intent to terminate. Corporate Agreement, § 11.1. The term of the Corporate Agreement was not contingent upon the effectiveness of the CSA, unlike the License and Trademark Agreements.

B. Examination of the Buy-In Payment for USGroup's Taxable Year 3

USGroup's Taxable Years 1, 2 and 3 are currently under examination. Examination does not seek advice on issues relating to Taxable Years 1 and 2. Taxable Year 3, the first year for which the cost sharing arrangement was effective, is the subject of this advice.

Following its review of USGroup's cost sharing documentation, Examination preliminarily proposed a \$ Amount D adjustment for USGroup's Taxable Year 3 with regard to the buy-in payment for Work-In-Process Technology based on a significant undervaluation of the technology which USGroup made available to FSub via the CSA.[13] Examination has determined that USGroup did not receive adequate compensation in Taxable Year 3 for Existing Technology and Work-In-Process Technology contributed to the cost sharing arrangement in light of their net present values as of the Date 2 effective dates for the License Agreement and CSA. Additionally, Examination inquires regarding the appropriate period of time over which to consider adjustments for the buy-in payments in Taxable Year 3 and subsequent years, since USGroup has structured its CSA and License Agreement with FSub as open-ended agreements, and has failed to provide information on the useful life of Existing Technology and Work-In-Process Technology.

[13] In its transfer pricing adjustments, Examination valued the Work-In-Process Technology as of the time of the buy-in payment at \$ Amount E. The preliminary proposed adjustments spread this valuation over P months, which in the absence of information from USGroup, is deemed to be the useful life of the Existing Technology and Work-In-Process Technology governed by the License Agreement and CSA, respectively. \$ Amount D represents the preliminary proposed adjustment for Taxable Year 3 given the number of months during which the CSA was effective. Examination also proposed a separate transfer pricing adjustment for Taxable Year 3 related to Existing Technology transferred pursuant to the Date 2 License Agreement in the amount of \$ Amount F.

Below, we provide a brief description of the transfer pricing methodology employed by USGroup regarding the buy-in payment,[14] as well as a brief discussion of methodologies which Examination is considering as either primary, alternative, or confirming bases of proposed adjustments relating to the buy-in payment for Taxable Year 3.

1. USGroup's Transfer Pricing Methodology Regarding the Buy-In Payment for Taxable Year 3

The taxpayer's section 6662(e) penalty documentation with regard to Taxable Year 3 purports to apply the residual profit method pursuant to Treasury Regulation section 1.482-6(c)(3) in order to evaluate the buy-in payment with regard to Existing Technology and Work-In-Process Technology for such year.

The analysis in the documentation separately considers the appropriate level of royalties for such technologies - i.e., USGroup's residual profit share (described below) as a percentage of worldwide consolidated sales - for the part of Taxable Year 3 preceding the effectiveness of the CSA (first R months)[15] and the part succeeding the coming into effect of the CSA and the License Agreement (last Q months).

For the first R months, the documentation in the first step of its residual profit split method allocates returns to what it characterizes as routine contributions of

[14] In USGroup's section 6662(e) penalty documentation prepared with respect to Taxable Year 3, the Date 2 cost sharing arrangement repeatedly was referred to as a "qualified cost sharing arrangement." We note that the final cost sharing regulations to which the section 6662(e) penalty documentation refers, do not govern USGroup's Taxable Year 3 cost sharing arrangement. See discussion infra Issue 1. The temporary cost sharing regulations, which govern treatment as a "bona fide cost sharing arrangement," were effective for Taxable Year 3, and therefore govern the year at issue in this advice. While use of the "qualified cost sharing arrangement" nomenclature as applied to Taxable Year 3 may be incorrect, it is unclear whether USGroup attempted to indicate in its Taxable Year 3 section 6662(e) penalty documentation that the Date 2 cost sharing arrangement met the Treasury Regulation section 1.482-7 (1995) requirements for qualified cost sharing arrangement treatment ipso facto, without making conforming amendments. See Treas. Reg. § 1.482-7(l) (1995).

[15] Although for the first R months, no royalty was actually charged with regard to products or services provided by FSub to USGroup, taxpayer's position concerning the level of consideration owing on account of USGroup's intangibles was reflected in the transfer price for products or services FSub provided to USGroup.

