

**APA Program Training on Cost Sharing Buy-In Payments**  
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**THREE ISSUES**  
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**0. Introduction**

This paper discusses the following three issues concerning cost sharing buy-ins:

1. Should a buy-in payment compensate the value of the ability to use preexisting intangibles in developing further technology?
2. What is the effect if one party to a cost sharing arrangement grants another very limited rights in preexisting intangibles (and perhaps in the cost-shared technology as well)?
3. What happens if the taxpayer structures a buy-in as a sales-based royalty, and there are little or no sales?

While it does not systematically discuss different buy-in valuation methods, this paper does:

- Briefly define six valuation methods.
- Mention these methods in discussing the issues listed above.
- Briefly note some issues pertaining to these methods.

This paper uses the following conventions:

1. Citations beginning with a hyphen, unless otherwise indicated, are to the Treasury Regulations section 1.482-\_\_\_\_.
2. We assume that controlled companies D and R are the sole participants in a cost sharing arrangement (CSA). D has some preexisting intangibles (generally technology) that it makes available

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<sup>1</sup>This work in progress gives the author's personal views on questions for which there is not yet a formal Service position. The author thanks his colleagues Bradley A. Smith, Russell Kwiat, Elizabeth Beck, David N. Bowen, and Clark Armitage for helpful comments.

to the CSA. D's and R's "benefit shares" are their respective shares of reasonably anticipated benefits under -7(f)(3). (I chose the letters D and R to connote that D is donating something and R is receiving something.)

This paper refers to several buy-in valuation methods defined briefly as follows. The methods are categorized as "full-value" and "partial-value" methods. As discussed under question (1) below, only the full-value methods in principle compensate the full value of the intangible rights made available.

### **Full-Value**

Market capitalization. Take D's stock price.<sup>2</sup> Add D's liabilities. Subtract items such as tangible assets and intangible assets not made available.<sup>3</sup> The result is the value V of the intangibles made available. The buy-in payment is a lump sum equal to V times R's benefit share.

Acquisition price. Suppose D buys unrelated company T and then makes T's technology available to the CSA. Use D's price paid for T to derive the value V of the intangibles made available. (One would adjust the purchase price, for example, by subtracting T's tangible assets and apportioning the value of T's technology between shared use and D's private use.) The buy-in payment is a lump sum equal to V times R's benefit share.

Foregone profits. Project R's net operating profits, including expenses and revenues relating to cost-shared R&D. Subtract a projected arm's length return for R's routine activities (which might be negative in start-up situations) to compute an expected net revenue stream due to the preexisting intangibles. Discount this stream using a discount rate appropriate for R's business to get a lump sum present value for the buy-in.

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<sup>2</sup>D might have no stock price. For example, D might be privately held, or D might be a division or subsidiary of a publicly held company with no publicly held stock of its own. In such cases, one might estimate a hypothetical stock price for D by applying financial ratios of comparable companies to D's own financial data. For example, one might multiply the comparables' stock-price-to-sales ratio by D's sales.

<sup>3</sup>For both this method and the acquisition price method, there is an issue whether certain assets sometimes thought of as intangibles (such as workforce in place, goodwill, and going concern value) are exempt from the Service's allocations under I.R.C. section 482 because they do not meet the definition of "intangibles" in -4(b). If certain assets are exempt, their value also would be subtracted under these methods.

## Partial-Value

Frozen foregone profits. The same as foregone profits, except count only the projected revenues, expenses, and routine profits from exploiting the preexisting intangibles “as is.” Do not include any projected revenues, expenses, or routine profits relating to cost-shared R&D or exploitation of the fruits of cost-shared R&D.

Residual profit split. Split the nonroutine profit from R’s operations (i.e., operating profit <sup>4</sup> minus a return for routine activities) each year between D and R according to relative intangible contributions of D and R to R’s business for that year. Compute the relative intangible contributions based on a ratio of intangible stocks.<sup>5</sup> D’s stock is based on its costs to develop preexisting intangibles, capitalized<sup>6</sup> and amortized according to an agreed useful life and amortization schedule, and multiplied by R’s benefit share.<sup>7</sup> R’s stock is based on its expenses for cost-shared R&D, similarly capitalized and amortized, but not multiplied by R’s benefit share. R’s payments to split its nonroutine profit with D constitute the buy-in payments.

