Transfer Pricing for Intangibles

A Commentary on the White Paper

edited by

Fred C. de Hosson

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Introduction

Fred C. de Hosson
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Responding to the recommendations of the Conference Committee Report on the Tax Reform Act of 1986, Treasury and IRS on 26 October, 1988 issued a 'White Paper' covering proposed international pricing rules under Section 482, IRC. Section 482 was amended in 1986 by the addition of the following sentence: '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'. This provision has become known as the 'Superroyalty' provision because of its potential to impute a much greater royalty on high-profit intangibles than had customarily been paid in the past.

The legislative history of the Superroyalty provision indicated Congressional concern that transfer pricing should reflect reality: related entities actually operate as economic units not as unrelated parties. A corporation that transfers potentially valuable property to its foreign affiliate does not incur the same risks that face unrelated parties, because the parent's equity interest assures it the ultimate benefit of future profits regardless of the transfer price set. To be sure, this problem is by no means restricted to the transfer of intangibles. The US Congress, however, believed that the problem was particular acute in the case of high-profit intangibles. When intangibles were transferred to foreign affiliates early on, parent companies could take the position that, at the time of transfer, it was not possible to predict the subsequent success of the products; thus, arm's length royalties would be set at a modest rate. Under the Superroyalty provision Congress intends to require corporations to 'look back' and reset royalty rates on the basis of actual profit experience with the transferred intangibles (the commensurate with income standard). The long-awaited White Paper intends to 'clarify' the commensurate with income standard and related adjustments over time concept. The White Paper also discusses issues related to cost sharing arrangements and administrative issues related to the transfers of intangible property.

The importance of the Superroyalty provision and the clarification offered by the White Paper can hardly be overstated. The provision introduces a completely new approach for intercompany pricing in the international context and does so without much consult with other countries including treaty partners.

In general one may feel sympathy for the position the IRS and other tax authorities find themselves in. Transfers of intangibles, particularly to tax haven affiliates, is a difficult area for many Revenues generally and an area which may give scope for avoidance by international groups. One may also welcome that the IRS is moving away from a rigid application of the 'four methods' of arriving at an arm's length price which, under the section 482 regulations, have to be applied in a particular order or priority. There is also not much doubt that the Treasury and IRS have tried in a principle and sincere way to develop a profit split approach which is related to the functional analysis approach often used as the 'fourth' method in resolving section 482 disputes with the IRS and by the courts.

There is, however, a general feeling that the functional analysis method developed by the White Paper is not soundly based and provides, in effect, a methodology to treat the transferree of intangibles as a contract manufacturer. To demenstrate this point: in cases where the US courts applied their version of the functional analysis approach (which looks at individual facts and circumstances and makes allowances for the reality of particular situations) in relation to the transfer of pharmaceutical industry intangibles to tax havens, the final result was that the tax haven afiliates were allowed a rate of return of between 55-70- percent[1] on their tangible assets.

In a similar case the White Paper's 'Arm's length Return Method' would allow a rate of return on tangible assets of only 12 percent, any remaining income would be treated as income due to intangible assets and allocated to the owner of the intangible assets.

It does not require much imagination to predict that treaty parties of the US may view an unmitigated application of the proposed method as in conflict with an arm's length or 'reasonable' allocation of the income and there could therefore be serious competent authority difficulties. Unfortunately it is difficult to see how these difficulties are going to be solved since the White Paper indicates that any bilateral solution must be consistent with Congressional intent in enacting the Superroyalty provision.

The White Paper considers cost sharing arrangements as an appropriate method of allocating income from intangibles, if and to the extent they are consistent with the purpose of the Superroyalty provision and reflect economic activity undertaken by each related party. The authors acknowledge, however, that they know little about cost sharing and this may be the explanation for the precise and onerous proposed rules for cost sharing in the Paper. Lack of knowledge can not be the explanation for the rule that US geographic rights may not be assigned to a foreign person if, for instance, a US person participates in the cost sharing or if the group is US owned. The White Paper refers to 'various reasons' for the inclusion of this requirement and prefers not to elaborate on the matter. It is especially here that one can not help to feel that there is a certain element of xenophobia in the report.[2]

The Paper requires an incredible amount of documentation from the taxpayer to support the transfer prices used. This information furthermore has to be available at the time of the preparation of the return and must be made available at the start of an IRS examination. Finally the White Paper proposes a review of existing penalties to determine whether they adequately cover failure to meet the proposed rules and to add new penalties if they do not.

The editorial board of *Intertax* considered the consequences of the rules proposed by the White Paper so significant that it was decided to publish a special issue of the Journal entirely devoted to the report (*Intertax* 1989-2/3).

The board invited experts in the transfer pricing area to write on the various aspects of transfer pricing for intangibles. The authors include tax advisors, revenue authorities both from the US and treaty parties of the US, and representatives of international business organisations. We think you will find a wealth of information in the articles and hope you will enjoy reading them.

Amsterdam, 12 April 1989

[1] See James P. Fuller, the IRS Section 482 White Paper, *Tax Notes*, 7 November 1988, p. 656. See also the recent Tax Court decision Boesch & Lomb Inc. and Consolidated Subsidiaries v. Commissioner No. 3394-89, 92 T.C. No. 33 (3.23.89).

[2] See *The Economist*, 'Taxidermy', 12 November 1988.

United States Section 482 White Paper*

Emil Sunley, Edward Maguire and John Wills
Deloitte Haskins & Sells, Washington D.C.

I. Background

The United States Treasury Department and the Internal Revenue Service have issued their 'White Paper' on related party transfer pricing for intangibles.[1] The White Paper is a detailed discussion draft (with invitations for comment from the public) on possible rules relating to intercompany pricing. The White Paper was drafted in response to a mandate from Congress in the 1986 Tax Reform Act for a study of US transfer pricing rules. This study will have a major impact on both US and foreign multinationals.

Under Section 482 of the Internal Revenue Code, the US Internal Revenue Service may reallocate income or deductions among related parties in order to 'prevent evasion of taxes or clearly to reflect the income of ... (the related parties)'. This broad grant of authority was the basis for comprehensive regulations governing intercompany pricing promulgated by the Treasury Department in 1968. Those regulations affirm that the arm's-length standard is the governing principle behind transfer pricing. The 1968 regulations provide specific rules for intercompany pricing with respect to loans, services, use of tangible goods, use or transfer of intangibles, and sales of tangibles.[2]

As formulated by the Section 482 regulations, the paramount test of an arm's-length price is a comparable transaction between unrelated parties. Practical experience over the years, however, demonstrated that the search for such 'comparables' was in many instances futile, and the appropriate transfer price was, in most cases, determined by hybrid methodologies.

The Internal Revenue Service was particularly frustrated in its effort to prosecute Section 482 cases in which US companies had transferred or licensed valuable intangibles to foreign subsidiaries. The problem was most acute with respect to US possessions (Puerto Rico) and operations in other tax favored jurisdictions. Accordingly, in the early 1980's the US Congress substantially restricted the tax benefits for US companies operating in possessions and imposed punitive rules on the transfer of intangibles by US companies as a contribution to capital to foreign affiliates. *See* Internal Revenue Code Section 936 and 367(d).

Congress made an even more sweeping attack on the perceived problems in the Tax Reform Act of 1986. A new sentence was added to Section 482 (with corresponding changes to Sections 936 and 367(d), popularly referred to as the 'super-royalty' provision, which states: 'In the case of any transfer (or license) of intangible property... the income with respect to such transfer or license should be commensurate with the income attributable to the intangible.'[3] The implications of this short sentence are enormous.

