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subject: Realistic Alternatives and Tax Considerations in the Application of Sections 482 and 367(d)

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether tax consequences that would result from a transaction subject to adjustment under section 482 or requiring income inclusions under section 367(d)[1] and from realistic alternatives to that transaction must be considered to determine an arm's length result.

CONCLUSION

Tax consequences that would result from a transaction subject to adjustment under section 482 or requiring income inclusions under section 367(d) may need to be considered to determine an arm's length result (or appropriate charge) pursuant to the section 482 and 367(d) regulations. The regulations under sections 482 and 367(d) require the consideration of tax consequences through various provisions including realistic alternatives and the arm's length standard because uncontrolled taxpayers

[1] Unless otherwise indicated, references to "section" are to the Internal Revenue Code of 1986, as amended, and Treasury Regulations issued thereunder.

generally consider their tax consequences when negotiating and agreeing to a transaction price.

FACTS

U.S. Parent ("USP") owns a patent ("Patent") for a manufacturing process ("Patent Process") that it uses to manufacture Product in Country A for sale to unrelated distributors located in Country A. USP projects that if it were to continue to use Patent Process in its operations in Country A, it would earn income directly[2] attributable to Patent with a pre-tax present value of $135 over the useful life of Patent.[3] USP's relevant marginal effective tax rate is expected to be a constant 26 percent over the period of exploitation of Patent. Because USP's expected marginal effective tax rate is 26 percent, USP's expected post-tax present value income related to Patent over Patent's useful life is $100.[4]

Scenario 1: Instead of continuing to use Patent Process, USP licenses Patent to its wholly owned subsidiary ("CFC") located in Country A. The license transfers to CFC, on an exclusive basis, all of USP's rights under Patent.[5] CFC expects to use Patent Process to manufacture Product in Country A for sale to unrelated distributors located in Country A, in the same manner that USP could have done. CFC projects to earn pre-tax income with a present value of $135 from the use of Patent over the useful life of Patent, based on projected financial data that are identical to what USP would have projected if it had continued to use Patent Process. CFC's relevant marginal effective tax rate is expected to be a constant percentage. CFC may deduct the total amount of

[2] The $135 referred to in the text excludes income not directly attributable to Patent, such as from routine manufacturing and distributing activity. It is assumed that the resources devoted to manufacturing activities using the Patent Process and distributing Product could alternatively be used in other activities where they would earn an equivalent economic return.

[3] "Present value" referred to herein is assumed to be calculated by applying an appropriately risk-adjusted discount rate to reliable projections of outcomes (including their reasonably foreseeable potential variation) from the exploitation of Patent. Pre-tax present value refers to a present value calculation that ignores relevant tax detriments or benefits, and post-tax present value refers to a present value calculation that encompasses relevant tax detriments and benefits. A risk-adjusted discount rate incorporates adjustments for all risks associated with an uncertain future income stream including, but not limited to, transaction costs, set-up costs for personnel, plant, and equipment, and lag time, all of which may vary for each reasonable alternative and for each entity's baseline resource level.

[4] $100 = $135 x (1-26 percent). USP's "marginal effective tax rate" incorporates all relevant and reasonably anticipated tax detriments and benefits, including relevant tax credits and tax basis and associated amortization deductions.

[5] To simplify this discussion, the facts in Scenarios 1 and 2 assume that Patent and Patent Process are only used in Country A to manufacture Product for sale to unrelated distributors in Country A.

Patent royalties CFC pays in the year of payment to determine its tax liability in Country A (and any other relevant tax jurisdictions).[6]

The license is structured with a royalty equal to a percentage of the sales of Product. USP determines the royalty rate to yield pre-tax royalty payments with an expected present value of $100, corresponding to the $100 expected post-tax present value income that USP would have earned from continuing to use Patent Process. Because USP's $100 present value royalty income is expected to be taxed at a 26 percent effective rate, USP's expected post-tax present value income from licensing Patent will be only $74.[7] Thus, by licensing Patent Process to CFC with a royalty rate based on income with a present value of $100, USP reduces the present value of its anticipated post-tax income from $100 to $74.

Scenario 2: The facts are the same as Scenario 1 except that USP contributes Patent to CFC in a section 351 transaction subject to section 367(d) annual income inclusions by USP over the useful life of Patent.