Declining royalty. The buy-in payments are a royalty stream. Compute an initial royalty rate (to apply immediately after the preexisting technology is made available) based on either a CPM approach (the royalty is the amount that leaves R with just a routine profit) or a CUT approach. Decline the royalty rate over time, based on either (1) assuming that the preexisting intangibles have a certain useful life and amortization schedule, or (2) each year multiplying the initial royalty rate by D’s share of D’s and R’s total intangible contribution for that year, computed as in the residual profit split method.

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<sup>4</sup>The treatment of R&D expenditures in calculating operating profit poses some tricky issues beyond the scope of this paper.

<sup>5</sup>One can also compute the relative contributions by means of market benchmarks. See -6(c)(3).

<sup>6</sup>The capitalization might reflect factors including the investment’s timing and risk and the option value of doing further R&D.

<sup>7</sup>There are issues regarding how the computation should be done, for example whether R’s benefit share should be computed each year and multiplied by D’s expenditures for that year.

**1. Should a buy-in payment compensate the value of the ability to use preexisting intangibles in developing further technology?<sup>8</sup>**

As discussed below, preexisting technology intangibles can be used in various ways:

- (1) Making and selling products that benefit from only the preexisting intangibles (the product incorporates those intangibles or was made using those intangibles).
- (2) Using the preexisting intangibles in doing cost-shared R&D.
- (3) Making and selling products that benefit from both (a) the preexisting intangibles and (b) cost-shared intangibles that were developed using the preexisting intangibles.
- (4) Making and selling products that benefit from only cost-shared intangibles that were developed using the preexisting intangibles.

When a license under the preexisting intangibles is needed to exploit the cost-shared intangibles, what appears to be use (4) may really be use (3). For example, suppose the preexisting intangible is a patent on a drug substance and the cost-shared intangible is a developed pharmaceutical product using that substance. In this case, making and selling the pharmaceutical product would involve using both the preexisting and cost-shared intangibles since such activity requires a license under the patent.

Uses (2) through (4) involve the use of the preexisting intangibles to develop further technology. Taxpayers sometimes do not wish to compensate such use. Thus, they might propose to compensate only use (1). An example might be a declining royalty method that includes a royalty only on products that use only the preexisting intangibles. The decline in the royalty would reflect that those preexisting intangibles become less

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<sup>8</sup>This section of the paper draws in part on John Wills, "Valuing Technology: Buy-in Payments for Acquisitions," Journal of Global Transfer Pricing, Feb./Mar. 1999, pp. 28-34; R. William Morgan, "Buy-in Payments and Market Valuations," Tax Management Transfer Pricing Report (BNA), Sept. 15, 1999, pp. 449-454; and J. Gregory Ballentine, "Technology 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).

valuable over time. Taxpayers might also propose to compensate only use (1) and that portion of use (3) that relates to the preexisting intangibles. An example might be a declining royalty method that includes a royalty on all products that use preexisting intangibles, even if they also use cost-shared intangibles. As regards products that use both types of intangibles, the declining royalty would reflect that over time the cost-shared intangibles are replacing the preexisting ones.

However, these proposals by taxpayers seem misguided. To begin with, uses (2) through (4) can be very important economically. Being able to build on preexisting technology might enable a company to develop additional technology with less expense and in less time than would otherwise be possible. Thus, preexisting technology may help a company achieve first-to-market rewards on products that benefit from cost-shared technology.

This benefit might sustain itself over many years. For example, being first to market with one generation of products might help a company to be first to market with the next generation, and this process might repeat indefinitely. Taxpayers may argue that after several generations the R&D is no longer benefitting from the preexisting intangibles, but it is not clear why that is so. Taxpayers sometimes say that R at this point is merely taking advantage of the business opportunity that the preexisting intangibles afforded. However, that business opportunity--consisting presumably of certain knowledge and the right to exploit it--seems to be an intangible requiring compensation.