USGroup and FSub (R&D, manufacturing, and distribution). In the second step, the documentation apparently would justify an allocation to FSub of the residual profit up to the absolute amount of manufacturing cost savings asserted to exist as between FSub and external benchmarks,[16] with the balance of the residual profit being allocated to USGroup by assumption on account of USGroup's intangible contribution. The documentation does not appear to attempt any measure, with reference to either external or internal benchmarks, of USGroup's intangible contribution to compare against a corresponding measure of FSub's intangible contribution for purposes of arriving at a relative value of USGroup's and FSub's contributions of intangible property for the first R months.

For the last Q months, the documentation in the first step of its residual profit split method allocates returns to what it characterizes as the routine activities of USGroup (only distribution) and FSub (manufacturing and distribution). In the second step, the documentation appears to increase the residual allocation share of FSub, and decrease the residual allocation share of USGroup, compared with the first R months, simply based on the assertion that, necessarily, FSub's share should increase, and USGroup's share should decrease, in light of FSub's greater risks assumed under the CSA.[17] The documentation, again, does not appear to attempt any measure, with reference to either external or internal benchmarks, of USGroup's intangible contribution to compare against a corresponding measure of FSub's intangible contribution for purposes of arriving at a relative value of USGroup's and FSub's contributions of intangible property for the last Q months.

2. <u>Transfer Pricing Methodologies Under Consideration by Examination Regarding the Buy-in Payment for Taxable Year 3</u>

Examination is considering several transfer pricing methodologies, including the two discussed below, as either primary, alternative, or confirming bases of proposed adjustments relating to the buy-in payment for Taxable Year 3.

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[16] Although the documentation speaks in terms of FSub savings vis-à-vis "external market benchmarks," the documentation apparently never identifies these benchmarks, but appears rather to enumerate internal cost savings. Examination may wish to consider further developing the facts in this area.

[17] The documentation then extrapolates what such decreased USGroup share of residual profits would have been for each of the prior three years, and the first R months, as a percentage of worldwide consolidated sales for such periods, and compares such rates to the rate equal to such share of the residual profits as a percentage of worldwide consolidated sales for the last Q months.

Examination is considering what it would view to be a more appropriate application of the residual profit method pursuant to Treasury Regulation section 1.482-6(c)(3) in order to evaluate the buy-in payment with regard to Existing Technology and Work-In-Process Technology for such year. In the first step, returns would be allocated to the manufacturing and marketing functions of FSub and USGroup, and in the second step the residual profit (pre-R&D) would be split in accordance with the relative value of the intangible contributions of FSub and USGroup. For these purposes, Examination may consider agreeing that FSub contributes intangibles to the extent of its past level of direct R&D as well as, after the CSA commences, to the extent of its share of the R&D under the CSA, as capitalized and amortized on an appropriate basis. USGroup would be viewed as contributing intangibles to the extent of its past and ongoing level of R&D, less cost sharing payments from FSub under the CSA after that commences, as capitalized and amortized on an appropriate basis. Importantly, under the approach presently being considered, Examination would estimate the relative value of FSub's and USGroup's respective intangible contributions with regard to their respective shares of such R&D.

A second approach under consideration would measure the buy-in payment based on the market capitalization value of USGroup, determined with reference to USCorp's publicly traded stock price contemporaneous with the entry into the CSA, less amounts appropriately computed on account of tangible assets, marketing intangibles, and manufacturing intangibles (i.e., other than those related to Existing Technology and Work-In-Process Technology). A buy-in payment for Taxable Year 3 would then be derived from such amount taking into account, among other circumstances, the useful life of the Existing Technology and Work-In-Process Technology.[18]

LAW AND ANALYSIS:

Issue 1 — The 1994 Final Regulations Govern the Buy-In Payment for Taxable Year 3

Section 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute,

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[18] As noted, the taxpayer has not provided information concerning the useful life of the Existing Technology and Work-In-Process Technology.

> apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. <u>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.</u>

I.R.C. § 482 (emphasis added).