Congress stated that its intent in enacting this language was to end the practice of transferring high-profit intangible assets to foreign affiliates in exchange for amounts which, though arguably derived from 'comparable' uncontrolled transactions, in fact represented remuneration for far less

* The authors thank their colleagues John Crawford, Valerie Amerkhail and Richard Clark for their valuable contributions to this article.

[1] US Department of the Treasury and Internal Revenue Service, *A Study of Intercompany Pricing*, 18 October 1988.

[2] Since promulgation of US Section 482 regulations, a number of countries have formulated rules in varying degrees of detail relating to intercompany pricing. Among these countries are Canada, Germany, Japan, France and the United Kingdom.

[3] The term intangible is defined to include a broad range of items including patents, know-how, trademarks, copyrights, franchises, contracts, customer lists, technical data, etc., having substantial value independent of the services of any individual. Section 936(h) (3) (B).

valuable intangibles.[4] Congress also recognized that many unanswered questions remained with respect to transfer pricing, and instructed the Internal Revenue Service to conduct a comprehensive review of all aspects of transfer pricing.[5]

On 18 October 1988 the Treasury Department and Internal Revenue Service released the requested study of transfer pricing. The report (hereinafter referred to as the White Paper) falls short of a comprehensive review because it avoids entirely certain problems that have long troubled practitioners (such as how to deal with currency fluctuations), and also treats other important areas (tangibles, services, financial transactions) only in passing or by implication. Nonetheless, the White Paper does address the two central and related conceptual issues confronting transfer pricing after the 1986 Act:

- the meaning of the 'commensurate with income' standard; and
- general principles for establishing transfer prices in the absence of comparables.

In addition to these two central issues, the White Paper proposes new and onerous documentation and reporting standards and increased penalties to stimulate more 'compliant' taxpayer behavior. The White Paper discusses and rejects a number of possible safe harbors for transfer pricing and substantially restricts the availability of research and development (R&D) cost sharing. Although the White Paper does not have the force of law, it indicates the probable direction of new regulations which are expected in 1989. Comments are invited to be submitted by 15 February 1989.

Section II of this article summarizes the White Paper. Section III comments on certain practical considerations in setting transfer prices within the framework set out by the White Paper. Before addressing the White Paper in detail, however, we offer several comments on the larger policy issues.

- If the transfer pricing methodology suggested by the White Paper is adopted in the United States, the potential for double taxation rises dramatically. The White Paper dismisses the prospect of double taxation rather cavalierly, relying on the competent authority and US foreign tax credit mechanisms, both of which would be inadequate to solve the problems of foreign country resistance to the super-royalty rules. (There is also no discussion of foreign exchange restrictions that might prevent the licensor from complying with the periodic adjustment requirement.)
- The methodologies described by the White Paper would create enormous and costly administrative burdens on US and foreign businesses attempting to comply. The solutions given in the examples in the White Paper are simplistic in the extreme, compared to the enormous work and potential controversy inherent in applying the new rules to real world situations.
- The White Paper's argument that super-royalty is in accordance with internationally accepted arm's-length principles is not persuasive, particularly with respect to periodic adjustments.
- The proposed cost-sharing rules appear to be so restrictive in their formulation and uncertain in their application that taxpayers will feel reluctant to enter into cost-sharing agreements. This result would be unfortunate since cost-sharing has been accepted as a legitimate solution to the uncertainties of transfer pricing.
- The pricing methodology of the White Paper appears at first glance to be a commendable effort to bring some order to valuing transfers of intangibles, an area which had been highly elusive in the past. Indeed, the White Paper proposals have a superficial appeal for some transactions outbound from the United States. As will be seen in greater detail later in this article, however, the arm's-length return method, which is the central IRS methodology, creates an illusion of precision which quickly disappears upon application to real cases.

In general, it appears highly questionable whether selective instances of perceived abuse (e.g. undocumented cases, pharmaceutical companies operating in Puerto Rico) justify the wholesale revision of the transfer pricing rules and imposition of new documentation rules and severe penalties.

II. Summary of the White Paper

The White Paper contains thirteen chapters and five appendices. The heart of the White Paper is contained in five chapters and a single appendix which discuss the new 'commensurate with income' standard and the 'basic arm's-length rate of return' method. Because these contain the most significant implications for businesses, our discussion focuses on these parts. The balance of the White Paper includes an historical review, a discussion of Treasury's experience in administering Section 482, a discussion of problems in implementing transfer prices based on comparables and on 'fourth methods', the rationale for Treasury's rejection of safe harbors, and a discussion of cost-sharing.

[4] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (the 'Blue Book'), 4 May 1987 at pp. 1011 ff. The Treasury Department apparently intends, however, to apply the new standard to *all* intangibles transfers or licenses, not only to high profit intangibles. *See* discussion below.

[5] H.R. Conf. Rep. No. 841, 99th Cong. 2nd Sess. II-638 (1986).

A. Recent difficulties

The White Paper begins with discussions of the Treasury Department's perception of the problems it currently faces with Section 482. These fall into two categories: (1) problems of administration and (2) problems of substance.

1. Problems of administration

The principal problem of administration that the Treasury Department identifies is the failure of taxpayers to document adequately the methodology they use in establishing intercompany prices. In some cases, Treasury alleges, this is due to resistance on the part of taxpayers to providing the information and the Treasury Department's unwillingness or inability to use legal methods to compel the release of the information. Treasury believes that often, however, it is because companies have never analyzed their transfer prices within the framework of the Section 482 regulations, and are simply unable to show that their prices conform to the regulations. Treasury makes a number of recommendations for increased documentation requirements and legal penalties. These are discussed below.

The White Paper also discusses problems of administration associated with the valuation of intangibles, especially in the absence of comparables, and discusses the absence of a rationale for the existing hierarchy of tangible goods pricing methods. Both of these relate closely to the commensurate with income standard and the arm's-length rate of return questions that are the heart of the White Paper.

Finally, the White Paper recommends earlier use of counsel and economists in transfer price examinations. Based on our recent encounters with the IRS, this is a recommendation that is already being carried out.

2. Problems of substance

In two chapters the White Paper discusses the difficulties it faces in implementing the existing regulations, which rely heavily on the use of comparables, whether it be for pricing tangibles, intangibles, or services. The White Paper acknowledges what practitioners have long felt: as a practical matter it is extremely difficult to find comparables, and it is usually much easier to discredit an asserted comparable than to defend it.

Given that comparables usually provide only weak guidance to the establishment of transfer prices, it is especially important that rules for pricing in the absence of comparables be clear. The White Paper asserts that the courts have 'failed to adopt a consistent and predictable methodology' when the absence of comparables forced the courts to turn to some profit-split method. The development of a clear methodology in the absence of comparables – the arm's-length rate of return method, discussed below – is a principal task of the White Paper.

B. The 'commensurate with income' standard

In addition to these long-standing problems, Congress injected a new element with its 1986 enactment of the 'commensurate with income' requirement for transfers of intangibles.

1. Profits

Implicit in the Treasury view of the commensurate with income standard is the belief that the essence of an intangible licensing agreement is that the parties estimate the income to the intangible (or intangibles), and strike a bargain to divide this income (profit split). The precise division of this income will depend on the various intangibles that each party brings to the bargaining table, as well as on other factors that determine their relative bargaining strength. But the point is that the object of contention is the division of total profits, not the royalty rate *per se*. The royalty rate is merely the expression of the terms of their final agreement, and is highly

sensitive to the total anticipated profits. As a result, normal royalty rates in an industry are irrelevant to the determination of the rate that would be expected to prevail in the case of a high profit intangible. It is more appropriate, Congress and the Treasury maintain, to estimate the arm's-length terms of high profit intangibles by looking *directly to the underlying income*. Far from being a departure from the arm's-length standard, this represents a strengthening of it, according to the White Paper.