Use (2) alone can be important economically, even if the preexisting technology leads to no saleable products. Suppose a company examines preexisting technology, but either immediately or after some further R&D concludes that the technology is not worth pursuing. Without the preexisting technology, the company might have spent time and money to develop that same technology in-house until it ultimately realized that the technology is not worth pursuing. Thus, the preexisting technology might enable the company to (1) save R&D costs, and (2) pursue other R&D avenues more quickly, perhaps enabling it to achieve first-to market rewards from those other avenues. Therefore, even if the preexisting technology does not directly lead to any products, the company's overall strategy and R&D effort may benefit from that technology.

The regulations seem to present a structure under which use (1) and that part of use (3) relating to the preexisting intangibles is compensated as a transfer of intangibles under -4 while the other uses are compensated as a buy-in under -7. Section -7(g)(2) requires a buy-in payment for the "use of the intangible" when "a controlled participant makes preexisting intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area"

(emphasis added).<sup>9</sup> Thus, the buy-in must compensate use for research; this provision also fairly seems to imply also compensation for using the preexisting intangible to the extent required to exploit the fruits of this research. Thus, the buy-in includes compensation for uses (2) and (4), and use (3) to the extent it involves use of the cost-shared intangibles. On the other hand, use (1) and that part of use (3) that relates to the preexisting intangibles do not directly relate to cost-shared research or its fruits, and should be compensated as a separate intangible license under -4.

Like the separate license, the buy-in is valued under the principles of sections 1, 4, 5, and 6 (see -7(a)(2)). However, because the buy-in calculations are not identical to the calculations under -4, to reach the proper result it may be important to separately analyze the buy-in and license values.<sup>10</sup> Taxpayers and the Service have sometimes applied buy-in valuation methods that ignore this distinction, lumping all uses of the preexisting intangibles together as a “buy-in.” This paper also sometimes follows that practice. However, this practice may be a mistake, and this issue merits further study. For now, it is useful to observe that if taxpayers propose compensating only use (1) (or only use (1) and that portion of use (3) that relates to the preexisting intangibles), they arguably are proposing a zero buy-in payment.

In economic terms, the pure buy-in value (as opposed to the value of the separate license) represents the premium value of being able to do R&D building on the preexisting intangibles. This premium value is the present value (using a discount rate appropriate for R’s business) of the projected net revenues from follow-on R&D. (If R did R&D from scratch, then with a discount rate appropriate for R’s business the net present value of the projected net returns to that R&D would by definition be zero.)

As just explained, the regulations seem to present a structure by which all uses of the preexisting intangibles are compensated, but in two different parts: a buy-in under -7, and a separate license under -4. Compensating all uses of the preexisting intangibles is consistent with the arm’s length principle, since all uses represent value that the transferor is giving up. FSA 200225009 states that “the buy-in payment . . . must reflect

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<sup>9</sup>If a controlled participant makes intangibles available to the CSA’s R&D shop, it is deemed to have made them available to the other participants. See 7(g)(1).

<sup>10</sup>As discussed under question (2) below, the buy-in calculation considers the intangible’s value to the CSA as a whole and then multiplies that value by R’s benefit share. Therefore, as discussed under question (3) below, a commensurate-with-income adjustment probably should apply to the value of the preexisting intangible to the CSA as a whole. In contrast, a valuation of a separate license under -4 would consider directly the value to R of the intangible in question, and a commensurate-with-income adjustment would apply to that value to R.

the value of all pre-existing intangible property made available to the cost sharing arrangement, not merely those pre-existing intangibles ultimately embedded in a manufactured product.” To compensate only those intangibles that are embedded in products “would disregard the transfer of interests in intangibles . . . which must be compensated at arm’s length pursuant to the provisions of Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6.” The FSA states that buy-in compensation is needed even for an intangible “on which no additional research is conducted.”

