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Memorandum

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to: Supervisory Appeals Officer
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subject: Taxpayer Use of Section 482 and the Commensurate With Income Standard

This memorandum addresses taxpayer asserted rights to use section 482, in particular to invoke the commensurate with income standard, to reduce the charge for transfers of intangible property. This advice may not be used or cited as precedent.

ISSUES AND SUMMARY CONCLUSIONS

1. If the Service has not proposed an allocation under section 482, may a taxpayer apply section 482 in the first instance, in the course of an examination, during consideration by Appeals, or in a docketed case?

   - The Treasury Department and IRS longstanding authoritative interpretation set forth in the regulations and other published guidance is that the commensurate with income standard must be applied consistently with the arm's length standard. The taxpayer, therefore, has the ability and the right to achieve a commensurate with income result through the structure, risk allocation, and fixed or contingent form of payment that it adopts upfront for its controlled transaction, so long as that comports with economic substance. Further, Treas. Reg. § 1.482-1(a)(3) authorizes taxpayer use of section 482 to report results on a timely return based on prices different from those actually charged, but only "[i]f necessary to reflect an arm's length result." The regulation further states that section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the IRS to apply such provisions. Clearly, therefore, a taxpayer in the first instance, in the course of an examination, during consideration by Appeals, or in a docketed case, may not invoke section 482 as grounds for making a hindsight adjustment that enables the taxpayer to walk away, without arm's length consideration, from a deal it struck for itself.

2. May a taxpayer apply the commensurate with income ("CWI") provision to challenge a section 482 adjustment that was made by Exam, in a situation where Exam did not itself apply the CWI provision?

   - As discussed under the previous issue, in the course of an examination, during consideration by Appeals, or in a docketed case, a taxpayer may not invoke section 482 as grounds for making a hindsight, so-called "CWI" adjustment. Treas. Reg. § 1.482-1(g)(4) (Setoffs) does provide for a limited taxpayer right to a setoff against an IRS section 482 allocation on account of another non-arm's length transaction. Treas. Reg. § 1.482-1(g)(4) (Setoffs) addresses a situation in which the IRS upon examination has made an original allocation under section 482 regarding a given non-arm's length transaction (the primary transaction). The regulation provides substantive and procedural rules under which a taxpayer's claim for a "setoff" will be allowed by the IRS against its original section 482 allocation on account of a section 482 allocation raised by the taxpayer regarding another non-arm's length transaction going in the opposite direction (the setoff transaction). The substantive requirements are that the setoff transaction must be "between the same controlled taxpayers" and "in the same taxable year" as the primary transaction. Furthermore, the taxpayer must establish "that the transaction that is the basis of the setoff was not at arm's length" and must establish "the amount of the appropriate arm's length charge" for such setoff transaction. The procedural requirements relate to documentation and timely notification to the IRS of the basis for any claimed setoff. Nothing in this or any other provision of the regulations suggests that the taxpayer may alter the terms or prices of the primary transaction itself (i.e., the subject of the IRS original section 482 allocation) based on hindsight in contravention of the arm's length standard.

3. Does the word "income" in the phrase "commensurate with the income attributable to the intangible" in section 482 refer to income received prior to the transfer or license of an intangible (past profits), income anticipated to be received after the transfer or license of an intangible (projected profits), income actually received after the transfer or license of an intangible (actual profits), or some other measure of income?

   - The word "income" in the phrase "commensurate with the income attributable to the intangible" in section 482 should generally be construed as operating profits attributable to the intangible the taxpayer would reasonably and conscientiously have projected at the time it entered into the controlled transaction. However, the IRS, coming to examine a transaction only after-the-fact, is inherently at a disadvantage in assessing whether the pricing was supported by such upfront reasonable and conscientious evaluation of projected operating profits attributable to the transferred intangible. Therefore, consistent with the legislative history, the regulations allow the IRS, in its discretion, provisionally to treat the income actually resulting from the transferred intangible as evidence of what should have been projected at the time of the transfer and to make periodic adjustments to reflect the pricing had such results been projected at such time. The regulations then allow taxpayers the ability to rebut such presumption, e.g., by showing that such results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time the transaction.

4. If a qualified cost sharing arrangement (CSA) specifies buy-in payments in the form of a royalty or other contingent consideration, and if the actual amount paid by a participant in a particular year differs from the amount estimated to be due in that year, does the CWI provision permit (or require) a CSA participant to make so-called "true-ups" to account for the difference?