2. Periodic adjustments

Even if the preceding description accurately characterizes the bargaining process, unrelated bargainers will still realize unanticipated profits or losses from their license agreements simply because the future is uncertain, and not all expectations are realized. The White Paper requires that such unanticipated profits or losses be minimized through periodic adjustments to the royalty rate, and argues that this is what would be expected in significant transactions between unrelated parties.

The White Paper proposes that royalty rates be adjusted whenever the profits associated with the intangible have changed 'substantially'. Revisions are not required for 'minor variations' in intangible income, unless an accretion of such minor variations has yielded a substantial modification. Otherwise, periodic adjustments can be avoided only if the taxpayer can show an exact comparable without such adjustments, or can show that the changed profitability was unanticipated at the time of the original license and that unrelated parties would not have made provision for such contingencies – a difficult task.

If an intangible is transferred for a lump sum consideration, then the White Paper proposes to treat the transaction as open for an indefinite period, and to impose allocations in subsequent years if the actual commensurate with income amount ever exceeds the lump sum payment (appropriately increased for the time value of money). This may go beyond the Section 482 allocation of income and deductions and recharacterize the economic substance of a transaction (*see* the discussion of Section 367(d) below).

3. A departure from arm's-length?

The commensurate with income standard was controversial as soon as it was enacted, particularly the requirement for periodic adjustments.[6] Some have said that the commensurate with income standard represents a departure from the arm's-length standard. This allegation is usually based on the assertion that unrelated parties dealing at arm's-length would not enter into contracts providing for such periodic adjustments. It is also based on the argument that Congress certainly intended some departure from current practice in 1986, otherwise it would not have amended the law. In fact, the Report of the House Ways and Means Committee indicates little regard for the arm's-length standard in the case of intangibles and appears to adopt 'commensurate with income' as the *measure* of the required return. H.R. Rep. No. 99-426, 99th Cong. 1st Sess. (1985) states at p. 425: 'There are extreme difficulties in determining whether the arm's-length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. The committee believes, therefore, that this is the measure that should be used under Section 367 and Section 482 in the case of transfers to a foreign corporation.'

The White Paper argues that no departure from the arm's-length standard was intended. Rather, the purpose of the new language was to assert that the arm's-length standard, properly applied, would result in remuneration for intangibles that was commensurate with the income of the intangibles, and that any other result was a misinterpretation of the arm's-length standard. Furthermore, the Treasury argued, its proposal for *prospective* periodic adjustments is common commercial practice.[7]

Although the White Paper cites various portions of the 1979 OECD report *Transfer Pricing and Multinational Enterprises* to justify the use of profits in determining transfer prices, no authority is cited in the OECD report or other sources for periodic adjustments or treating lump-sum transfers as open transactions.

As the arm's-length justification for period adjustments, the White Paper first refers to 'the

[6] This requirement is contained in the legislative history accompanying the statute.

[7] Prior to the publication of the White Paper there had been speculation that it would propose retrospective adjustments to transfer prices, as well as prospective periodic adjustments. Such retrospective adjustments are not proposed.

rarity of long-term, fixed licenses negotiated at arm's-length'. A study was conducted by the authors of the White Paper of 60 license agreements between unrelated companies that were on file with the United States Securities and Exchange Commission. These licenses are analyzed in Appendix D to the White Paper. We have obtained and reviewed to 60 licenses referred to. These licenses simply do not support the White Paper conclusions that long-term fixed royalty licenses are 'rare' or that parties dealing at arm's-length would provide for upward adjustments in the licensor's share of the profits. In fact, the sample contains a good number of fixed rate long-term licenses; and rates are more likely to be adjusted downward rather than upward as sales increase or time passes. There are a number of short-term licenses and licenses terminable at will in the sample. These, however, do not substantiate the idea that arm's-length parties provide for adjustments of the kind envisioned by the White Paper. The White Paper cites no instance of post facto adjustments to a lump sum payment transaction involving the sale of intangibles.

As its second reason for the consistency of periodic adjustments with the arm's-length standard, the White Paper states that taxpayers can avoid periodic adjustments if they can demonstrate on the basis of arm's-length evidence that 'no such adjustments would have been made by unrelated parties'. This standard of proof seems impossible.

4. Scope of application

The legislative history of the super-royalty provision in the 1986 Act made clear that its genesis was in Congressional concern over high profit intangibles. The plain language of the statute, however, addresses all intangibles. The White Paper makes clear that the commensurate with income standard will be applied to all intangibles, not just to high profit intangibles. Furthermore, the provisions will apply equally to marketing and to manufacturing intangibles, and equally to inbound and outbound transactions.

The White Paper points out that intangibles may be incorporated into tangible good and implies that in some circumstances it may be necessary to independently value the tangible and intangible elements of the item in question in order to determine the correct transfer price. The White Paper gives no guidance as to when the authors think such an approach would be necessary, nor the methodology for applying it.

The White Paper does not purport to apply its methodology to transfers of tangibles. There may, however, be an inevitable carryover of the reasoning of the White Paper to cases involving the sale of goods. The White Paper does recommend eliminating the current priority of resale price over cost plus methodologies in favor of a facts and circumstances test. This change would conform the US regulations to the OECD guidelines.

5. Inbound transactions

The pricing methodology proposed in the White Paper may be good news, on the other hand, for foreign businesses licensing technology to US affiliates. The implications of inbound super-royalty were sufficiently clear to the US Congress that, in the recent Technical Corrections Act of 1988, it delayed the effective date of the super-royalty provisions for inbound transfers of intangibles to 16 August 1986 (while the effective date for outbound transfers was 16 November 1985).

Although the new administrative and documentation proposals of the White Paper could be particularly burdensome for foreign taxpayers, a foreign licensor, after review of all the intangibles transferred to its US affiliate (including items which may not have been noticed as intangibles heretofore), might find that an even greater charge will be justified. Obviously the new super-royalty provisions are but one factor in setting charges for intangibles made available to US affiliates.

6. Joint ventures

In 1984 the US Congress enacted a particularly punitive provision covering the transfer of intangibles by a US entity to a foreign corporation in a transaction falling within the parameters of Section 351 (contributions to capital) and certain other code sections relating to tax-free reorganizations. The effect of this provision is to require the transferor to recognize royalty income over the life of the intangible (but not in excess of twenty years). Such income is treated for US tax purposes as from US sources, thus undermining the availability of the foreign tax credit.

Section 367(d) was particularly onerous for US companies entering into joint ventures abroad with third parties. While the US party had previously been able to contribute valuable intangible

property to the joint venture entity without incurring US tax, after the passage of Section 367(d), the US venture partner had the following choices:

(1) contribute the intangible to the joint venture and recognize the royalty income under Section 367(d);
(2) alternatively, under temporary regulations, the US partner could elect to pay US tax on gain from the contribution of intangibles to the foreign joint venture, but only under narrow circumstances (e.g., the US partner owned between 40 and 60 per cent of the joint venture); or
(3) actually sell or license the intangible to the joint venture for an arm's-length charge. This approach avoided Section 367(d) but might require substantial cash payments from the joint venture, thus upsetting the normal commercial balance.