Despite the regulatory structure and arm’s length principle, some practitioners seem to believe that only the separate license need be compensated, and not the true buy-in (the use of the preexisting intangibles for research and the exploitation of the fruits of that research). One author (Ballentine, cited in a footnote above) presents this view as follows. Suppose that D owns technology that it continually improves with R&D. Suppose that in the absence of a CSA D would spend \$10 on R&D allocated to R’s operations and would get \$50 in royalties from R, so that D would realize a net profit of \$40 per year. If D and R enter a CSA under which R will reimburse D \$10 each year for R&D and will pay no royalties, an arm’s length compensation (including both the true buy-in and the separate license value) would be the value of D’s foregone net income, or the present value of \$40 of income per year.

In Ballentine’s view, a common approach to compensating D would be a declining royalty approach. This approach, however, really values just the separate license. Assuming a three-year useful life, the compensation might for example consist of the full \$50 royalty in the first year of the CSA, a \$33 royalty the next year, a \$17 royalty the year after, and no royalties thereafter. Compare the income stream D is foregoing with the one it is getting:

	Year 1	Year 2	Year 3	All Further Years
D foregoes	\$40	\$40	\$40	\$40
D gets	\$50	\$33	\$17	\$0
difference	-\$10	\$7	\$23	\$40

The second line of this table represents the value of commercially exploiting the preexisting intangibles for their assumed useful life, and the third line represents the uncompensated premium value of being able to do follow-on R&D. Ballentine states:

The typical buy-in<sup>11</sup> payment understates the present value of the income foregone by the parent. The understatement arises because the typical buy-in payment omits the value of the opportunity to make future investments that are expected to generate premium returns. Furthermore, that omission is the sole source of expected tax savings from R&D cost sharing.

However, as discussed above, the assumption that this premium value need not be compensated seems incorrect. Rather, this premium value is precisely what constitutes the true buy-in. Why, however, do some taxpayers make this assumption?

Taxpayers sometimes object that compensating this premium value denies D the intended tax benefits of CSAs. One could reply that from a tax point of view, a CSA is a gamble. To the extent that cost-shared R&D is more successful than expected, forming a CSA results in D having less income (on a discounted present value basis) than it would have in the absence of a CSA; to the extent that cost-shared R&D is less successful than expected, forming a CSA results in D having more income than it would have in the absence of a CSA. The cost sharing regulations were not designed to automatically result in D having less income.

Taxpayers also sometimes object that compensating uses (2) through (4) prevents R from enjoying the benefit of cost-shared R&D. One could reply that R's fortunes still rise or fall depending on the success of the cost-shared R&D. In this regard, commensurate-with-income adjustments to the buy-in amount under -4(f) should reflect only the extent to which the preexisting intangibles turned out to be more or less valuable than expected, and should not reflect the extent to which the cost-shared R&D is more or less successful than expected. For example, suppose that cost-shared R&D produces a pharmaceutical product using a drug substance covered by a preexisting patent. Consider some factors that might yield profits greater than expected:

- There are surprise epidemics of the target disease.
- The drug substance proves effective beyond expectations, making clinical trials unusually successful and speeding the approval process.
- Cost-shared R&D unexpectedly identifies additional diseases for which the pharmaceutical would work.

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<sup>11</sup>Ballentine is using the term "buy-in" to cover both the true buy-in (which is valued at zero under this approach) and the separate license.



- The regulatory affairs department shows unusual skill in obtaining quick approvals.

Perhaps the first two factors would be grounds for a commensurate-with-income adjustment, since they seem to relate to the preexisting intangibles. Regarding the third factor, one might ask to what extent the success arises from an unexpectedly versatile drug substance, and to what extent it arises from unexpectedly successful cost-shared R&D. The former relates to preexisting intangibles, while the latter relates to cost-shared intangibles. The fourth factor might not be grounds for a commensurate-with-income adjustment because it seems to relate to the cost-shared intangibles. How to apply this distinction deserves further study, including input from IRS economists.

Here is the extent to which various buy-in valuation methods<sup>12</sup> include compensation for the different types of uses:

<b>Method</b>	<b>Category</b>	<b>Compensate all types of uses?</b>
Market capitalization	Full-Value	Compensates all uses since stock price reflects the market's assessment of the value of all uses. (A startup company, for example, might have no revenue prospect without further R&D, in which case the stock value is based solely on uses (2) through (4).)
Acquisition price	Full-Value	Compensates all uses since the purchase price reflects the value of all uses.
Foregone profits	Full-Value	Compensates all uses since projections reflect the value of all uses.
Frozen foregone profits	Partial-Value	Compensates only use (1) since the costs and benefits of further R&D are excluded.