The legislative history of the Tax Reform Act of 1986 indicates that Congress amended section 482, by adding the second sentence highlighted above, due to concern over income tax deferral and effective tax exemptions where U.S. corporations transfer intangible property without receiving adequate consideration from related foreign corporations in low tax jurisdictions. Joint Committee on Taxation Staff, <u>General Explanation of the Tax Reform Act of 1986</u>, 99th Cong., 2d Sess., 1013-1014 ["JCT Explanation"]. The second sentence requires that where a transfer or license of intangible property occurs between controlled parties, "the income with respect to such transfer or license shall be <u>commensurate with the income attributable to the intangible</u>." Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2561, <u>et. seq</u>., 1986-3 C.B. (Vol. 1) 1, 478-81 (emphasis added). "Commensurate with income" is a standard by which to ensure that allocation of income between related parties reasonably reflects economic activity and risks undertaken by each. <u>See</u> H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985), 1986-3 C.B. 424-26; JCT Explanation at 1015.[19]

In revising section 482, Congress did not intend

> to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this

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[19] The 1993 temporary and 1994 final section 482 regulations note that the "commensurate with income" standard is to be applied for taxable years beginning after the December 31, 1986, effective date of the statutory amendment, but prior to the effective dates of the 1993 and 1994 regulations, using any reasonable method consistent with the statute. Temp. Treas. Reg. § 1.482-1T(h)(1993); Treas. Reg. § 1.482-1(j)(3) (1994). A "reasonable method" includes one which applies the regulations or their general principles. <u>Id</u>.

> provision that the income allocated among the parties reasonably reflect the economic activity undertaken by each.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 638 (1986), 1986-4 C.B. 638; JCT Explanation at 1017.

However, Congress singled out the issue of buy-in payments, and noted they must be measured independently of the allocation of cost shares:

> [T]o the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.

Id.

The cost sharing provisions of Treasury Regulation section 1.482-7 are effective for taxable years beginning on or after January 1, 1996. Treas. Reg. § 1.482-7(k). There is no election to apply such regulations retroactively for any open taxable year.[20] Instead, a transition rule is provided for preexisting cost sharing arrangements to the effect that a cost sharing arrangement that was, prior to January 1, 1996, a “bona fide cost sharing arrangement” under the provisions of Treasury Regulation section 1.482-7T,[21] will be considered a “qualified cost sharing arrangement” under Treasury Regulation section 1.482-7, but only if the arrangement is amended, if necessary, to conform with the provisions of Treasury Regulation section 1.482-7 by December 31, 1996. Treas. Reg. § 1.482-7(l).

Taxable Year 3 is a year beginning prior to January 1, 1996. Accordingly, Treasury Regulation section 1.482-7 is inapplicable for such year. The Date 2 cost sharing arrangement is, thus, a preexisting cost sharing arrangement whose status for purposes of taxable years beginning on or after January 1, 1996, depends on whether it constituted a “bona fide cost sharing arrangement” under the prior

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[20] Compare Treas. Reg. § 1.482-1(j)(2).

[21] The provisions of Treasury Regulation section 1.482-7T of the 1993 temporary regulations are identical to the corresponding provisions of Treasury Regulation section 1.482-2A(d)(4) of the 1968 regulations.

regulations, and whether any necessary conforming amendments were made by December 31, 1996.[22]

The cost sharing provisions of Temporary Treasury Regulation section 1.482-7T and Treasury Regulation section 1.482-2A(d)(4) address only the acquisition of an interest in intangible property that is developed pursuant to the cost sharing arrangement. These cost sharing provisions do not address the license, transfer or acquisition of an interest in any preexisting intangible property, i.e., intangible property developed prior to participation in a cost sharing arrangement, typically referred to as the "buy-in" with respect to such preexisting intangible property. These regulations provide in pertinent part:

> Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development to such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the cost and risks of developing the property. A bona fide cost sharing arrangement is an arrangement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.

Temp. Treas. Reg. § 1.482-7T (1993); Treas. Reg. § 1.482-2A(d)(4) (1968) (emphasis added).