Scenario 3: The facts are the same as Scenario 1 except that USP has worldwide exclusive rights to the Patent Process and forms a cost sharing arrangement ("CSA") with CFC to improve that process. Under the CSA, CFC will have rights to use the improved process to manufacture products for sale in Country A, and USP will have rights to use the improved process to manufacture products for sale in all other countries. If USP had not entered the CSA, but had developed the improved process on its own, USP would project to earn income with a pre-tax present value of $135 from using the improved process to manufacture products for sale in Country A over the useful life of the improved manufacturing process.[8] USP expects to have a constant relevant marginal effective tax rate of 26 percent. Therefore, USP projects to earn income with a post-tax present value of $100 if USP does not form the CSA and instead uses the improved process itself to manufacture products for sale in Country A.

USP's worldwide exclusive rights in the Patent Process constitute a platform contribution under the CSA, for which arm's length platform contribution transaction

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[6] The facts described in this memorandum reflect a transaction with a single deal point in which the transferor's minimum acceptable price is equal to the transferee's maximum acceptable price. However, it is conceivable that the relevant costs and benefits (e.g., tax considerations) may result in the transferor's minimum acceptable price being more than the transferee's maximum acceptable price pursuant to each party's analysis of its realistic alternatives. See discussion in "Law and Analysis" section, *infra*. For simplicity, this memorandum assumes the existence of a single arm's length deal point, rather than a range.

[7] $100 x (1 – 26 percent) = $74.

[8] This amount is net of the portion of the projected cost to improve the manufacturing process that is allocable to sales in Country A. Footnote 2, *supra*, applies in this Scenario 3 also.

payment(s) ("PCT Payment") is (are) required. USP charges a PCT Payment with an expected present value of $100 based on the post-tax present value of USP's realistic alternative of using the improved manufacturing process itself to manufacture products for sale in Country A. Because USP's PCT Payment will be taxed at 26 percent, USP's expected post-tax present value income from the PCT will be only $74.[9] Thus, by contributing the Patent Process to the CSA in exchange for a PCT Payment with an expected present value of $100 from CFC, USP reduces its expected post-tax present value income from $100 to $74.

LAW AND ANALYSIS

Arm's Length Standard – In General

Under the arm's length standard, the pricing of a controlled transaction should be consistent with how uncontrolled taxpayers would have priced "the same transaction under the same circumstances (arm's length result)."[10]

Realistic Alternatives Principle

An uncontrolled taxpayer will not engage in a particular transaction at a particular price if that transaction would leave the taxpayer worse off than it would be under an alternative course of action realistically available to that taxpayer. As stated in the regulations under section 482, the Commissioner may take this "realistic alternatives" principle into account in determining arm's length pricing.

The section 482 regulations make several references to the realistic alternatives principle. The Commissioner "may 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," and "may adjust the consideration charged in the controlled transaction based on the costs or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction."[11] The section 482 regulations addressing transfers of intangible property provide that "[c]onsistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if

[9] $100 x (1 – 26 percent) = $74.
[10] Treas. Reg. § 1.482-1(b)(1).
[11] Treas. Reg. § 1.482-1(f)(2)(ii)(A).

none of the alternatives is preferable to it."[12] Other sections of the regulations have similar statements.[13]

The preamble for the 1993 Regulations emphasizes that the analysis of realistic alternatives is "central to the arm's length standard and the traditional notion of comparability":

> For example, under the comparable uncontrolled price method, the objective is to identify an alternative price at which the taxpayer could have conducted the controlled transaction. The section merely broadens this traditional analysis by permitting examination of other alternatives when the controlled taxpayer has the option of internally obtaining the goods or services that it obtained in the controlled transaction. In such a case, an otherwise acceptable comparable transaction may not provide a reliable measure of an arm's length result if the controlled taxpayer could have obtained the object of the controlled transaction more cheaply by obtaining it from internal sources. This approach duplicates the analysis that an uncontrolled taxpayer would employ in considering whether to obtain a product from an unrelated party or to produce the product itself, and the amount that it would be willing to pay an unrelated supplier of that product.

T.D. 8470, 58 FR 5263, 5267 (January 21, 1993).