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<sup>12</sup>While commonly called "buy-in" valuation methods, these methods also include, or sometimes only include, the value of the separate license.

Residual profit split	Partial-Value	<ul style="list-style-type: none"> <li>• If R's nonroutine profits are as originally projected, compensation for all uses would require that R pay all such profits to D for the buy-in. By paying only some of those profits to D, R is paying a lesser buy-in.</li> <li>• Using a short useful life (perhaps based on the life of preexisting products) excludes uses (3) and (4) (and, if applicable, (1)) as applied to products sold after that assumed useful life has expired.</li> <li>• This method ignores use (2), except as it might lead to products that increase the residual profit from R's operations..</li> <li>• Low profits in initial years can distort the result downward.</li> </ul>
Declining royalty	Partial-Value	<ul style="list-style-type: none"> <li>• As typically structured, compensates only use (1) and perhaps part of use (3).</li> <li>• Using a short useful life (perhaps based on the life of preexisting products) excludes uses (3) and (4) (and, if applicable, (1)) as applied to products sold after that assumed useful life has expired.</li> <li>• This method ignores use (2), except as it might lead to products on which R pays royalties.</li> <li>• Low sales in initial years can distort the result downward.</li> </ul>

**2. What is the effect if D grants very limited rights to R in the preexisting technology (and perhaps the cost-shared technology as well)?**

The simplest picture of a qualified CSA (QCSA) and buy-in might be as follows. D and R jointly perform (or at least jointly control) cost-shared R&D. D and R split the world into two parts, and each has exclusive rights to exploit the developed intangibles in its territory. D makes preexisting intangibles available to the CSA, makes no private use of those intangibles, and grants R exclusive rights to exploit those intangibles in R's territory. In this case, it seems that R should compensate D an amount computed in principle as a share of the total value of the preexisting intangibles.<sup>13</sup>

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<sup>13</sup>As discussed under question (1) above, sometimes taxpayers and the Service have lumped both the true buy-in value and the separate license value together and

However, the cost sharing regulations seem to imply that taxpayers have some flexibility to fashion a QCSA with a different division of rights. The first sentence of -7(a)(1) states:

A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. [emphasis added]

This sentence might imply that a QCSA may assign rights in cost shared intangibles in various ways. (One restriction, however, is that each controlled participant in a QCSA must anticipate some benefit from the cost shared intangibles (-7(c)(1)(i)).)

Taxpayers sometimes present CSAs involving grants of rights that are in legal terms very limited. D may perform and control all cost-shared R&D, with R having no rights to do R&D using preexisting or cost-shared intangibles. R may have a nonexclusive, revocable-at-will license to use the preexisting intangibles as well as the cost-shared intangibles.

This scenario raises a host of threshold questions. Would parties at arm's length ever enter into such an arrangement, and is that question legally relevant under the cost sharing regulations? Is the conduct of the parties consistent with the agreement? (For example, if the technology turns out to be more valuable than expected, does D revoke the licenses or demand increased compensation to maintain them?) If D revokes the licenses, does the CSA provide for a buy-out payment based on the current worth of the cost-shared technology, and is such a provision necessary in order to have a QCSA? Are there other legal objections to the taxpayer's structure?

While these questions are important, answering them is beyond the scope of this paper. Assume for our purposes that these threshold issues pose no problem. For example, assume that parties at arm's length might enter into such an agreement; that the conduct of the parties is consistent with their agreement; that the CSA provides a

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called it all a "buy-in." Under that approach, one might compute the total compensation to be paid by multiplying the total value of the preexisting intangibles by R's share of total anticipated benefits from the preexisting R&D, including benefits derived through cost shared research and otherwise. However, as discussed above, such an approach may be flawed. One perhaps instead should separately compute the true buy-in and the compensation for the separately license. In that case, the total compensation would still be based ultimately on the total value of the intangibles, reflecting separately R's shares of benefits from both cost-shared and other uses.

buy-out payment should the licenses be revoked; and that there are no other legal objections. We now address whether the limited nature of the rights granted affects the buy-in calculation. Taxpayers sometimes argue that a buy-in for limited rights should be valued using uncontrolled similarly limited licenses. However, the regulations do not support that view.