The 1986 Act also made the commensurate with income super-royalty rules applicable to Section 367(d) transfers, sales and licenses. As a result, each of the three solutions above will be subject to the super-royalty rules, including the BALRM methodology, periodic adjustments and the lump-sum rules. This adds a further burden to solutions which already could create difficulties with the foreign partner. Perhaps seeing some of these problems, the White Paper suggests that an exception to the periodic payment approach might be allowed, particularly where intangibles are transferred to an entity in which an unrelated corporation has a substantial interest. The White Paper invites comments on whether or not a standard different from the concept of control under Section 482 should apply for purposes of this exception.

C. Selection of method for pricing intangibles

The White Paper envisions that comparable transactions will continue to be the preferred method of establishing transfer prices where such comparables exist, *provided the comparables are exact*. If the comparables are only inexact, then they should be reviewed for the information they may provide, but they will not necessarily be given priority over a profit-based method of setting the transfer price.

The White Paper enunciates stringent standards for comparables to be considered exact. In particular, they must involve (i) the same intangibles, (ii) in substantially similar economic environments, and (iii) with substantially similar contractual features. If the transfer price is set by reference to an exact comparable, then periodic adjustments need not be made provided that (i) the comparable *remains* exact over time, and (ii) there is no adjustment in the comparable.

If exact comparables cannot be found, the White Paper stipulates that either a method based on inexact comparables or based on profits is to be used depending on the facts and circumstances. The particular profit-based method prescribed by the White Paper is called the basic arm's-length return method (BALRM, popularly called 'ballroom'), and is discussed below. Where significant intangibles are held by the affiliate, the basic arm's-length return method might be augmented by a profit-split of the profits accruing to the intangibles. The White Paper calls this method 'BALRM with profit split'.

The choice between the use of an inexact comparable vs. the BALRM method depends on (i) whether the intangible being licensed is unique or admits of (inexact) comparables, and (ii) whether the affiliate also brings other than routine intangibles to the bargaining table. The matrix below summarizes the relationship of method to facts and circumstances.

	Intangible is unique	*Inexact comparables exist*
Affiliate has significant intangibles	BALRM profit split	Inexact comparables
Affiliate has no significant intangibles	BALRM	BALRM or inexact comparables

D. The arm's-length rate of return method

The White Paper asserts that the basic arm's-length rate of return method is theoretically sound because it permits one to disentangle the return to different assets and functions in an integrated

business setting, and ensures that the sum of the returns so calculated will equal the economic income of the firm.

The core requirements of the BALRM method are as follows:

1. Profits to identified assets (i.e. manufacturing assets) and activities (marketing) are segregated by applying quantitative 'arm's-length rate of return' tests. In activities using significant assets, the arm's-length return is measured in the first instance by looking at comparable returns on assets (ROAs). (Note that return on assets, rather than on equity, must be used. This is because under economic reasoning there is no reason why the transfer price should depend on the leverage of the seller.) With respect to activities such as marketing, which tend not to use significant tangible assets, the White Paper suggests the use of such indicators as ratios of profits to sales or to costs.
2. Subtracting the returns to the explicit functions or factors calculated above from the combined total operating income of the group leaves a residual profit which is deemed to be a return on intangibles. If only one party to the transaction brings intangibles to the table, then the White Paper asserts that party should enjoy 100 per cent of this intangible income.

Steps (1) and (2) constitute the basic BALRM method.

3. If both parties bring significant intangibles to the table, then the intangibles income is split between the parties according to the value of the intangibles they contribute. This is called the BALRM with profit split.[8]

The BALRM method, for all its shortcomings, at least provides a consistent economic model for viewing intercompany transactions. Indeed, shortcomings in the BALRM method are, to a certain extent, also shortcomings that exist under the current regulations, but which are not obvious simply because the conceptual model behind the existing regulations has never been clearly articulated. If the BALRM method would reduce the use of *ad hoc* methods both by the courts and the Internal Revenue Service it could represent an improvement over the existing state of affairs.

Unfortunately, however, the BALRM method is unlikely to achieve this in practice. The economic relationships to which BALRM appeals are abstract concepts which are usually argued to hold as a matter of long run equilibrium under certain idealized conditions. They have never been postulated to apply to every entity or every transaction. In seeking to force all transfer pricing into this mold, the White Paper is imposing a highly artificial standard which is not justified by economic theory. Furthermore, the White Paper neglects to consider a number of factors that have long been known to bear on firm-specific rates of return. Section III of this article lists some of these factors.

E. Documentation and safe harbors

1. Documentation requirements

The White Paper contains suggestions for more stringent documentation requirements. The taxpayer would be required to identify the information gathered by it in connection with applying the methodology prescribed by the White Paper. In addition Forms 5471 and 5472 might be expanded to require information relating to the determination of inter-company pricing.

The documentation would have to be gathered by the taxpayer prior to filing its tax return and would have to be made available to the IRS upon request. The taxpayer would also be required to attest on its return to the availability of the information. The White Paper also discusses the possibility of imposing more severe penalties in connection with inter-company pricing.

As a practical matter the BALRM methodology and documentation requirements could be a severe burden on non-US entities and to US companies forced to try to analyze rates of return with little or no access to foreign profit data.

[8] The White Paper suffers from circular reasoning at this point. On p. 101 the White Paper says that the rents to intangibles should be split '... according to the relative value... [of] each party's significant intangible...'. But the value of the intangible is, by definition, the present value of the income that would accrue to it, which depends (in turn) on the profit split. The White Paper invites comment on this issue (p. 5). Note also that even if there is some way of establishing the intangible asset values, the division of profits depends also on other factors related to the bargaining position of the companies. The White Paper acknowledges this complication in a footnote on p. 85, but says that the issue is beyond the scope of the White Paper.

2. Safe harbors

The White Paper devotes an entire chapter to discussing various proposals for safe harbors in inter-company pricing and rejects all of them. Safe harbors are rejected for two reasons: (1) Because they do not produce an arm's-length result and (2) Treasury alleges that they are almost entirely to the benefit of the taxpayer and not the government. The first reason misses the point of safe harbors, and the second ignores the benefit *even to the government* of certainty and simplified administration.

F. Cost-sharing

The legislative history of the 1986 Act indicated that bona fide research and development cost-sharing arrangements would continue to be accepted. The White Paper, however, severely undercuts the viability of cost-sharing in several ways:[9]

- It makes highly equivocal statements about the permitted breadth of a cost-sharing project;
- It would require that new participants to a cost-sharing arrangement pay for 'pre-existing' intangibles at fair market value;
- It would require geographic exclusivity of interests acquired under the arrangement;
- It would require periodic adjustments to the allocation method;
- It would require that allocations be made based on relative contributions to profitability, with the proviso that profitability may in many instances be impossible to ascertain, thus defeating cost-sharing.

The United States has not until now promulgated a detailed set of rules concerning cost-sharing. The present Section 482 regulations give only the broadest outlines. A more detailed set of rules was contained in the proposed version of the Section 482 regulations published in 1966; however, these were deleted in the final version of the Section 482 regulations published in 1968. Both the proposed and final regulations on cost-sharing gave the taxpayers far more latitude than the White Paper proposals.

Perhaps fearing avoidance of the super-royalty rules, Congress stated three new requirements for related party research and development cost-sharing arrangements:[10]

- The arrangement must involve the sharing of R&D costs of unsuccessful as well as successful products within an 'appropriate product area';
- The cost-sharing allocation should be on the basis of relative profits;
- If one party contributes funds toward research and development at an earlier point in time, or is effectively more at risk, such party should receive an appropriate return.

