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From:
Sent: Friday, June 25, 2010 5:21:12 PM
To:
Cc:
Subject: materials on methods

Dear

The attached materials may be helpful in understanding the income method and related concepts. However, I need to carefully explain their relevance, which is different from what one might first think. These materials relate to cost sharing buy-in payments (called PCT Payments under the 2009 temporary cost sharing regulations). I am not sending them because our case has a cost sharing arrangement. Rather, I am sending them because they address the following Question:

If one party (call it D for donor) gives a related party (call it R for recipient) something valuable, which R must further develop at its own expense before any exploitation (or at least before full exploitation is possible), how can one determine the compensation that R owes to D?

This Question occurs in the cost sharing context. Under cost sharing, two parties (call them again D and R) agree to share costs of intangible development in proportion to each party's anticipated benefit from exploiting the intangibles to be developed. (Of course, the parties also need to specify how they will divide between themselves the interest in the intangibles to be developed. A simple and typical approach is to divide the world into D's exploitation territory and R's exploitation territory.) Typically, D and R do not share such costs from scratch. Rather, when the cost shared development is about to start, D provides preexisting "intangible property" (under the 1995 permanent cost sharing regulations) or a "platform contribution" (under the 2009 temporary cost sharing regulations), which is available to R and to the cost shared development program. R will bear that part of the subsequent intangible development costs that are allocable to its interest in the project (e.g., to its territory of eventual exploitation). The compensation due from R to D (for what D provided) is called a "buy-in payment," or "buy-in," under the 1995 regulations, and a "PCT Payment" under the 2009 regulations. Determining this compensation has often been difficult and contentious.

This Question similarly occurs outside the cost sharing context. For example, D could develop a pharmaceutical substance to a particular point, and then give R exclusive worldwide rights to the substance as so far developed. R will then pay for any further intangible development (with no cost sharing by D), and will have worldwide exploitation rights. This contrasts with the cost sharing context, in which further development costs are shared, and R and D each will exploit the developed intangibles (e.g., each in its own territory). However, in the cost sharing context, if one looks at just R's operations (e.g., the operations in R's territory of exploitation), it appears that (1) R bears all further development costs applicable to those operations, and (2) R has exclusive rights to exploit the developed intangibles. Thus, these two different contexts (cost sharing, and this pharmaceutical example) are really quite similar.

This Question also occurs in our case, where D is the parent and R is the CFC. D provides valuable initial services (with embedded intangibles) to R that lead to R owning rights to . R must conduct further at its own expense before any exploitation is possible. (At that

stage of further D also provides valuable services to R. Similarly, in the cost sharing context, D might make its research team available on an ongoing basis.)

[redacted] The -4 regulations generally address a license of rights to exploit an intangible "as is." The residual profit split method in the -6 regulations do address this Question to some extent. Under that method, routine activities are given a return determined by comparables, and any residual profit is split according to each party's relative intangible contributions. However, usually the only practical way to determine relative intangible contributions is to look at each party's past intangible development costs as capital expenditures. One capitalizes and amortizes each year's expenditures (using an assumed useful life), and computes a running total, for each party, of the capitalized and unamortized expenditures (a running total of each party's "intangible stock"). Each year's residual profit is split between the parties in proportion to their relative intangible stocks in that year. The regulation states that splitting residual profit by this capitalized costs approach diminishes the reliability of the method. In fact, while a capitalized costs approach can sometimes be fairly reliable (e.g., when both parties build up intangibles together over many years, in roughly the same proportion over time), that approach tends to be unreliable when one party's investment period entirely precedes another party's investment period. This circumstance is present in the cost sharing context. (As discussed above, as far as R's own operations are concerned, R funds all further development after R starts cost sharing.) This circumstance is also present in the pharmaceutical example above (R completely takes over intangible development from D). Finally, this circumstance is present in our case (after being given the project, R funds all).

In fact, none of the traditional specified methods tend to work well for this Question, as explained in section III of the attached October 2007 LMSB Coordinated Issues Paper (CIP) on cost sharing buy-ins. (The residual profit split method in particular is discussed in section III.D.) One thus needs other methods. More than that, one needs a new approach to valuation, relying less on comparables and more on fundamental financial principles. (One normally cannot find good comparables for the rights to further develop a company's core valuable intangibles, because such rights normally have a unique profit potential not directly reflected in the marketplace. See CIP, section III.C.) [redacted]

The IRS's early thinking on this Question was largely in the cost sharing context. Some of this thinking occurred in the APA Program [redacted] practitioners did write about this Question. I am attaching in one .pdf file three seminal articles: Wills (1999), Morgan (1999), and Ballentine (2002). With the benefit of these articles, [redacted] the attached "Three Issues" paper [redacted]. This paper was made an exhibit to our APA Study Guide, and as such was published by BNA (and, as I was told by [redacted], was read fairly widely by practitioners). While our thinking on many points has progressed beyond what is reflected in this paper, I think that this paper remains a useful introduction to many concepts (e.g., "full value," platform vs. make-sell rights, contingent payment form).

Together, these four attached papers provide a ground-floor intellectual introduction to the Question posed. (The CIP, of course, represents important later thought.) As I said, while this thinking was developed for the cost sharing context, it is relevant to our case as well.

[redacted]

[redacted] the IRS position is that the economic result should control: there is in general no legal loophole to avoid full economic compensation, and methods that deny full compensation should be rejected.

Attached:

1. October 2007 LMSB Coordinated Issues Paper (CIP) on cost sharing buy-ins, 16 TM TPR 386 (Westlaw)
2. .pdf file with papers by:
    a. Wills (1999); John Wills, AValuing Technology: Buy-in Payments for Acquisitions,@ Journal of Global Transfer Pricing, Feb./Mar. 1999, pp. 28-34
    b. Morgan (1999); R. William Morgan, ABuy-in Payments and Market Valuations,@ Tax Management Transfer Pricing Report (BNA), Sept. 15, 1999, pp. 449-454
    c. Ballentine (2002); J. Gregory Ballentine, ATechnology Buy-Ins, Do the Law and the Arm=s Length Standard Conflict?@ (paper and accompanying slides), The Future of International Transfer Pricing: Practical and Policy Opportunities (Annual Federal Tax Policy. Symposium of the Tax Council Policy Institute, Feb. 7-8, 2002, Washington, DC)
3. "Three Issues" (Weissler 2002); http://www.irs.gov/businesses/corporations/article/0,,id=96186,00.html#A