    - The taxpayer's form of buy-in payment will be respected, if consistent with economic substance. For example, a taxpayer could conceivably adopt a fixed outcome payment form structured as preliminary royalties with subsequent true-up/down to a liquidated amount agreed in advance before the actual results were known. Conversely, taxpayers could conceivably adopt a contingent outcome payment form structured as a preliminary lump sum with true-up/down in light of subsequently arising actual results. However, taxpayers must clearly have adopted these deals – the IRS is not obligated to write in such contractual terms for the taxpayer's benefit (i.e., as drafter, the taxpayer may and should be held to its deal). By the same token, if the taxpayer conscientiously wrote and lived by a truly contingent form of payment, and subsequent events do not turn out as reasonably anticipated, then the IRS may not impose a "true-up" adjustment on the ground that is necessary to reach the originally projected present value.

5. May Appeals take into account provisions in an Income Tax Treaty, Convention, or the OECD Transfer Pricing Guidelines in determining the appropriate settlement of a section 482 allocation proposed by Exam?

    - Treaty provisions do not dictate the specifics or application of domestic law to the extent the domestic law reaches results consistent with the treaty obligations. The Treasury and IRS consider section 482 and the regulations to be wholly consistent with treaty obligations and the OECD Transfer Pricing Guidelines. Outside of the competent authority process under a treaty, tax administrators, including Appeals, are bound to enforce compliance with section 482 and the regulations without reference to the OECD Transfer Pricing Guidelines. The purpose of the Guidelines is to provide a common reference point for resolution of transfer pricing disputes between treaty partners within the context of the competent authority process. A taxpayer may request simultaneous assistance from U.S. Competent Authority and Appeals under Rev. Proc. 2006-54, § 8, 2006-49 I.R.B. 1035, 1043-44. In such case, the Appeals representative will consult and coordinate with the U.S. Competent Authority to develop a tentative resolution, which is then presented to the foreign competent authority. Under this procedure, the U.S. Competent Authority, not Appeals, is the IRS function responsible for developing the U.S. position paper and conducting the mutual agreement procedure with the treaty partner.

STATEMENT OF FACTS

1. The Service does not propose any section 482 allocation during the examination. The taxpayer affirmatively applies 482 in the course of the examination, Appeals consideration, or in a docketed case. (Issue #1, above)

2. In an examination, the Service proposes a section 482 allocation that relies on principles other than CWI, but the taxpayer challenges the allocation by reference to CWI. (Issue #2, above)

3. In an examination, the Service applies the CWI provision to a controlled transfer of intangible property. The taxpayer contests whether the application is appropriate. (Issue #3, above)

4. A CSA participant specifies that the buy-in payment is in the form of a royalty or other contingent consideration, and the actual amount paid by the CSA participant in a particular year is greater than the amount estimated to be due in that year. The taxpayer asserts that a downward adjustment or "true-up" is appropriate under the CWI standard. (Issue #4, above)

5. Exam has made a section 482 allocation to a controlled transaction and Appeals is considering that allocation. One of the controlled parties affected by this allocation is domiciled in a country that has entered into an Income Tax Treaty or Convention with the United States and the controlled transaction is governed by that Treaty or Convention. (Issue #5, above)

LAW AND ANALYSIS

I. Background: Longstanding Authoritative Interpretation that Commensurate With Income Standard Must Be Applied Consistently with the Arm's Length Standard

The two sentences of section 482 provide:

> 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, 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. 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.

Several conclusions follow from the face of the statute. The first sentence empowers “the Secretary” to allocate “gross income, deductions, credits, or allowances” among controlled taxpayers. The premise of every such allocation must be the Secretary’s determination that it is necessary in order either “to prevent evasion of taxes” or “clearly to reflect income” of any controlled taxpayer. The Tax Reform Act of 1986 added a second sentence, in the same paragraph as the first, as an additional specific condition “[i]n the case of any transfer (or license) of intangible property.”[1] Namely, the income with respect to such license or transfer shall be commensurate with the income attributable to the intangible. Notably, the second sentence does not authorize any person other than “the Secretary” to make section 482 allocations, whether generally or “[i]n the case of any transfer (or license) of intangible property.”