The implications of these standards are spelled out in the White Paper. The specific requirements proposed by the White Paper, especially with respect to the second and third of the abovelisted requirements, are analogous to the BALRM methodology.

The specific requirements proposed by the White Paper are as follows:[11]

Product area

As described by the White Paper, the starting point for an appropriate product area is a three-digit category in the Standard Industrial Classification Code; however, the Internal Revenue Service will challenge a cost-sharing arrangement if it believes that its scope is either too broad or too narrow. According to the White Paper, this is to prevent foreign developers from charging their US affiliates on a very broad basis (thus increasing deductible payments) and US developers from charging their tax haven affiliates on a very narrow basis (charging only for the most successful projects). Much uncertainty will be created by this ambivalence.

[9] Despite its severe restrictions on taxpayer's use of cost-sharing, the White Paper suggests that the Internal Revenue Service will continue to advance the theory of *de facto* cost sharing in attempting to disallow royalty payments from US subsidiaries to their foreign parents. (Footnote 229.) This theory was rejected by the Tax Court in *Ciba-Geigy*, 85 TC 172 (1985).

[10] H. R. Rep. No. 841, 99th Cong. 2d Sess. (1986) II-638.

[11] The statutory cost-sharing election available to US corporations with operations in possessions of the United States under Section 936 of the Internal Revenue Code presents a special situation and is not discussed here. It should also be noted that the White Paper discussion relates to the sharing of costs of developing intangibles and not the allocation of costs of various services.

Cost shares and benefits

The White Paper goes on to deal with the fundamental rule of a cost-sharing arrangement that costs should be shared in accordance with the relative benefits to be received by the participants. In order to implement this principle, the White Paper establishes several subsidiary rules:

- The participants must be assigned specific and exclusive geographic rights to the intangibles developed under the arrangement. In general, US rights may not be assigned to a foreign person unless it is a member of a foreign-owned multinational group that conducts the research outside of the United States and no US affiliates are participants in the arrangements.
- Participants in the cost-sharing arrangement must exploit the intangible in the *manufacture* of products. In other words, a pure marketing affiliate could not participate.
- Cost shares are to be determined in accordance with relative profits of the participants (determined before research and development expenditures). After discussing the difficulties of measuring benefits, particularly profits, the White Paper makes a rather startling comment:
  'It may be that a cost-sharing agreement should not be recognized if units of production or sales are not appropriate measures and gross or net margins are extremely difficult to estimate.' (p. 120)
  Here the White Paper seems to be saying that since it may be impossible to estimate profits accurately, cost sharing should not be allowed. This may illustrate the wisdom of the 1968 regulations, which rejected precision in favor of a general rule.
- The cost-sharing allocation must be revised on a prospective basis when there is a change in the relative benefits of the participants. This might be very difficult in practice, particularly where there are substantial minority interests.
- The costs to be shared are all the costs, direct and indirect, attributable to the research and development activities. In defining the amount of costs to be shared, the White Paper introduces some US tax accounting principles. First, a US participant in a cost-sharing arrangement cannot make a cost-sharing payment attributable to a charge for depreciable assets in excess of US depreciation rules. Secondly, indirect costs should include the portion of overall management expense and interest expense allocable to research and development activities in accordance with the US expense allocation principles. Given the highly arbitrary nature of some of these tax accounting rules, one questions how appropriate they are to a cost-sharing arrangement, or whether a cost-sharing arrangement would even lead to any fiscal abuse if these rules were not applicable.

Buy-in requirements

A crucial element of the new cost-sharing rules is the so-called buy-in requirement. The buy-in requirement stems from the statement in the legislative history that pre-existing research and development activity and significantly greater risks should receive an appropriate return.

What intangibles does the buy-in apply to and what is the appropriate charge? The buy-in requirement, first of all, does not apply to fully developed intangibles, which require a royalty to the same extent as if actually licensed or sold. In other words, a company cannot obtain an ownership interest in a fully developed intangible by means of a cost-sharing arrangement. Finding the boundaries of a 'fully developed intangible' will undoubtedly be difficult in many cases.

The buy-in requirement, therefore, applies to intangibles which are 'pre-existing' but not 'fully developed'. The White Paper lists three types of intangibles falling into this category:

- Pre-existing intangibles at various stages of development in which the participants will have ownership rights;
- Basic research not associated with any product;
- Going concern value associated with the participant's research facilities and capabilities that will be used in the arrangement.

Once these intangibles have been identified, they must be charged at full fair market value and not merely cost. The concern seems to be that US taxpayers might use the cost-sharing rules to avoid the superroyalty provisions. The remedy is an administrative morass.

The requirement that taxpayers identify, allocate and value all pre-existing but not fully developed intangibles, basic research and going concern value will require extensive identification and allocation rules to provide any certainty that all intangible assets subject to the buy-in have been taken into account. The White Paper would then require that each such intangible be valued. No guidance is given. One would assume that the value is the difference between the present value of the R&D investment opportunity without the pre-existing intangible and its value with the pre-existing intangible – measurement of which would be virtually impossible.

The White Paper has set an almost impossible standard with respect to measuring cost shares or evaluating the buy-in requirement. Any forecast of future profitability extending more than a trivial amount of time into the future is fraught with great uncertainty. (Not a single example in the White Paper deals with cost-sharing.) Under the White Paper regime, however, such forecasts would be the centerpiece of R&D cost-sharing. Failure to document such forecasts to the satisfaction of the IRS could lead the IRS to disqualify the agreement.

Administrative requirements

The White Paper recommends that taxpayers be required to make a formal election if cost-sharing is desired, to file a copy of the cost-sharing agreement with their tax return, and that extensive required backup documents (including those located abroad) be submitted to the Internal Revenue Service upon a 60 days' notice.

III. Factors to consider when setting transfer prices using the BALRM method

The White Paper offers guideposts for calculating transfer prices based on the BALRM method, but does not discuss many specific factors on which the outcome should depend. Without doubt, the most important factor neglected by the White Paper is currency fluctuations. The BALRM method is linked to operating income, as if foreign exchange gains and losses were a peripheral aspect of the transaction.

In addition, the factors discussed below all are well-known to affect rates of return. Failure to consider these factors could conceivably expose the company to tax adjustments, interest, and penalties. Perhaps more importantly, the affirmative consideration of such factors might help a business establish transfer prices that conform to its overal tax planning goals. A full discussion of these factors is beyond the scope of this paper, but we offer brief outlines of some of the more important of them as suggestions to companies evaluating their transfer pricing in light of the White Paper.

A. Selection of 'comparable' rate of return

Replacing transfer pricing methods based on comparable uncontrolled transactions with methods based on profits does not eliminate the search for comparables. It merely shifts the search from one for comparable transactions to one for comparable rates of return. Perhaps the single greatest difficulty which the analyst must confront with the BALRM method is the selection of an appropriate rate of return.