Section -7(g)(1) provides that if a controlled participant “makes intangible property available to a qualified cost sharing arrangement,” that participant “will be treated as having transferred interests in such property to the other controlled participants.” Those other participants then “must make buy-in payments to it, as provided in paragraph (g)(2).”

Section -7(g)(2), in turn, provides a two-step process for determining a buy-in payment when “a controlled participant makes preexisting intangibles available to other controlled participants for purposes of research.” First, compute the “arm’s length charge for the use<sup>14</sup> of the intangibles under the rules of §§1.482-1 and 1.482-4 through 1.482-6”; second, multiply that amount by “the controlled participant’s share of reasonably anticipated benefits”. In the first step, “the intangibles” refers to the entire intangibles made available to the CSA for purposes of research. This interpretation is the natural reading of the language, and it makes logical sense because the second step is in effect dividing the total intangibles into shares for each participant.

Thus, if D makes intangibles available to the CSA’s research shop, the first step in the calculation is the arm’s length charge for the research shop’s right to use those intangibles. For this step, it does not matter if D controls the research shop and R has limited rights to the intangibles. If R has limited rights, then that will be reflected in the second step, to the extent that the limits on R’s rights act to reduce R’s share of anticipated benefits. (It would not make sense to reduce the amount in the first step because of limited rights if the second step would further reduce the amount for the same reason.) This approach reflects the analytic structure of the cost sharing regulations. These regulations focus on each controlled participant’s share of reasonably anticipated benefits as the measure of that participant’s stake in the CSA. The economic benefits, rather than the particular legal rights, are the key.

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<sup>14</sup>As mentioned previously, this provision probably refers not only to use in research itself but also to use in exploiting the fruits of cost-shared R&D to the extent R is permitted to do so. Also, as discussed above, the CSA can use the preexisting intangibles in various ways, including examining them and deciding they are not worth developing further. To connote such possibilities, this paper sometimes will refer to the value of the CSA’s “right to use” the preexisting intangibles, which includes the right to examine the intangibles and then decide against further development.

The question then remains: what is the value to the CSA as a whole of the right to use the preexisting intangibles? To begin with, D might make some private use of those intangibles. If so, then the buy-in calculation should reflect some apportionment of the intangibles' value between private and cost-shared use.<sup>15</sup> Suppose, however, that D makes and is expected to make no private use of the intangibles, but formally limits the rights in the intangibles that are made available to the CSA?<sup>16</sup> In that case, it is difficult to see how the formal limitations diminish the value of the rights made available to the CSA. If the intangibles were worth \$1M, for example, and D's only use of them is through the CSA, then how is less than \$1M worth of intangibles being made available to the CSA?

Suppose that a court rejected the analysis above and determined that the first step in the -7(g)(2) buy-in calculation must as a legal matter reflect that R will have only limited rights. The Service could still argue that as an economic matter that limitation of rights makes little difference. The arguments could develop as follows.

Taxpayers might propose to compute that first step by reference to uncontrolled licenses with similar limited rights. Section -4(c)(2)(iii)(B)(2) discusses comparability of circumstances of transactions in intangible property and lists certain factors as particularly relevant. Taxpayers might cite the following factors:

- (i) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which

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<sup>15</sup>See FSA 200001018 (applying old regulations):

Determining the portion of the overall value of [the preexisting technology, in this case acquired technology] that relates to the [cost-shared use] involves issues similar to those that exist for determining the appropriate amount of ongoing R&D costs to be shared under the CSA. Thus, the overall value of [the preexisting intangibles] must be adjusted to account for the portion of the value that relates to third-party sales [related to the private use] and for that portion of the value that relates to [cost-shared use].”