More recently, the Tax Cuts & Jobs Act of 2017, Pub. L. 115-97, § 14221(b), 131 Stat. 2054, 2218 (2017) amended sections 367(d) and 482 to clarify that "the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers." The Conference Report explains:

> The provision codifies use of the realistic alternative [principle] to determine valuation with respect to intangible property transactions. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. For example, [the] existing

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[12] Treas. Reg. § 1.482-4(d)(1).

[13] Treas. Reg. §§ 1.482-3(e), -7(g)(2)(iii), and -9(h). Treas. Reg. § 1.482-3(e) is applicable to transfers of tangible property. Treas. Reg. § 1.482-7(g)(2)(iii) is applicable to cost sharing arrangements and is relevant to certain other arrangements. See Treas. Reg. §§ 1.482-4(g) and -9(m)(3). Treas. Reg. § 1.482-9(h) is applicable to transfers of services. Treas. Reg. § 1.482-7(g)(2)(iii) further specifies that the comparison of present values between a course of action and its alternative is "[i]n principle . . . made on a post-tax basis."

> regulations provide the IRS with the ability to determine an arm's length price by reference to a transaction (such as the owner of intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee).

H.R. Rep. No. 115-466, at 662 (2017) (Conf. Rep.).

Relevance of Tax Considerations in Applying the Arm's Length Standard

As stated above, the arm's length standard requires a determination of an arm's length result of the particular controlled transaction(s). This requires application of the best method rule, which may involve many economic considerations.[14] As demonstrated by the following discussion of the three factual scenarios set forth above, tax considerations of each controlled party related to the controlled transaction may be a relevant element in determining an arm's length result. Further, in applying the realistic alternatives principle, the Commissioner will consider that uncontrolled parties to a transaction aim to maximize their post-tax profit, which represents the economic return for the transaction. Therefore, for example, the price the transferor receives for the sale of an asset must be sufficient to provide the transferor with income with a post-tax present value at least equal to the post-tax present value the transferor would have realized had it not transferred the asset.[15]

Analysis of Scenario 1

Under these facts, USP's expected post-tax present value income from royalties is less than the expected post-tax present value income USP could have earned by retaining its rights to Patent. Specifically, USP's expected post-tax present value income from the $100 (pre-tax) of royalties is $74, whereas USP could have earned an expected post-tax present value income of $100 from continuing to use the Patent Process. At arm's length, USP would not agree to exchange $100 of expected post-tax present value income from the use of the Patent Process for royalties with an expected post-tax present value income of $74. To comply with the arm's length standard and satisfy the realistic alternatives principle, the total expected pre-tax present value income from royalties paid to USP must equal at least $135. With expected pre-tax present value income of at least $135, USP will expect to earn income from Patent with a post-tax present value income of at least $100,[16] which is the same as the post-tax present value

[14] Treas. Reg. §1.482-1(b) and (c).
[15] See fn. 3 and Treas. Reg. §1.482-7(g)(2)(v)(B)(*1*) for a discussion of appropriate risk-adjusted discount rates under different scenarios.
[16] As noted above, $100 = $135 x (1-26 percent).

that it would have realized had it not transferred the asset and continued to use the Patent Process in its Country A operations.

On these facts, USP's minimum acceptable royalty ($135 expected pre-tax present value income) is also the maximum royalty that CFC would be willing to pay. If CFC does not engage in the licensing transaction, and thus does not exploit Patent, CFC will have income with expected pre-tax and post-tax present values of zero related to Patent. Therefore, under the realistic alternatives principle, CFC will not engage in the licensing transaction unless it will earn income with expected pre-tax and post-tax present values of at least zero from using Patent Process.[17]

If CFC engages in the licensing transaction, based on the assumed facts, CFC would earn income with an expected present value of $135 from using Patent Process. If CFC pays $135 in expected present value royalties (as would be required by USP if acting at arm's length), then CFC's net projected pre-tax present value income attributable to using Patent Process would be zero. Also, in this case CFC's net expected present value tax from using Patent Process would be zero because CFC's expected present value of deductions equals its expected present value of income from using Patent Process ($135 times CFC's marginal effective tax rate, both for the tax-deductible royalties and for the income earned from use of Patent Process[18]). Thus, CFC's expected post-tax present value from using Patent Process would be zero. Assuming CFC's relevant marginal effective tax rate does not vary between the licensing transaction and earning income through any other realistic alternatives, CFC is indifferent as between entering into the licensing transaction and not entering into that transaction.[19] Any royalty payment by CFC with a net present value higher than $135 would violate the realistic alternatives principle because it would leave CFC with a negative anticipated post-tax present value from using Patent Process, which is less than the present value realistically available to CFC from not licensing Patent (zero). Therefore, a royalty with a net present value of $135 is the maximum royalty CFC would be willing to pay.[20]