Neither the original first, nor the later added second, sentence mentions the arm’s length standard or the role it plays in implementing the statute. Instead, the Treasury and IRS have long maintained in regulations and other published guidance that transfer pricing allocations pursuant to the provisions of either sentence must be in accordance with the arm’s length standard as the unifying principle. The regulation promulgated in 1935 under section 482’s predecessor introduced the arm’s length standard and it has been the constant in all transfer pricing regulations since.[2]

The Conference Report accompanying the Tax Reform Act of 1986 directed the Treasury and IRS to study the section 482 regulations in light of the concerns regarding their application to intangible transfers.[3] Certain passages in the Committee Reports arguably might be construed as an invitation to the Treasury and IRS to interpret the CWI standard in a manner that would depart from the arm’s length standard. However, in the authoritative study undertaken pursuant to the Conference Report – the White Paper[4] – the expert agencies reaffirmed the primacy of the arm’s length standard for

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[1] Pub. L. No. 99-514, Section 1231(e)(1), 100 Stat. 2085, 2562-63 (1986).
[2] Notice 88-123, 1988-2 C.B. 458, 459-60, nn.8-9 and accompanying text.
[3] H.R. Rep. No. 99-841 (Conference Report), 99th Cong., 2d Sess. II-638 (1986).
[4] Notice 88-123, 1988-2 C.B. 458.

transfer pricing.[5] The final regulations adopted in 1994 mandate that the IRS must apply CWI periodic adjustments consistently with the arm's length standard.[6]

The operative language in both sentences of section 482 – e.g., "to prevent evasion of taxes," "clearly to reflect income," and "commensurate with the income attributable to the intangible" – leave ample scope for interpretation. As the expert agencies expressly tasked by the statute with its administration – i.e., as "the Secretary" or his delegate – the Treasury and IRS authoritative interpretation of these provisions, in their regulations and other published guidance, is entitled to deference.[7]

II. Responses to Specific Issues

Issue 1 – Taxpayer's Affirmative Use of Section 482 When IRS Has Not Made an Allocation under Section 482

The first issue is if the Service has not proposed an allocation under section 482, may a taxpayer apply section 482 in the first instance, in the course of an examination, during consideration by Appeals, or in a docketed case?

The second sentence of section 482, added by the Tax Reform Act of 1986, 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." As discussed above, the commensurate with income standard articulated in this second sentence is a specific condition "[i]n the case of any transfer (or license) of intangible property" regarding the allocation authority conferred upon "the Secretary" by the first sentence. Further, under the longstanding authoritative interpretation set forth in the regulations and other published guidance, both sentences must be applied consistently with the arm's length standard.

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[5] The White Paper notes that "virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases [footnote omitted]. This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard."
Later, the White Paper states, "It is equally clear as a policy matter that, in the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over the primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm's length standard." Notice 88-123 at 458, 475.

[6] Treas. Reg. § 1.482-4(f)(2)(i) ("Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1.").

[7] A court is generally required to uphold an agency's interpretation of a statute within that agency's jurisdiction if two requirements are met: 1) the statute is ambiguous; and 2) the agency's interpretation is reasonable. This is the case even if the court concludes that the agency's interpretation is not the best interpretation of the statute. National Cable & Telecommunications Association v. Brand X Internet Services, 125 S.Ct. 2688, 2699, 162 L. Ed. 2d 820, 837 (2005); Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984). See also, Swallows v. Commissioner, 126 T.C. 96 (2006)(Tax Court majority invalidated regulation it found to be inconsistent with plain and unambiguous meaning of the statute there at issue), appeal docketed, No. 06-3388 (3rd Cir. July 18, 2006).

Taxpayers may disingenuously interpret the CWI provision as authorizing them to "adjust" the consideration they themselves set for controlled intangible transfers. In effect, they would treat the charges in the related-party deals as paid by blank checks, to be filled in by them with the benefit of hindsight. For example, they may initially state the royalty in a controlled license as a lump sum of, say, $100 million. If the actual results of the licensed activity are favorable, the taxpayer lets the lump sum royalty stand as is. However, if the actual results – or what are represented as the actual results – are unfavorable, these taxpayers claim the entitlement to make an affirmative adjustment to the prior fixed royalty so that it can be made "commensurate with the income" – here the losses – "attributable to the intangible." In other words, heads the taxpayer wins, and tails the government loses.

Ironically, if accepted, this approach would sanction precisely the type of abuse the CWI principle was enacted to police. In 1986, Congress indicated a significant degree of skepticism about related-party transfers of high-profit potential intangibles for relatively insignificant lump sum or contingent royalty consideration that effectively place all the intangible development downside risk in one controlled taxpayer and all the upside profit potential in another. See H.R. Rep. No. 99-426, at 424-25 (1985). See also Notice 88-123 (i.e., the White Paper), 1988-2 C.B. 458, at 472-74, 477-80.