<sup>16</sup>Under the assumed scenario, in which D makes the intangibles available to its own research shop, that might be difficult. It seems hard for D to limit its own rights. However, D might, for example, tell its research shop to use the intangible only in certain ways (e.g., for certain applications). Under a different scenario, in which D lets R's research shop use the preexisting intangibles, D could for example grant a revocable, nonexclusive license, perhaps also limited by field of use.

the rights may be exploited;

. . . .

(v) The duration of the license, contract, or other agreement, and any termination or revocation rights;

Thus, taxpayers might argue for example that nonexclusive, revocable-at-will licenses make good CUTs. However, the Service might cite another factor:

(vii) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; . . .

Thus, the Service might argue that the existence of the CSA makes taxpayer's proposed CUTs not comparable. D and R are together exploiting the preexisting and cost-shared intangibles. While D is the legal owner of certain rights, R is an economic stakeholder in the whole CSA. R shares, for example, in the economic benefits of D's ability to direct the course of R&D.<sup>17</sup>

Taxpayers making an argument based on a grant of limited rights might propose a declining royalty approach using CUTs that involve limited rights. They will likely object to full-value methods since they treat R as a full economic partner to the extent of its benefit share.<sup>18</sup>

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<sup>17</sup>The Service might also argue that particular proposed CUTs are unreliable because they do not involve the licensor's core technology, do not include the right to develop and use derivative technology, or in practice include only the right to make minor adaptations. In this regard, the Service might cite the importance of "the exploitation rights granted" in factor (i) quoted above.

<sup>18</sup>Taxpayers have also advanced some specific arguments regarding the acquisition price method, both in the limited rights context and more generally. One argument is that the acquisition price should be adjusted downward to reflect that D paid a control premium to acquire the target company T, while R is not in control. However, as discussed above, the buy-in value should be based on the value of the preexisting intangibles to the CSA as a whole, which is in control and enjoys the benefits of control. A second argument is that the acquisition price should be adjusted downward to eliminate the value of synergies that made the technology more valuable to D than they were to T. However, again the pertinent value for buy-in purposes is the value of the preexisting intangibles to the CSA, which includes those synergies (except those that concern any private use by D). In fact since D's purchase price may be an intermediate

### 3. What happens if the taxpayer structures a buy-in as a sales-based royalty, and there are little or no sales?

Taxpayers sometimes propose a buy-in in the form of a royalty on R's sales of products that use the preexisting intangibles and, in some cases, also products that use intangibles that were developed by building on the preexisting intangibles. (The former pertains to a separate license, while the latter pertains to a true buy-in.) An example is the declining royalty method. If R has little or no such sales, this approach yields a small or zero buy-in amount. Taxpayers sometimes argue that that result is correct under commensurate-with-income principles because in this case there is zero income attributable to the preexisting intangibles. As discussed below, as regards the true buy-in this approach by taxpayers may be flawed in at least two respects: sales of follow-on products are not the only way in which the preexisting intangibles contribute to income, and the focus perhaps should be on total sales by D and R instead of on R's sales alone.

As background, Section -7(g)(7) states that a buy-in may be paid in "any of the following forms":

- "Lump sum payments" subject to commensurate-with-income adjustments under -4(f)(5).
- "Installment payments" based on a lump sum, with interest calculated under -2(a).
- "Royalties or other payments contingent on the use of the intangible by the transferee."

While the term "royalty" can connote a payment based on sales or production,<sup>19</sup> there

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figure between a relatively low value of the technology in T's hands and a relatively high value of the technology in D's or the CSA's hands, one might argue for an upward adjustment to the purchase price to reflect the technology's value in the hands of the CSA.

<sup>19</sup>*Black's Law Dictionary* (West Publishing Co., St. Paul: 5th ed. 1979) defines "royalty" as follows:

Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in

are other ways to structure a contingent payment. Sometimes a licensee pays a flat fee each year to keep a license in force; if the licensee decides that it does not want to use the intangible any more, it can stop paying after the current year. Licensees of information services such as Compustat and Lexis might pay a fee per user or a fee per search, regardless of any sales that might result. A laboratory might pay a fee to use an intangible in its research or analysis, contingent on use but not on any resulting sales.