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[17] CFC's total expected profit from engaging in the licensing, manufacturing, and distributing transactions will be greater than zero because CFC will earn a return from manufacturing and distributing activities.
[18] As noted, CFC marginal effective tax rate is expected to remain constant.
[19] As assumed in footnote 2, declining to enter the licensing transactions would not affect the return to the resources that would have been devoted to manufacturing activities using the Patent Process and distributing Product.
[20] In the case of controlled parties wholly owned by the same person or persons, as assumed herein, the combined pre-tax present value of the controlled parties generally will not be affected by whether they engage in a particular transaction because the transaction generally will affect only intercompany payments and/or intercompany allocation of costs and income and will not affect costs paid to and income received from third parties. However, even as between such parties, tax effects can cause the combined post-tax present value of the parties to be different.

As noted at footnote 6, these facts reflect a transaction with a single arm's length deal point in which the transferor's minimum acceptable price is equal to the transferee's maximum acceptable price. In some cases, there may be a range of possible deal points, akin to the application of a transfer pricing method that produces results from which a range of reliable results may be derived.[21] And for certain transactions, tax consequences can result in the transferor's minimum acceptable price being more than the transferee's maximum acceptable price pursuant to each party's analysis of its realistic alternatives (a "no deal point scenario"). In an apparent no deal point scenario for controlled parties, further analysis will be needed to determine what price or prices are arm's length, or whether the transaction lacks economic substance.[22]

Analysis of Scenario 2

Scenario 2 may result in a no deal point scenario to the extent CFC is unable to deduct or amortize at least the equivalent amount of USP's income inclusions under section 367(d). However, there is no evidence in the Code or legislative history to suggest that the amount of a taxpayer's section 367(d) inclusions is impacted by the hypothetical foreign tax consequences of the deemed sale pursuant to section 367(d)(2)(A)(i) and (ii).

Under section 367(d), USP is treated as having sold Patent to CFC in exchange for "payments which are contingent upon the productivity, use, or disposition of" Patent. Treas. Reg. § 1.367(d)-1T(c)(1) requires the income inclusion be determined in accordance with section 482 and the section 482 regulations. As a result, the "Law and Analysis" for Scenario 1, discussed *supra*, applies to this Scenario 2 in determining USP's income inclusions under section 367(d). Therefore, the annual income inclusions must correspond to income with an expected post-tax present value to USP of at least $100, which is the same amount that USP would have earned had it retained ownership

[21] Treas. Reg. § 1.482-1(e)(1).

[22] An apparent no deal point scenario may suggest a greater need to expand the scope of review to evaluate the risk allocation between the parties and other relevant members of the controlled group. For example, marketing intangibles in Country A may be acquired from an unrelated third party through a Country A acquisition entity and sold on to a Country B affiliate shortly thereafter. In selecting and applying the most reliable transfer pricing method, consideration of each affiliate's realistic alternatives may support comparability adjustments related to the allocation of risk and associated allocation of transaction costs (including taxes) between the controlled taxpayers, thereby eliminating an apparent no deal point scenario. At arm's length, the Country A acquisition entity should not incur an economic loss for its purchase and sale of IP to the Country B affiliate. Therefore, the transfer price ultimately determined through application of a reliable method should generally provide the Country A acquisition entity with sufficient compensation to at least provide for its recovery of all relevant economic costs, including taxes.

of Patent and continued to use Patent Process in its Country A operations. Such income inclusions would have an expected pre-tax present value of at least $135.

Analysis of Scenario 3

Although the facts involved in this Scenario 3 (involving USP's realistic alternative to entering into a PCT) differ from Scenario 1 (USP's realistic alternative to entering into a license), the "Law and Analysis" for Scenario 1, discussed *supra*, applies to this Scenario 3. Additional rules apply under the section 1.482-7 regulations, with a consistent result. As in Scenario 1, USP would require a PCT Payment with an expected post-tax present value to USP of at least $100. Such PCT Payment would have an expected pre-tax present value to USP of at least $135.