The CWI principle effectively anticipates that controlled taxpayers must price an intangible transfer consistent with the expectation that the income with respect to that transfer be commensurate with the relative risks and economic activity the parties undertake regarding the intangible. Thus, the CWI principle requires that the parties' risks be reflected in upfront pricing that appropriately accounts for the expected benefits of those risks over time. The proper accounting for risk may take different forms, and the taxpayer's choice of form will be respected, provided that it is clearly documented and conforms with economic substance.[8] For example, a taxpayer may adopt a lump sum royalty payment form, provided that the lump sum amount reflects a conscientious upfront valuation of the risks and expected benefits. Having made that choice, the taxpayer must stick with it and accept the actual outcome. A taxpayer may not rely on the CWI principle to attack its own pricing of an intangible transfer or choice of payment form.[9] The CWI principle does not provide the taxpayer a ticket to back out of a deal, without arm's length consideration, when the deal plays out differently than expected.

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[8] See generally Treas. Reg. § 1.482-1(d)(3)(ii)(B) & (iii)(B).
[9] See Notice 88-123, 1988-2 C.B. at 480:

> Because section 482 may be applied only by the Service, no refunds could be allowed if an excessive lump sum was paid. However, to prevent abuse of outbound lump sum payment in inbound licensing arrangements the Service would be allowed to adjust excessive lump sum payments that clearly exceed the commensurate with income standard. (Emphasis added).

Alternatively, a taxpayer may adopt a contingent form of royalty payment, provided that such choice is clearly documented, and provided further that the expected present value of future payments (appropriately discounted to reflect risk) is consistent with the taxpayer's conscientious upfront valuation. If appropriately structured and valued, a contingent payment may reflect the profit potential and risks, while also permitting actual royalty payments to vary with later outcomes. In such arrangements, less income will properly result if the outcomes are less successful than reasonably anticipated, and more income will result if the outcomes are more successful. In other words, the outcome is not heads the taxpayer wins, and tails the government loses.

The taxpayer, therefore, has the ability and the right to achieve a commensurate with income result through the structure, risk allocation, and fixed or contingent form of payment that it adopts upfront for its controlled transaction, so long as that comports with economic substance. Further, Treas. Reg. § 1.482-1(a)(3) authorizes taxpayer use of section 482 to report results on a timely return based on prices different from those actually charged, but only "[i]f necessary to reflect an arm's length result."[10] The regulation further states that section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the IRS to apply such provisions.

Clearly, therefore, a taxpayer in the first instance, in the course of an examination, during consideration by Appeals, or in a docketed case, may not invoke section 482 as grounds for making a hindsight adjustment that enables the taxpayer to walk away, without arm's length consideration,[11] from a deal it struck for itself.

By contrast, if the taxpayer's pricing fails to reflect a conscientious upfront valuation effort, the IRS has the ability to make periodic adjustments to bring the pricing in line with the CWI principle.[12] Although the IRS necessarily must examine the taxpayer's transaction after-the-fact, it should exercise its periodic adjustment authority consistent with what would have been a conscientious upfront valuation – had the

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[10] Treas. Reg. §§ 1.482-1(a)(3) and 1.6662-6(a)(2) also permit taxpayers to <u>increase</u>, as opposed to <u>decrease</u>, their taxable income by qualified amended return or statement in order to avoid penalties. In addition, Treas. Reg. § 1.482-1(g)(4) (Setoffs), discussed under Issue 2, provides for a limited taxpayer right to a setoff against an IRS section 482 allocation on account of another non-arm's length transaction.

[11] Taxpayers may cite to the White Paper as putative support for the existence of an implied renegotiation clause in every controlled intangible transfer. Notice 88-123, 1988-2 C.B. at 477 ("It is, therefore, perfectly consistent with the arm's length standard to treat related party license agreements generally as renegotiable arrangements and to require periodic adjustments to the transfer price to reflect substantial changes in the income stream attributable to the intangible.") However, the context makes clear that the reference is only meant to justify IRS periodic adjustments. <u>See</u> <u>id</u>. ("The Congressional directive to the Service to make adjustments to intangible returns that reflect the actual profit experience …"). Controlled taxpayers that include renegotiation clauses in their contractual terms, or that simply renegotiate in the absence of an advance option to do so, must provide consideration and price any original renegotiation option and/or subsequent renegotiation at arm's length. See Issue 4, note 21 and accompanying text.