Rather, a buy-in between controlled taxpayers with respect to preexisting intangibles - in this case, the Existing Technology and Work-In-Process Technology - is governed by the general provisions under the regulations relating to the transfer of intangible property. Since Taxable Year 3 is a taxable year beginning after October 4, 1994, the 1994 final regulations - in particular Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6 - govern the buy-in

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[22] See supra footnote 14.

payment for Taxable Year 3. Treasury Regulation section 1.482-4(f)(3)(i), for example, provides that "[i]f the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration with respect to such transfer that is determined in accordance with the provisions of this section."[23]

Issue 2 The Buy-In Payment for Taxable Year 3 Should Be Determined in the Form of a Royalty

Treasury Regulation section 1.482-1(f)(2)(ii)(A) provides that the Service "will evaluate the results of a transaction as actually structured by the taxpayer unless

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[23] Compare Treasury Regulation section 1.482-7(b)(2) of the 1995 final cost sharing regulations which provides in pertinent part:

> If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6. See paragraph (g) of this section.

Treas. Reg. § 1.482-7(b)(2) (1995) (emphasis added).

The corresponding provision in the 1968 regulations, Treasury Regulation section 1.482-2(d)(1)(i), provided as follows:

> Except as otherwise provided in subparagraph (4) of this paragraph [relating to bona fide cost sharing arrangements for developing new intangibles quoted in the text], where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use.

Treas. Reg. § 1.482-2(d)(1)(i) (1968) (emphasis added). Accord Temp. Treas. Reg. § 1.482-4T(e)(3)(ii) (1993).

its structure lacks economic substance."[24] For purposes of evaluating the taxpayer's transactions in comparison to comparables, the regulations provide:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482-4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms that are inconsistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994).

As regards the form of consideration paid for intangible property, the regulations provide

> If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

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[24] However, the regulation goes on to note that, even where the taxpayer's structure has economic substance, the Service

> [M]ay consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction as if the alternative had been adopted by the taxpayer. See § 1.482-1(d)(3) (Factors for determining comparability, Contractual Terms and Risk); §§ 1.482-3(e) and 1.482-4(d) (Unspecified methods).

Id. See discussion infra Issue 3.

Treas. Reg. § 1.482-4(f)(1) (1994).[25]

Here, FSub's payment to USGroup for Existing Technology and Work-In-Process Technology pursuant to the Date 2 License Agreement and CSA is structured as a royalty. The regulations cited above effectively provide that this form of consideration as a royalty will be respected, unless a royalty does not reflect the economic substance of the buy-in transaction pursuant to the Date 2 CSA and License Agreement, or a different form is otherwise demonstrably more appropriate.[26]

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[25] The corresponding provision of the 1995 final cost sharing regulations states:

> The consideration for an acquisition described in this paragraph (g) may take any of the following forms:
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> (i) *Lump sum payments*. For the treatment of lump sum payments, see § 1.482-4(f)(5) (Lump sum payments);
>
> (ii) *Installment payments*. Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with § 1.482-2(a) (Loans or advances); and
>
> (iii) *Royalties*. Royalties or other payments contingent on the use of the intangible by the transferee.

Treas. Reg. § 1.482-7(g)(7). Accord Temp. Treas. Reg. § 1.482-4T(e)(1).

[26] Additionally, we note that section 367(d) would not generally apply in the case of an express sale or license of intangible property by a U.S. person to a foreign corporation. Temp. Treas. Reg. § 1.367(d)-1T(g)(4)(i) (effective for transfers occurring after December 31, 1984). See also Temp. Treas. Reg. § 1.367(d)-1T(g)(4)(ii) (circumstances under which a purported sale or license may be disregarded for these purposes); and the White Paper, A Study of Intercompany Pricing under Section 482 of the Code, 1988-2 C.B. 458, 473, stating

> [T]he commensurate with income standard treats related party transfers of intangibles as if an intangible had been transferred for a license payment that reflects the intangible's value throughout its useful life, a result similar to section 367(d) . . . . [A] license payment that is less than some specific percentage of the appropriate arm's length amount could be considered so devoid of economic substance that the arm's length charge should be subject to section 367(d). Thus, those related party transfers

While the form of the consideration as a royalty must generally be respected, the amount of such royalty, if not consistent with the arm's length standard in light of the commensurate with income principle of the second sentence of section 482, remains subject to adjustment in accordance with the section 482 regulations.