The White Paper displays an almost cavalier attitude to this issue in its examples, creating the impression that selection of a comparable rate of return is straightforward. In fact, however, an entire subdiscipline of economics – industrial organization – is largely concerned with why rates of return vary across firms. Relevant factors include the following:

- *expected vs. realized rates of return*
  The rate of return which matters for decision making is the *expected* rate of return at the time the bargain is struck. Historical yields on assets reflect, however, realized rates of return. Some adjustment to observed historical yields should presumably be made to reflect this when looking for 'comparable' rates of return, although the White Paper does not discuss this. Current yields on financial assets do reflect expected yields, but also incorporate unknown inflation expectations (see below).
- *real vs. nominal rates of return*
  Investment decisions are made based on expected *real* (after inflation) rates of return. Both historical data and current yields on financial assets, however, reflect *nominal* rates of return. Measuring inflation expectations can be expected to be a source of contention, and the problem will be exacerbated by currency fluctuation.
- *risk*
  The expected rate of return is higher to operations that show greater variability of income than to operations with steady income, even if the *levels* of income are the same.
- *market structure/conditions of entry*
  Rates of return to assets in any particular industry may display permanent premiums over market rates if there are significant barriers to entry. A large variety of factors can create such barriers. By the same token, some market structures have been alleged to yield rates of return to capital with permanent discounts from market rates.

- *relation of comparable ROAs to cost of capital*
  The White Paper is silent on the question of what to do if estimated comparable rates of return on assets are lower than the firm's own weighted average cost of capital, a common occurrence. The weighted average cost of capital is at least as accurately measurable as a comparable ROA, and presumably should play some role in the BALRM method.
- *yield curves*
  The rate of return to assets is a function of the term/liquidity of the assets. Empirically, however, the relationship between return and term is volatile.

Each of these subjects could be the subject of a treatise in its own right. Our purpose here is merely to highlight factors that should be considered in setting transfer prices.

B. Measurement of rate of return

The conceptual framework behind the BALRM method requires use of *economic* rate of return. This often differs from the apparent rate of return calculated from accounting data. Some of the reasons for this are:

- *Profits by line of business vs. reporting entity*
  The White Paper acknowledges that corporate entities consist of aggregates of lines of business, and rates of return vary across the lines of business. In general, however, rates of return from accounting data can be computed only for reporting entities that correspond to the entire business enterprise. The US Federal Trade Commission used to maintain data which at least made an effort to disentangle this issue, but these data are no longer available. There will certainly be scope for disagreement over this issue.
- *Differences between GAAP and economic reporting*
  There are significant conceptual differences between GAAP and economic accounting. Some of the differences are academic niceties, but others (such as asset valuation) are not only empirically significant, but also go directly to the heart of transfer pricing issues.

C. Bargaining position

As discussed previously, the White Paper acknowledges that when both parties to a transaction bring intangibles to the table, the profit split becomes a bargaining situation. The conventional economic model does not yield determinate outcomes in such bargaining situations, because their essence is that both parties possess factors of production capable of earning permanently above-normal rates of return.

In such a situation, the profit split will depend on factors such as the following:

- Is the licensed product a major part of the licensor's/licensee's income?
- How many fixed (as opposed to variable) costs does the licensor/licensee have associated with this intangible?
- Will the value of the product decay?
- What external pressures does each bargainer face?
- Which party is better situated to withstand foregone income from a delay in striking a bargain?

The White Paper is silent on these factors.

IV. Conclusion

Styled a 'Discussion Draft', the White Paper itself does not have any binding effect.[12] It is, however, a statement of the thinking of policy makers in the Treasury Department and the Internal Revenue Service. The Department and the Service have invited comments on the White Paper, and after reviewing those comments are expected to propose new regulations governing transfer pricing, perhaps in the second half of 1989.

The White Paper is designed to deemphasize the role of comparable transactions in setting transfer prices. In its place it would install the BALRM methodology, and insist that all transfer pricing be justified according to this method.

The BALRM method sounds highly precise in its White Paper description. When applied to the real world, however, its precision vanishes. Even if all intangible assets belong to only one party to a transaction, a whole host of economic factors bear on the rate of return that various assets

[12] It is understood that certain agents of the Internal Revenue Service have already been asserting the White Paper in taxpayer matters. One should keep in mind, however, that the law of super-royalty is in effect by virtue of the Tax Reform Act of 1986. The impact of some of its rules is quite severe, with or without the White Paper elaboration.

should enjoy. More importantly, the White Paper does nothing to advance certainty in the most common case of all: When both parties to a transaction possess significant intangible assets.

Furthermore, the White Paper methodology assumes that transfer prices are set centrally, and that a wide range of relevant data are readily available to the price setter (who is apparently assumed to be the tax director of the company). All of these are highly suspect assumptions.

The White Paper's fundamental flaw appears to be that it has transferred an abstract economic model directly to a real-world policy setting. The model was never intended for such a purpose, and in attempting to impose it Treasury is violating the practice both of good economics and of good business.

IRS White Paper revisits Section 482

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Introduction

The Tax Reform Act of 1986 mandated Treasury to revise its transfer pricing rules under Revenue Code Section 482. Congress was concerned that US corporations were receiving inadequate compensation for intangibles transferred to their controlled foreign operations.

Under the old transfer pricing rules, compensation for intangibles is determined by comparing what unrelated parties pay to one another – the arm's length standard. Unrelated pricing comparisons do not consider that intangibles transferred to a related foreign entity may have higher income potential than those transferred to unrelated parties. Royalties of 5 to 10 per cent are common between unrelated parties, whereas intangibles of high income potential might command 'super royalties' of 30 to 40 per cent, or more.

The Congressional mandate to Treasury was not easy to fulfill. What is fair compensation for high income intangibles when the arm's length standard dictates 5 to 10 per cent? How can the intangibles' contribution be valued without austensibly departing from the arm's length principle, the internationally accepted standard?

The 'Study on Intercompany Pricing', released in October by Treasury/IRS, is the long-awaited White Paper. The study proposes a new method for valuing intangibles that attempts to preserve and redefine the arm's length standard.

The major goal of the White Paper is to provide a way to price intangibles in the absence of comparables on which to base an arm's length price. The new method introduces a 'commensurate-with-income' standard for the valuation of high income intangibles. Under this approach, a functional analysis will test that income reported by related entities is in line with what unrelated parties earn for functions they perform and risks they incur. The residual income is then considered to be return for intangibles and is attributed to the owner of the intangibles.

Treasury and IRS are emphatic in saying that the new method merely refines and improves the arm's length approach to transfer pricing. Many observers disagree. The reaction of our foreign trading partners, both governments and corporations with operations in the United States, may provide the necessary answers about how well Treasury and IRS have succeeded in adhering to the international transfer pricing standard.

The Commensurate-with-Income Standard

The 1986 Tax Reform Act revised Section 482 to require that transfers of intangibles to a related party receive payment 'commensurate with the income' attributable to the intangible. The Regulations [1.482-2(d)(3)] broadly define intangibles as:

- patents, inventions, formulas, processes, designs, patterns, and other similar items;
- copyrights, literary, musical or artistic compositions, and other similar items;
- trademarks, tradenames, brand names, and other similar items;
- franchises, licenses, contracts, and other similar items;
- methods, programs, systems, procedures, campaigns, surveys, customer lists, technical data, and other similar items.

The legislation addresses primarily transfers of high profit intangibles. Since these intangibles are often unique and typically are not transferred to unrelated parties, it is difficult, if not impossible, to find comparable transactions to confirm an arm's length price.

Intangibles are often transferred as part of a tangible property, as in the case of a logo, a tradename or a trademark. For comparison purposes, it is difficult to value a trademark that is transferred along with a tangible product in the absence of similar products sold, with or without trademarks.

The difficulty is no different from when the transfer involves intangibles alone – for example, establishing a royalty rate for licensing the use of an intangible. A similar problem may exist with regard to the performance of services. By loaning employees to its foreign operations, a company may provide services and transfer valuable intangible know-how. In the absence of comparables, the value of both the services and the related intangibles are difficult to determine.