Treas. Reg. § 1.482-7(g) contains certain guidance concerning how tax consequences are considered in determining an arm's length result, including examples that demonstrate how tax consequences are considered when a post-tax value is computed as part of a transfer pricing method (specifically, the income method). Treas. Reg. § 1.482-7(g)(2)(iii)(A) states that the realistic alternatives principle is "[i]n principle" applied by comparing alternatives scenarios on a "post-tax basis." This principle is the same as that expressed in the "Law and Analysis" for Scenario 1, discussed *supra*, in which uncontrolled parties compare their realistic alternatives using post-tax present value income.

Treas. Reg. § 1.482-7(g)(2)(x) states that the methods in Treas. Reg. § 1.482-7(g) to determine the amount of PCT Payments are "without regard to tax effects," and that these methods might need "suitable adjustments . . . to determine the PCT Payments on a pre-tax basis." That paragraph refers to Treas. Reg. § 1.482-7(g)(4)(i)(G), which further explains this point under the income method. The income method is based on the realistic alternatives principle in that it determines the PCT Payment that will make a "controlled participant's present value, as of the date of the PCT, of its cost sharing alternative of entering into a CSA" equal to "the present value of its best realistic alternative." Treas. Reg. § 1.482-7(g)(4)(i)(A). Generally, the "best realistic alternative" would be a licensing alternative in which the party with the platform contribution develops that contribution on its own and licenses out the resulting intangibles to the other party. *Id*. Depending on the facts and circumstances, realistic alternatives may also include "the owner of intangible property using it to make a product itself." Conf. Rep. at 662.

Treas. Reg. § 1.482-7(g)(4)(i)(G) clarifies that this determination of the PCT Payment under the income method is done by applying post-tax discount rates to post-tax income. This requires a determination of the "post-tax value . . . of the PCT Payment"

that will equate the present values of the "post-tax" income of the controlled participant under the cost sharing and licensing alternatives. This principle is the same as that expressed in the “Law and Analysis” for Scenario 1, discussed *supra*, in which uncontrolled parties compare their realistic alternatives using post-tax present value income.

Treas. Reg. § 1.482-7(g)(4)(i)(G)(1) further states that the post-tax value of the PCT Payment then "must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis." This statement is consistent with the reasoning expressed in the “Law and Analysis” for Scenario 1, discussed *supra*, that USP will require pre-tax compensation with an expected present value of $135 to replace the $100 of expected post-tax present value income that it would have realized under a realistic alternative. Treas. Reg. § 1.482-7(g)(4)(viii), Examples 4 and 5 illustrate the adjustment from a post-tax value to a pre-tax payment. These examples are similar in concept to Scenarios 1 and 2.

Treas. Reg. § 1.482-7(g)(4)(i)(G)(*3*) goes on to say that in certain circumstances (when the tax rate of the controlled participant in question is the same constant factor in both alternatives), a short-cut calculation can be applied that directly determines the pre-tax PCT Payment that would equate the controlled participant's pre-tax present value of income under the two alternatives (using post-tax discount rates). *Accord*, Treas. Reg. § 1.482-7(g)(2)(iii)(A) (while realistic alternatives are in principle compared on post-tax basis, "in many cases, a comparison made on a pre-tax basis will yield equivalent results"). Treas. Reg. § 1.482-7(g)(4)(viii), Example 6 illustrates a pre-tax comparison under these circumstances. Use of a pre-tax comparison under these circumstances is consistent with the “Law and Analysis” for Scenario 1, discussed *supra*. In this Scenario 3, compensation with a present value of $135 leaves USP as well off on a post-tax and pre-tax basis as under its realistic alternative.

As a final note, the principles, methods, and comparability and reliability considerations described in Treas. Reg. § 1.482-7 are also relevant in some cases to determine the best method in other contexts under section 482, including Treas. Reg. §§ 1.482-4 and 1.482-9. *See, e.g.*, Treas. Reg. § 1.482-1(c), Treas. Reg. § 1.482-4(g) and Treas. Reg. § 1.482-9(m)(3).

Please call Branch 6 at (202) 317-6939 if you have any further questions.