[12] I.R.C. § 482 ("… the Secretary may … allocate gross income, deductions, credits, or allowances …"); Treas. Reg. § 1.482-4(f)(2)(i) ("… the district director …"); Notice 88-123, 1988-2 C.B. at 477 ("The Congressional directive to the Service to make adjustments to intangible returns that reflect the actual profit experience …"). See also background at beginning of section I.

taxpayer in fact made one. Thus, the IRS should decline to make a periodic adjustment to a royalty on the basis of outcomes that could not be reasonably anticipated at the time the intangible transfer was entered into. The regulations clearly reflect the intent that the IRS exercise restraint in making periodic adjustments based only on the upfront reasonable expectations and not based on subsequent events which could not be reasonably anticipated.[13]

On the other hand, in making appropriate periodic adjustments, the IRS may adopt a form of payment different than that the taxpayer adopted for its royalty payment – such as a contingent royalty rather than a lump sum form. The legislative history plainly intends that the IRS may make periodic adjustments as a contingent royalty when the taxpayer provides only an inadequate lump sum. See H.R. Rep. 99-426, at 424-25 (1985). See also Notice 88-123, 1988-2 C.B. at 479-80. The regulations also clearly authorize the IRS to make periodic adjustments in a different form than that adopted by the taxpayer, e.g., an equivalent royalty in lieu of a lump sum. See Treas. Reg. § 1.482-4(f)(5) (lump sum payments adjusted on the basis of equivalent royalty).

Issue 2 – Taxpayer's Use of CWI to Challenge an IRS Section 482 Allocation

The second issue is may a taxpayer apply the commensurate with income provision to challenge a section 482 adjustment that was made by Exam, in a situation where Exam did not itself apply the CWI provision?

As explained in connection with the previous issue, a taxpayer may achieve CWI results through the structure, risk allocation, and fixed or contingent form of payment that it adopts upfront for its controlled transaction, so long as that comports with economic substance. In the course of an examination, during consideration by Appeals, or in a docketed case, a taxpayer may not invoke section 482 as grounds for making a hindsight, so-called "CWI" adjustment that enables the taxpayer to walk away, without arm's length consideration, from a deal it struck for itself.

Treas. Reg. § 1.482-1(g)(4) (Setoffs) does provide for a limited taxpayer right to a setoff against an IRS section 482 allocation on account of another non-arm's length transaction. This provision addresses a situation in which the IRS upon examination has made an original allocation under section 482 regarding a given non-arm's length transaction (the primary transaction). The regulation provides substantive and procedural rules under which a taxpayer's claim for a "setoff" will be allowed by the IRS against its original section 482 allocation on account of a section 482 allocation raised by the taxpayer regarding another non-arm's length transaction going in the opposite direction (the setoff transaction). The substantive requirements are that the setoff transaction must be "between the same controlled taxpayers" and "in the same taxable year" as the primary transaction. Furthermore, the taxpayer must establish "that the

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[13] Treas. Reg. § 1.482-4(f)(2)(ii)(D). See also Treas. Reg. § 1.482-4(f)(2)(i) ("Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1.").

transaction that is the basis of the setoff was not at arm's length" and must establish "the amount of the appropriate arm's length charge" for such setoff transaction. The procedural requirements relate to documentation and timely notification to the IRS of the basis for any claimed setoff. Nothing in this or any other provision of the regulations suggests that the taxpayer may alter the terms or prices of the primary transaction itself (i.e., the subject of the IRS original section 482 allocation) based on hindsight in contravention of the arm's length standard.[14]

Issue 3 – CWI, Past or Projected or Actual Profits

The third issue is does the word "income" in the phrase "commensurate with the income attributable to the intangible" in section 482 refer to income received prior to the transfer or license of an intangible (past profits), income anticipated to be received after the transfer or license of an intangible (projected profits), income actually received after the transfer or license of an intangible (actual profits), or some other measure of income?