The White Paper addresses the current Section 482 regulations and problems resulting from the lack of specific rules for situations where comparable transactions do not exist. What is described as 'any other reasonable method' has been interpreted to support different methods and ad hoc approaches by which the IRS, taxpayers and the courts have resolved transfer pricing disputes. The White Paper draws austensibly on these earlier methods to address situations that are without comparisons in the open market place.

The White Paper takes the position that payments with respect to intangibles be measured by, and be proportional to, the income stream generated by the intangible property, taking into account the assets used, the economic functions performed, and the risks borne by the related parties. In broad terms, the amount of compensation must reflect the profitability of whatever is being transferred, since that is what an unrelated third party would consider.

By proposing this 'commensurate-with-income' standard, the White Paper hopes to formally fill the gap left in the poorly defined fourth method under the current regulations. The commensurate-with-income standard requires a functional analysis of the transactions. It would test the income reported by the related entities using comparable transactions when they exist, and rate of return comparisons when there is not comparable pricing information. Absent valid rate of return comparisons, the White Paper proposes the use of a profit split to determine the appropriate compensation for intangibles.

The commensurate-with-income approach not only applies to licensing agreements and the determination of appropriate compensation for intangible, but also to other types of transfers such as the sale of products with intangibles aspects, e.g., components used by foreign manufacturers. The IRS argues that this approach is consistent with the arm's length standard.

Functional Analysis

The White Paper specifically states (Chapter 6, p. 54) that the application of the commensurate-with-income standard requires a determination of income from transferred intangibles. The intangible income must be allocated on the basis of the economic contributions of the related parties, requiring a functional analysis of the economic activities performed and the economic costs and risks borne by the related parties.

A functional analysis must be applied in the basic arm's length rate of return method ('BALRM'). First, the assets and other factors of production that are used by the related parties in the relevant lines of business must be identified and assigned market returns. Certain functions are performed by a wide range of unrelated parties, providing open market comparables. In addition to 'tangible' functions, such as manufacturing, distribution and marketing, return on production assets and exposure to risk must be identified and rewarded. Once income has been assigned to these functions, the residual income is classified as return on intangible, and is allocated to the owner of the special intangible.

Assuming the foreign affiliate to be a manufacturer only, it would use measurable factors of production such as labor, plant, equipment, working capital and ordinary manufacturing intangibles. The income that a manufacturer should earn for performing these functions is to be determined by comparing what unrelated manufacturers make for performing those roles. The residual income in this scenario would be allocated to the owner of the intangible – assumedly the US parent corporation.

BALRM

Not surprisingly, the White Paper upholds primary reliance on comparables. If exact comparables exist, or even if inexact comparables are available, these comparables must be used to determine arm's length compensation. Only in the absence of comparable pricing information, does the White Paper propose the use of the basic arm's length rate of return method ('BALRM', or the so-called 'ballroom method'). The study suggests a number of approaches to use and factors to consider, such as return on assets, and margins over costs, as well as return for risks borne, to determine compensation for contribution to income.

To use the BALRM, the taxpayer needs to perform a functional analysis to assign income to such 'tangible' functions as manufacturing, distribution and marketing. The residual income is designated as return on intangibles and assigned to the owner of the intangible.

Clearly the White Paper intends to assure compliance with the arm's length standard to whatever extent possible, and to depart from the old standard only when comparables can absolutely not be found. However, valuable intangibles are often unique and have no comparables, so changes are that the BALRM is going to become the standard in most transactions involving valuable intangibles.

Criticism has been expressed that the White Paper overstates the BALRM's use and the precision with which it can be applied. It would clearly be wrong to develop average rates of return to be applied to all taxpayers when rates of return vary tremendously from one company to another, and from one year to the next. Market performance is not static and is subject, among other things, to the degree of market penetration and product maturation. Tax audits are done on a year-to-year basis, which may distort rate of return computations on intangibles whose commercial potential is realized only over a longer period of time.

Profit Split

In cases where the BALRM will not adequately resolve questions about appropriate compensation for unique intangibles, the White Paper proposes the use of a profit split. Examples of such cases are

(a) two related parties have each developed valuable intangibles; or
(b) one party has developed a manufacturing intangible, and the foreign subsidiary has developed and owns valuable marketing intangibles.

In each instance, both parties are entitled to income on the intangibles they own. A profit split approach assures that due consideration is given to the relative value of economic functions performed, as well as to risks borne and costs incurred.

The White Paper confines the use of the profit split method to situations where both parties contribute valuable intangibles. The problem here is that the White Paper unduly limits the profit split approach despite its somewhat general use by the courts to resolve transfer pricing disputes with IRS. Giving the BALRM approach priority over the use of a profit split to resolve issues that are without comparables may attach an undesirable stigma of prior 'cost-plus/contract manufacturing' treatment, when the intent is to provide a new method of valuing unique intangibles.

BALRM vs. Cost Plus

The BALRM is seen as resembling the contract manufacturing method (cost plus) extensively used by IRS in its examinations of Puerto Rican manufacturing operations. Does the commensurate-with-income standard require licensees to be treated as contract manufacturers?

While IRS denies any similarities, the White Paper's proposal to develop comparisons of return on manufacturing assets, and comparisons of contract manufacturer's information is in no way different from the mark-up on cost the IRS allowed Puerto Rican manufacturers. To arrive at the residual income on intangibles by comparing the mark-up on functions performed by unrelated parties is paramount to cost plus.

Before the White Paper, the IRS argued that the manufacturer's income should be determined using a cost-plus method, while the taxpayer argued for the resale price method. After the White Paper, the results and arguments may be similar, with the IRS arguing that BALRM should be used, while the taxpayer argues for a profit split, or an inexact comparable.

Cost-sharing Arrangements

Cost-sharing arrangements ('CSAs') are covered in the White Paper as an alternative approach to the sale of intangibles. Under such agreements, two parties would agree up-front to jointly pay for the research to develop intangibles. Both parties would have ownership rights, thereby pre-empting the need for further compensation between them. Obviously, parties with a current licensing agreement cannot switch to a cost-sharing arrangement without compensation for intangibles that are already owned by one or the other party.

The White Paper insists that for CSAs to be valid, they must be in writing, and they must cover broadly defined product areas, rather than covering costs of only those projects with an expected high profitability. Costs to be shared must further satisfy the commensurate-with-income language: the costs shared must be in proportion to the expected benefits to the related party. The White Paper also discusses how anticipated benefits from CSAs are to be measured. Sales volume or units of production or profitability are suggested as acceptable measures of benefit.

The White Paper does not make cost sharing any easier, and leaves several questions unresolved. Will foreign governments recognize CSAs and/or the transfer of US rights under these arrangements? Foreign tax officials in reacting to the White Paper have raised concern about the threat of double taxation, particularly in the area of cost-sharing.

The requirement to predict anticipated future benefits is seen by some observers as an attempt by IRS to preclude the use of CSAs in a wide range of factual situations. Treasury/IRS acknowledge in the White Paper that it is difficult to estimate margins on sales that can be expected to result from successful research and product development efforts.

The White Paper makes it clear that new participants in a cost-sharing arrangement must compensate other participants for the *value* of the previously expended R&D efforts ('buy-in'). Likewise, a participant wishing to leave a CSA would have to receive from the remaining participants compensation equal to the value of the exiting party's contribution ('buy-out'). If a new affiliate is acquired, must it compensate the US parent and other subsidiaries for prior effort? In the case of the sale of an affiliate, would the parent be required to make a 'buy-out' payment to the new owner, as required when a participant exits a CSA?