Issue 3 Inconsistency of Results with Available Evidence of Present Value of Intangibles Should Be Taken into Account in the Best Method Analysis

Discussed below are some considerations which may tend to support Examination's conclusion that the purported application of the residual profit method under taxpayer's section 6662(e) penalty documentation does not provide as reliable a measure of an arm's length result as the transfer pricing methodologies that Examination is exploring as either primary, alternative, or confirming bases of proposed adjustments relating to the buy-in payment for Taxable Year 3. This advice is not intended to constitute a full analysis which Examination will need to complete in light of all the facts and circumstances.

There is no general requirement that a transfer pricing methodology for determining a buy-in payment in relation to a given taxable year must estimate a net present value of the relevant intangibles. The comparable uncontrolled transaction (CUT) method does require comparable intangible property for purposes of such method to have a similar profit potential to the intangible property involved in the controlled transaction; and profit potential is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1)(ii). Moreover, an inexact CUT or unspecified method might use an estimate of such present value derived from market data as evidence of a realistic alternative to the controlled transaction. See id; Treas. Reg. § 1.482-4(d)(1). By contrast, the residual profit split method, which the taxpayer's section 6662(e) penalty documentation purports to apply, contains no similar focus on the absolute present value of the intangibles. See Treas. Reg. § 1.482-6(c)(3)(i)(B).[27]

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which deviate substantially from the proper commensurate with income payment would be subject to 367(d), even if cast in the form of a sale or license.

[27] We do note, however, that for purposes of allocating the residual intangible profit pursuant to the second step of the residual profit split as prescribed by the regulation, one alternative for arriving at a relative value of the of intangible property

It is for Examination to determine, under the best method rule, which among competing applications of potential transfer pricing methodologies for computing the buy-in payment provides the most reliable measure of an arm's length result. Treas. Reg. § 1.482-1(c)(1). If a CUT involves the transfer of the same intangible under the same, or substantially the same circumstances as the controlled transaction, the results derived from applying the CUT method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Treas. Reg. § 1.482-4(c)(2)(ii).

The market capitalization method, one of the methods under consideration by Examination, is a type of CUT method. USCorp's publicly traded stock price reflects the market price contemporaneous with the entry into the CSA for the same intangible property as is involved in the CSA buy-in transaction, along with USGroup's other assets whose value is subtracted in the analysis. It may be that, in light of the necessary adjustments, this should be considered an inexact CUT or unspecified method. Nevertheless, depending on consideration of the degree of comparability between the controlled and uncontrolled transactions[28] and the quality of the data and assumptions utilized in the analysis, an application of this method based on a present market value of the intangibles may provide a more reliable measure of an arm's length result than the one in taxpayer's section 6662(e) penalty documentation that omits any consideration of such present valuation.[29] Certainly, any inconsistency of taxpayer's reported results with this

contributed by each controlled taxpayer is to look to external market benchmarks that reflect the fair market value of such intangible property. Id.

[28] The market capitalization method represents a "sale" price, while arguably the License Agreement and the CSA might be viewed to be short-term transfers. However, the agreements appear to contemplate that in the event of their termination, USCorp would have to make a buy-out of FSub's rights in the Work-In-Process and Developed Technology, which makes the position of FSub more like an owner than a short-term licensee. Alternatively, Examination might consider whether the apparent short-term arrangement is inconsistent with the economic substance of the underlying transaction in which FSub agrees to assume G% of the ongoing research and development costs. See Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1) and (C), Example 3 (Contractual terms imputed from economic substance).

[29] See also Treas. Reg. § 1.482-1(c)(2) ("Data based on the results of transactions between unrelated parties provides the most objective basis for

available market evidence of the present value of the intangibles is a factor that should be taken into account in the best method analysis. See Treas. Reg. § 1.482-1(c)(2)(iii).

We also note the following additional shortcomings of the purported application of the residual profit split method under taxpayer's section 6662(e) penalty documentation in comparison to the methodologies that Examination is considering. The residual profit split method pursuant to the regulation contemplates a two-sided analysis of both the routine and non-routine contributions by the controlled taxpayers. In particular, in the second step, the residual profit remaining after the allocation to the routine contributions is to be divided based upon the relative value of the controlled taxpayers' contributions of intangible property, each measured against a common measuring stick. See Treas. Reg. § 1.482-6(c)(3)(i)(B).[30] The

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determining whether the results of a controlled transaction are arm's length.").