The arm's length standard requires that a controlled transaction be priced so as to realize results consistent with those uncontrolled taxpayers would have realized if they engaged in the same transaction under the same circumstances.[15] In determining the price for a controlled intangible transfer under this standard, a key consideration is the profit potential of the intangible which uncontrolled taxpayers would have reasonably anticipated in terms of operating profits from exploitation (or subsequent transfer) of the intangible projected as of the time of the transfer.[16]

Both the legislative history and the White Paper expressed concern about the disadvantage IRS faces, after-the-fact, in examining profit potential reasonably

[14] The taxpayer is always free to defend against an IRS adjustment at any time, including on the basis of a transfer pricing method or exact or inexact comparables that it did not rely upon contemporaneously with entering into the controlled transaction. See, e.g., Compaq v. Commissioner, T.C. Memo 1999-220. However, any such subsequently adopted method must still be tested under the arm's length standard. In other words, the defense will stand only to the extent it supports arm's length results based on the deal actually adopted by the taxpayer at the time it entered into the transaction. Furthermore, to the extent a subsequently adopted method fails to fully support the taxpayer's results as arm's length, such method does not protect against the transfer pricing penalty. See Treas. Reg. § 1.6662-6(d)(2)(iii)(A)(the documentation that avoids the penalty must be "in existence when the return is filed").

[15] Treas. Reg. § 1.482-1(b)(1).

[16] For purposes of this memorandum, "operating profits" are to be understood as profits from use, including an on license or retransfer, of the transferred intangible (since the profits on the on license or retransfer in turn estimate the profits from use by the ultimate licensee or transferee). See Treas. Reg. § 1.482-4(c)(2)(iii)(B)(*1*)(*ii*):

> The profit potential of an intangible 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 invested and start-up expenses required, the risks to be assumed, and other relevant considerations.

expected by taxpayers at the time of controlled intangible transfers.[17] Accordingly, the regulations allow the IRS, in its discretion, provisionally to treat the income actually resulting from the transferred intangible as evidence of what should have been projected at the time of the transfer and to make periodic adjustments to reflect the pricing had such results been projected at such time. Taxpayers might argue that certain portions of the legislative history and the White Paper appear to suggest that actual profit experience should be determinative.[18] The better reading, however, is that the intention is to give the IRS a presumptive basis for making periodic adjustments.[19] The regulations then allow taxpayers the ability to rebut such presumption, e.g., by showing that such results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time the transaction.[20]

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[17] H.R. Rep. No. 99-426, 99th Cong., 1st Sess., 1986-3 C.B. (Vol. 2) 420, 424:

> Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

The White Paper echoed these concerns, when it observed that taxpayers often looked solely at the "purportedly limited facts" known at the time of the transfer to justify an inappropriately low charge for the intangible, or when it noted "[p]eriodic adjustments will also obviate the need for the often fruitless inquiry into the state of mind of the taxpayer and its affiliate at the outset." Notice 88-123, 1988-2 C.B. at 472, 480 n.173.

[18] See, e.g., H.R. Rep. No. 99-426, 99th Cong., 1st Sess., 1986-3 C.B. Vol. 2 420, 425:

> The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer.

See also Notice 88-123, 1988-2 C.B. 458, 472 ("Congress determined that actual profit experience should be used in determining the appropriate compensation for the intangible").

[19] See, e.g., Notice 88-123 at 477 ("Aside from the empirical evidence of what unrelated parties seem to do, actual profit experience is generally the best indication available, absent comparables, of anticipated profit experience that arm's length parties would have taken into account at the outset of the arrangement."); Id. at 473 ("The arm's length bargaining of unrelated parties over the terms of the arrangement reflects each party's judgment about what its share of the combined income (or appropriate expense reimbursement) ought to be.").

[20] See Treas. Reg. § 1.482-4(f)(2)(ii)(D)(Extraordinary events). In addition, the regulations exclude periodic adjustments under certain conditions, including the deviation between actual and projected results being less than certain thresholds. See Treas. Reg. §§ 1.482-4(f)(2)(ii)(B)(*6*) & (C)(*4*)(80% to 120% of the prospective profits or cost savings that were foreseeable).

In sum, the word “income” in the phrase “commensurate with the income attributable to the intangible” in section 482 should generally be construed as operating profits attributable to the intangible the taxpayer would reasonably and conscientiously have projected at the time it entered into the controlled transaction. However, the IRS coming to examine a transaction only after-the-fact is inherently at a disadvantage in assessing whether the pricing was supported by such upfront reasonable and conscientious evaluation of projected operating profits attributable to the transferred intangible. Therefore, the IRS, in its discretion, provisionally may treat actual profits as evidence of projected profits and make periodic adjustments as if such results were projected at the time of the controlled intangible transfer. Taxpayers may rebut such presumption, e.g., by showing that such results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time of the transaction.