Taxpayers seem to have some freedom to choose the form of a buy-in payment. As a general principle, the Service will conduct a transfer pricing analysis based on “a transaction as actually structured by the taxpayer unless its structure lacks economic substance” (-1(f)(2)(ii)(A)). The regulations also express a preference in some cases for a royalty:

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.

Section -4(f)(1). There may be some tension between these two regulatory provisions, since the latter one might in some cases limit the taxpayer’s ability to choose a form other than royalties. However, both of these provisions support a taxpayer’s ability to choose a royalty form. (See also FSA 200023014.)

For a cost sharing buy-in, a sales-based royalty, depending on how it is computed, may ignore certain possible benefits of the right to use the preexisting intangibles.<sup>20</sup> For example, the preexisting intangible may allow the CSA to better direct R&D activities and get some other product line (not directly related to the preexisting intangibles) to market earlier. The CSA might also benefit by saved R&D costs.<sup>21</sup>

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respect of each copy of his work which is sold, or to an inventor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. . . .

<sup>20</sup>These benefits were discussed under question (1) above and are only summarized here.

<sup>21</sup>The regulations recognize saved costs as part of the value of an intangible, both for its initial valuation (-4(c)(2)(iii)(B)) and in considering adjustments to make compensation commensurate with income (sections 4(f)(2)(ii)(B)(6), (C)(4), and (D)(1)).



If a taxpayer calculates a sales-based royalty by a method that ignores these various benefits (e.g., a CUT approach that ignores these benefits), then the royalty rate should be increased to compensate for the ignored benefits. If the proper increase is difficult to compute because the relative amount of ignored benefits is difficult to determine, then an alternative approach may be more reliable. For example, one could compute a lump sum buy-in value using a full-value method (which includes the value of the benefits just discussed) and then convert that lump sum to a sales-based royalty rate.<sup>22</sup> A still more reliable approach might be to somehow convert the lump sum value to a contingent payment stream that depends not only on sales of the products that use the preexisting intangibles but also to some extent on R&D costs, total sales, or other factors that reflect the range of benefits from the preexisting intangibles.

Another issue concerns whose sales are used as a base for a sales-based royalty. Taxpayers usually structure the royalty based on R's sales alone, citing -7(g)(7) (forms of payment) and arguing that under commensurate-with-income principles the buy-in should reflect the actual benefit to R from the preexisting intangibles. However, under -7(g)(2), as discussed above under question (2), the buy-in is computed as the value under -4 of the preexisting intangibles made available to the CSA, times R's benefit share. Under this structure, it seems that the commensurate-with-income principle of -4(f) would be applied to the value of the intangibles to the CSA as a whole, not the value to R. Conceptually, the buy-in price should be adjusted to reflect the actual value of the intangibles to the CSA as a whole, times R's benefit share; the extent to which R in particular benefits from those particular intangibles does not matter.<sup>23</sup> Thus, D's and R's combined sales, rather than R's sales alone, would to some extent reflect the pertinent income attributable to the preexisting intangibles. A royalty based on these combined sales (with the rate reduced to reflect R's fractional benefit share) would thus more appropriately reflect commensurate-with-income principles.

The structure under -7(g)(2) makes sense if one considers that a royalty based on R's sales alone (based on a commensurate-with-income focus on the value to R alone) could invite abuse. D and R might arrange that R will sell no products incorporating preexisting intangibles, but instead will sell other lines of products that would not have been successfully developed in the absence of the preexisting technology. A royalty based on R's sales alone would then amount to zero. (In that case one might say that the royalty arrangement "lacks economic substance" (-1(f)(2)(ii)(A)) (or perhaps is a sham), and that some other form of payment "is demonstrably more appropriate" (-

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<sup>22</sup>See -4(f)(5) and FSA200023014 on how to do such a conversion.

<sup>23</sup>Beyond the scope of this paper is the question of how commensurate-with-income principles might apply if R's benefit share changes. For our purposes, assume that R's benefit share does not change.

4(f)(1)).)