[30] For convenience, the full text of the regulation follows below:

> The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of intangible contributions may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must

regulation provides that the common measuring stick may consist either of external benchmarks that reflect the fair market value of such intangible property contributions, or the capitalized cost of developing the intangibles, less an appropriate amount of amortization based on the useful life of each intangible.[31] The rationale is that while the measuring stick employed might only be an indirect indicator that may not yield an absolute value for each of the intangible contributions individually, the comparison of the two measurements may provide a reliable relative value of the two intangible contributions for purposes of making the split of the residual profit.

The residual profit split method set forth in taxpayer's section 6662(e) penalty documentation appears to reflect only a one-sided analysis in its second step. The documentation apparently would justify an allocation to FSub of the residual profit up to the absolute amount of manufacturing cost savings asserted to exist as between FSub and external benchmarks,[32] with the balance of the residual profit being allocated to USGroup by assumption on account of USGroup's intangible contribution. However, this approach only involves valuing one party's intangible contribution, namely FSub's, and then only gives USGroup the residual of the residual profit. The documentation does not appear to attempt any measure, with reference to either external or internal benchmarks, of USGroup's intangible contribution to compare against a corresponding measure of FSub's intangible contribution for purposes of arriving at a relative value of USGroup's and FSub's contributions of intangible property.

By contrast, Examination is considering an application of the residual profit split method that is two-sided in the manner prescribed by the regulation. Examination may consider agreeing that FSub contributes intangibles to the extent of its past

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be made among all the business activities in which it is used.

Treas. Reg. § 1.482-6(c)(3)(i)(B) (emphasis added).

[31] The regulation also states the conditions under which the amount of actual expenditures in recent years may be used as the common measuring stick (rather than the capitalized cost less amortization), namely that the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same. Id.

[32] Although the documentation speaks in terms of FSub savings vis-à-vis "external market benchmarks," the documentation apparently never identifies these benchmarks, but appears rather to enumerate internal cost savings. This may be an area in which Examination may wish to consider further developing the facts.

level of direct R&D as well as, after the CSA commences, to the extent of its share of the R&D under the CSA, as capitalized and amortized on an appropriate basis. USGroup would be viewed as contributing intangibles to the extent of its past and ongoing level of R&D, less cost sharing payments from FSub under the CSA after that commences, as capitalized and amortized on an appropriate basis. Importantly, under this approach, Examination would estimate the relative value of both FSub's and USGroup's respective intangible contributions with regard to their respective shares of such R&D. The reliability of the analysis under this method, in contrast to the method under the taxpayer's section 6662(e) penalty documentation, may be enhanced by the fact that both parties' intangible contributions would be evaluated under the second step of the residual profit split. See Treas. Reg. § 1.482-6(c)(3)(ii)(D).[33]

A final observation is that Examination is considering several transfer pricing methodologies as either primary, alternative, or confirming bases of proposed adjustments relating to the buy-in payment for Taxable Year 3. To the extent the results of those methods appropriately and consistently applied are mutually reinforcing, and the results of the method under the taxpayer's section 6662(e) penalty documentation are outlying by comparison, that is a further factor that suggests the latter method is not as reliable as the former methods under the best method rule. Treas. Reg. § 1.482-1(c)(2)(iii).[34]

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[33] Again, the discussion in the text is not a full analysis of the relative merits of the various methods under the best method rule which Examination will need to complete based on all the facts and circumstances. For example, for the last Q months, the taxpayer's documentation relating to the second step of its residual profit split appears to increase the residual allocation share of FSub vis-à-vis the first R months, and decrease the residual allocation share of USGroup, simply based on the assertion that, necessarily, FSub's share should increase, and USGroup's share should decrease, in light of FSub's greater risks assumed under the CSA. Thus, the reliability of the profit shares for the last Q months rests on the reliability of the shares determined for the first R months, some of the shortcomings of which are discussed in the text.