Issue 4 – “True-Ups” and Contingent Buy-in Payments

The fourth issue is if a qualified cost sharing arrangement (CSA) specifies buy-in payments in the form of a royalty or other contingent consideration, and if the actual amount paid by a participant in a particular year differs from the amount estimated to be due in that year, does the CWI provision permit (or require) a CSA participant to make so-called “true-ups” to account for the difference?

Taxpayer’s form of buy-in payment will be respected, if consistent with economic substance. For example, a taxpayer could conceivably adopt a fixed outcome payment form structured as preliminary royalties with subsequent true-up/down to a liquidated amount agreed in advance before the actual results were known. Conversely, taxpayers could conceivably adopt a contingent outcome payment form structured as a preliminary lump sum with true-up/down in light of subsequently arising actual results. However, taxpayers must clearly have adopted these deals – the IRS is not obligated to write in such contractual terms for the taxpayer’s benefit (i.e., as drafter, the taxpayer may and should be held to its deal). By the same token, if the taxpayer conscientiously wrote and lived by a truly contingent form of payment, and subsequent events do not turn out as reasonably anticipated, then the IRS may not impose a “true-up” adjustment on the ground that is necessary to reach the originally projected present value.[21]

Issue 5 – Appeals, Treaties, and OECD Transfer Pricing Guidelines

[21] The present value projected for the consideration under these payment form variants must be consistent with the present value reasonably expected for the buy-in. As just one example, consider a form of payment under which one controlled taxpayer agrees to pay a lump sum buy-in to the other at the time of entering into a CSA, but with the right to demand a refund subsequently if results actually realized are worse than reasonably projected at the time of the buy-in. In such a case, the first controlled taxpayer must purchase the refund option for arm’s length consideration. So, the upfront lump sum payment under this form will be greater than for a purely fixed lump sum buy-in, because the arm’s length refund option price must be added to the arm’s length fixed buy-in price.

The fifth issue is whether Appeals may take into account provisions in an Income Tax Treaty, Convention, or the OECD Transfer Pricing Guidelines in determining the appropriate settlement of a section 482 allocation proposed by Exam?

Treaty provisions do not dictate the specifics or application of domestic law to the extent the domestic law reaches results consistent with the treaty obligations. The Treasury and IRS consider section 482 and the regulations to be wholly consistent with treaty obligations and the OECD Transfer Pricing Guidelines.[22] Outside of the competent authority process under a treaty, tax administrators, including Appeals, are bound to enforce compliance with section 482 and the regulations without reference to the OECD Transfer Pricing Guidelines. The purpose of the Guidelines is to provide a common reference point for resolution of transfer pricing disputes between treaty partners within the context of the competent authority process.[23]

Two basic procedures are available to taxpayers to obtain assistance from the U.S. Competent Authority and Appeals. See Rev. Proc. 2006-54, §§ 7.02, 7.05, and 8, 2006-49 I.R.B. 1035, 1042-44. Under one procedure, a taxpayer may obtain review by Appeals in the first instance and then seek assistance from the U.S. Competent Authority.[24] If the taxpayer follows this procedure, the U.S. Competent Authority generally will not take any action that would alter the resolution reached by Appeals, but will only seek to obtain a correlative adjustment from the foreign competent authority under the applicable tax treaty or convention.[25]

Under the second procedure, a taxpayer may request simultaneous assistance from the U.S. Competent Authority and Appeals.[26] In such case, the Appeals representative will consult and coordinate with the U.S. Competent Authority to develop a tentative resolution, which is then presented to the foreign competent authority. Under this procedure, the U.S. Competent Authority, not Appeals, is the IRS function responsible for developing the U.S. position paper and conducting the mutual agreement procedure with the treaty partner.[27]

cc: Division Counsel
(Large & Mid-Size Business)

[22] See Statement of the Hon. Leslie B. Samuels, Treasury Assistant Secretary for Tax Policy, July 27, 1995 (“These new OECD guidelines are fully consistent with current U.S. tax rules”).
[23] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ¶ 17 (July 1995)(“These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD Member countries and, where appropriate, arbitration proceedings.”)
[24] See Rev. Proc. 2006-54 at § 7.02.
[25] Id. at § 7.05.
[26] Id. at § 8.
[27] Id. at § 8.05(2).