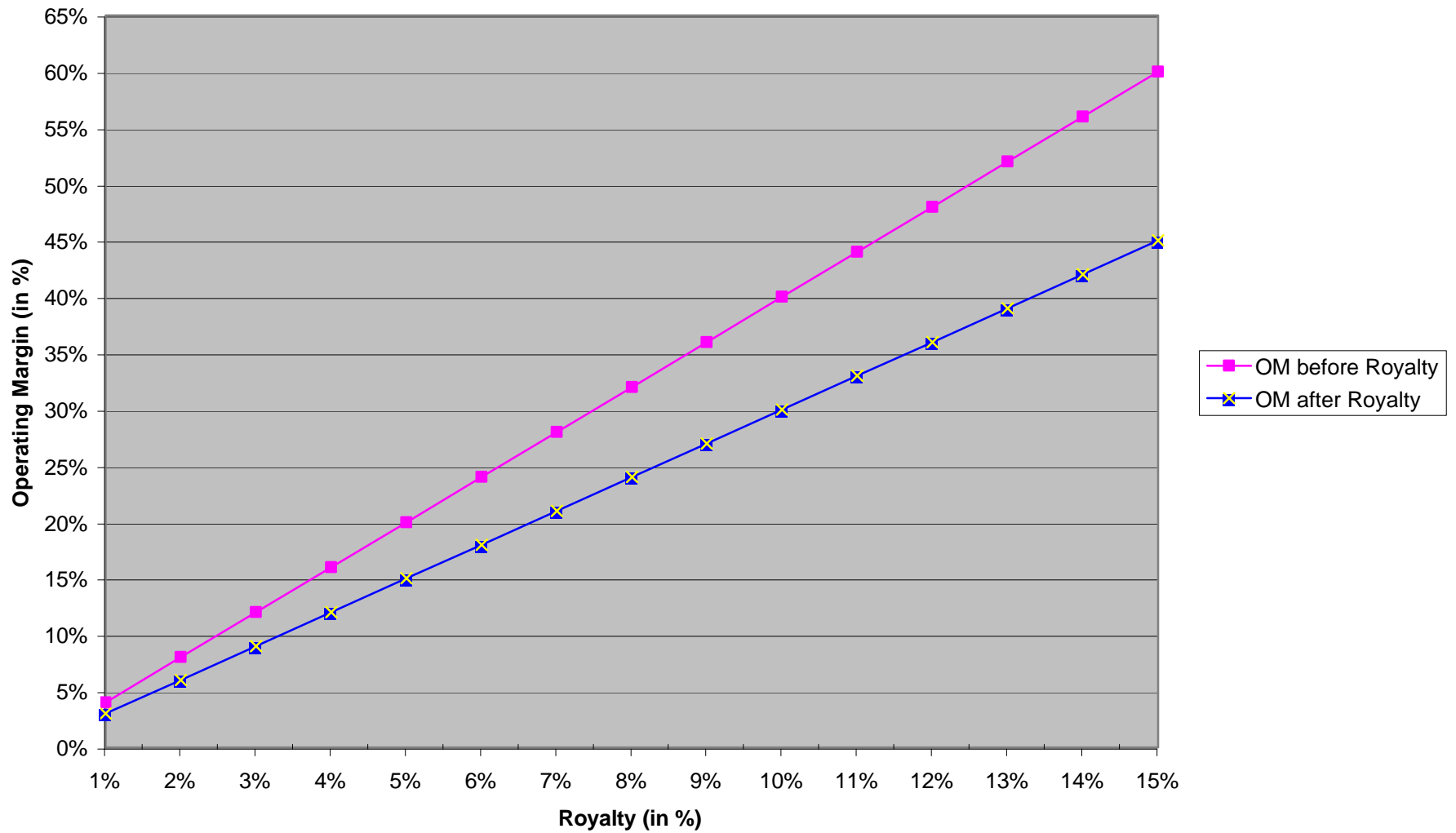


Double Dipping			
		Contract Manufacturing	Contract R&D
			Proposed Tested Party Data for Contract Manufacturing
	Sales	90	90
-	<u>COGS</u>	<u>75</u>	<u>75</u>
=	Gross Profit	15	15
-	<u>SG&A (operating expenses)</u>	<u>10</u>	<u>9</u>
=	Operating Profit	5	6
	<u>Operating Margin</u>	<u>5.6%</u>	<u>6.7%</u>

Illustration of Royalty Cap of 25% of Profits



Example of Residual Profit Split
(Based on Example in 1.482-6)

Line	Formula		USP (A)	ForSub (B)
(1)		Sales		\$ 500
(2)		Pre-Royalty Expenses		\$ 300
(3)	(1)-(2)	Pre-Royalty Profit		\$ 200
		Step I: Routine Return		
(4)		Operating Assets		\$ 200
(5)		Benchmark Return on Assets		10%
(6)	(4)*(5)	Routine Return		20
		Step II: Allocation of Residual Profit		
(7)	(3)-(6)	Residual Profit		\$ 180
(8)		Value of Capitalized R&D/Marketing Intangible Development Costs	\$ 100	\$ 200
(9)		Share of Capitalized R&D/Marketing Intangible Development Costs	33%	67%
(10)	(7)*(9)(A)	Royalty to be received (paid)	\$ 60	\$ (60)

Resale Price Method Vs. Cost Plus Method

	Manufacturing	Distribution
Sales		100
- <u>COGS</u>	<u>90</u>	
= Gross Profit	10	10
- <u>SG&A (operating expenses)</u>		
= Operating Profit		
- Interest		
- <u>Income Tax</u>		
= Net Income		

Residual Profit Split
 Example of Calculation of R&D Stocks

Assumptions	
Cost of Capital	10.0%
Useful Life (years)	3
Gestation Period (years)	1
<i>Assumes Half Year Convention</i>	

<i>Year</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	
R&D	10.000	15.000	20.000	25.000	30.000	
Pre-Service R&D (1)	11.000	16.500	22.000	27.500	33.000	
R&D Put In Service (2)		11.000	16.500	22.000	27.500	
<i>In-Service R&D Amortization</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	
	1996	11.000	1.833	3.667	3.667	1.833
	1997	16.500		2.750	5.500	5.500
	1998	22.000			3.667	7.333
	1999	27.500				4.583
	2000	33.000				
Total Amortization			1.833	6.417	12.833	19.250
In-Service R&D Stock - BOY		0.000	9.167	19.250	28.417	
+R&D Put in Service		11.000	16.500	22.000	27.500	
<u>-R&D Amortized</u>			<u>1.833</u>	<u>6.417</u>	<u>12.833</u>	<u>19.250</u>
=In-Service R&D Stock - EOY			9.167	19.250	28.417	36.667
Total R&D Costs (Pre-Service & In-Service)						
In-Service			9.167	19.250	28.417	36.667
<u>Pre-Service</u>		<u>16.500</u>	<u>22.000</u>	<u>27.500</u>	<u>33.000</u>	
Total		25.667	41.250	55.917	69.667	

Notes

- (1) Equal to R&D multiplied by (1+Cost of Capital)
- (2) Due to one year gestation period R&D Put In Service is equal to previous year's Pre-Service R&