[34] For convenience, the full text of the regulation follows below:

> If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in

Issue 4 Buy-In Payment Should Generally Be Royalty for the Taxable Year in a Commensurate with Income Stream of Royalties Extending Over the Remaining Useful Life of the Transferred Intangibles

The second sentence of section 482 provides:

> 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.

The regulations regarding periodic adjustments provide in pertinent part:

> If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent year without regard to whether the taxable year of the original transfer remains open for statute of limitations purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.[35]

> evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

Treas. Reg. § 1.482-1(c)(2)(iii) (Confirmation of results by another method).

[35] It is assumed for purposes of this advice that none of the exceptions under the regulations to the periodic adjustments rules apply in this case.

Treas. Reg. § 1.482-4(f)(2) (emphasis added).

Consistent with the statute and the foregoing regulations, in our view where a buy-in payment for a taxable year must be computed in the form of a royalty, it should generally be set at the amount of the royalty for such year in a stream of commensurate with income royalties, determined as of such taxable year, extending over the remaining useful life of the transferred intangibles. This relates to the issue of how to derive a royalty adjustment for Taxable Year 3 from a lump sum valuation of the transferred intangibles.[36]

The regulations addressing the treatment of a lump sum form of consideration for the transfer of intangibles between controlled taxpayers impliedly confirm our view:

> If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The <u>equivalent royalty amount for a taxable year</u> is the amount determined by treating the lump sum as an advance payment of <u>a stream of royalties over the useful life of the intangible</u> (or the period covered by an agreement, if shorter) taking into account the projected sales of the license as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482-4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

Treas. Reg. § 1.482-4(f)(5)(i) (emphasis added).

The regulation defines an equivalence between a lump sum form of consideration and a royalty form of consideration, namely the "equivalent royalty." Our view is that like such an equivalent royalty, a buy-in payment in the form of an actual royalty should be evaluated as the amount of a royalty for the taxable year in a stream of commensurate with income royalties extending over the useful life of the transferred intangibles.[37]

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[36] <u>See</u> <u>supra</u> Issue 3.
[37] Compare the provisions in the 1995 final cost sharing regulations:

> The consideration for an acquisition described in this paragraph (g) may

Further confirmation is provided by the regulations regarding application of the residual profit split method. In the second step of allocating the residual intangible profit, where the amortized capitalized cost of developing the intangibles is used as the common measuring stick for dividing the residual profit between the parties' respective contributions of intangible property, the amortization is to be accomplished based on the useful life of each intangible. Treas. Reg. § 1.482-6(c)(3)(i)(B). Thus, where the residual profit split is applied on this basis to compute the buy-in payment for intangibles contributed to a cost sharing arrangement, the buy-in payment royalties will effectively extend over the useful life of the contributed intangibles.

In summary, in our view the buy-in payment for Taxable Year 3 should generally be computed as what would be the royalty for such year in a stream of commensurate with income royalties, determined as of such year, extending over the remaining useful life of the Existing and Work-In-Process Technology.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. We note that this advice does not purport to be an exhaustive analysis of the taxpayer's application of the residual profit split method. [redacted]

2. [redacted]

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take any of the following forms:

(i) *Lump sum payments*. For the treatment of lump sum payments, see § 1.482-4(f)(5) (Lump sum payments);
(ii) *Installment payments*. Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with § 1.482-2(a) (Loans or advances); and
(iii) *Royalties*. Royalties or other payments contingent on the use of the intangible by the transferee.

Treas. Reg. § 1.482-7(g)(7) (emphasis added).

[redacted]

3. In Issue 4, we concluded that buy-in royalties for the Existing Technology and Work-In-Process Technology should generally extend over the useful life of these intangibles. [redacted]

4. Our discussion, particularly as set forth in Issue 3, of the taxpayer's section 6662(e) penalty documentation points out several shortcomings in the purported application therein of the residual profit split method to justify taxpayer's reported results in regard to the buy-in payment for Taxable Year 3. Ultimately, whether application of the section 6662(e) or (h) penalty is appropriate in this instance is a determination within the purview of Examination in consultation with the Penalty Oversight Committee.

Please call (202) 874-1490 if you have any further questions.

By: ______________________________

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