An appraisal seems to be required to determine the value of intangibles each time an affiliate is both or sold, affecting a cost-sharing arrangement. The White Paper requires buy-in/buy-out compensation to be based on current value, not on historic cost. However, there is no indication as to how the amount of compensation is to be determined. Further, it is not clear if a previously paid arm's length royalty payment qualifies as a buy-in or not, and if so, to what extent. What would happen subsequently if the amount of the buy-in payment is considered incorrect?

Documenting Transfer Pricing

The White Paper recommends that corporations be required to document their pricing methodology at the time of the transfer. The documentation would have to be attached to the taxpayer's return at the time of filing. The up-front documentation requirement is in reaction to complaints by IRS examiners about the dearth of contemporaneous information documenting transfer pricing methods. The IRS is apparently contemplating penalties for taxpayers failing to document prices. The predictable consequence of this requirement is that corporations will have to devote more time to their transfer pricing and that the corporate tax functions will have to become involved with pricing decisions, which historically has not been the case.

Periodic Adjustments

The White Paper proposes periodic pricing adjustments for intangibles transferred. That proposal stems from the idea that renegotiation of compensation is something third parties would do. While it is questionable that unrelated parties enter into agreements that allow for a subsequent renegotiation of terms, the periodic adjustment is seen as another example of where the proposed rules depart from the international transfer pricing standard.

The periodic pricing requirement would force companies to look not only at the profitability of the intangible in the early years, but also down the road. The government has defended the periodic pricing adjustment by pointing out that only 'substantial changes in income would trigger pricing adjustments'. Substantial changes can affect profits, market penetration, or sales volume. No specific rules have been proposed to help determine whether or not the changes are significant enough to warrant pricing adjustments. As a result, the entire area of periodic pricing adjustments might have companies wishing for more certainty.

Foreign entities in particular may find the possibility of periodic pricing adjustments troublesome, since that is not a commonly accepted practice abroad. Not only is there risk of double taxation, but there is risk that US-based operations may, in their willingness to comply with US regulations, be reporting more of their income in the United States, to the detriment of foreign operations.

Double Taxation/Competent Authority

The White Paper proposes to increase compensation for valuable intangibles transferred abroad based on the proposed new standard – the BALRM. Predictions are that the White Paper will be extensively reviewed within the Organization for Economic Cooperation and Development ('OECD'). It is far from clear that foreign tax authorities will recognize any payments above the traditional 'arm's length' payments. Also, the periodic adjustments (increases) to the amounts of compensation after the date of the initial transfer may be difficult for foreign authorities to accept.

When two jurisdictions have similar laws, it is easy to resolve double taxation issues. But when transfer pricing laws differ from one country to another, it may be difficult to make corresponding adjustments to avoid double taxation. The foreseeable result is a rise in corporations' exposure to double taxation and an increase in the workload of cases before competent authority.

IRS, for its part, does not anticipate a significant increase in the number of double taxation cases because 'the White Paper adheres to the international arm's length standard'. Private sector tax practitioners are highly skeptical and predict larger and more frequent price adjustments, as well as disagreements between fiscal authorities here and abroad.

Under the old transfer pricing rules, the foreign subsidiaries were permitted a return on intangibles even though they were not the rightful owner and paid only an 'arm's length' compensation for the intangible. Under the BALRM, that will not longer be possible. According to the White Paper, foreign subsidiaries can only earn a return on their own intangibles, economic functions, assets, and risks assumed. The residual income represents intangible income that goes to the licensor. As a result, royalty income to US parent companies should be expected to increase.

Foreign tax authorities may not be nearly as accepting of IRS imposed revised compensation for intangibles. If foreign countries do not recognize the higher compensation paid to the US parent company, profits will be repatriated to the US without a commensurate decrease in foreign taxes paid, resulting in double taxation.

The commensurate-with-income standard applies to outbound and inbound intangibles alike. Consequently, in the case of foreign parent companies transferring intangibles to their US subsidiaries, the US subsidiaries' royalty payments will be subjected to that same standard in the US: the compensation paid to the foreign parent is deductable. The compensation must be the residual amount of income determined by the functional analysis that gives market rate returns to other factors of production.

Problems could arise in situations where US subsidiaries of foreign parents develop technology and license it to the parents. If the higher compensation is not deductable at the foreign parent's level, the result will be double taxation.

The White Paper increases the risk of international corporations' being exposed to double taxation or to lengthy negotiations with competent authority for relief from double taxation. The real effect in any specific case will depend on many different factors, including the foreign tax credit situation of the US company, the tax rate of the foreign country, and whether or not dividends are paid by the foreign subsidiary to the US parent.

Foreign Reaction

Foreign tax authorities will be confronting a new transfer pricing standard applied in the United States that actually shifts more of the income from intangibles to the owner, presumably the US parent corporation. US subsidiaries of foreign corporations will be subjected to the same new transfer pricing standard. US and foreign tax authorities are bound to disagree about the proper treatment of payments for intangibles. The foreseeable consequence is that more companies will be exposed to double taxation and to negotiations with competent authority for relief thereof.

It has been noted that competent authority usually handles issues related to the pricing of goods and services which are typically easier to resolve than issues involving the transfer of intangibles. Resolving these situations is going to impose a substantial cost on tax authorities, their competent authority mechanisms, and on corporations in particular. The prospect of having more transfer pricing cases subjected to the delays of competent authority procedures will do nothing to help corporate tax planners feel more certain about the new transfer pricing rules.

Puerto Rico/Section 936(h)

Manufacturing operations in Puerto Rico making the formulary cost-sharing payment prescribed by Section 936(h) are entitled to a return on intangibles owned by them. Unlike the 50/50 profit split election, the cost-sharing election has always presented taxpayers with substantial uncertainty. Though entitled to the return on intangibles, the cost-sharing election does not specify the value to be placed on the intangibles for transfer pricing purposes.

The White Paper includes Section 936(h) companies under the commensurate-with-income standard, and increases the uncertainty about the amount of cost-sharing and the value of the manufacturing intangibles. The payment must satisfy the commensurate-with-income standard, thereby diluting the benefit of the cost-sharing election. More Section 936(h) corporations will be forced into the 50/50 profit split election.

In Summary

The White Paper proposal to impose compensation 'commensurate with the income' attributable to intangibles transferred was to allay fears that the super royalty provision would have a major effect on transfer pricing rules. Government officials have gone on record to say that the pricing of intangibles is the same as before. Tax practitioners have found reason to disagree with the Treasury/IRS assessment, particularly in areas including the basic arm's length rate of return method, the pricing documentation requirements, the periodic adjustment rules, and the lack of safe harbors.

In talking about the White Paper, government officials have been particularly verbal in emphasizing the proposal's sensitivity to international implications. According to the Treasury/IRS:

(a) The commensurate-with-income standard is designed to comply with the arm's length pricing standard adhered to in the tax treaties between the United States and foreign countries.
(b) In particular, focusing the analysis on income and profits derived from intangibles is merely a refinement or modernization of the basic arm's length standard.

The IRS expects the revised transfer pricing rules to have 'enormous' revenue potential. Currently, transfer pricing issues comprise the bulk of international cases at IRS. Treasury officials are convinced that, because of the new rules, pricing will undoubtedly provide bigger audit issues in the future.

The White Paper attempts to formalize the fourth method and gives specific guidance for the use of a functional analysis, particularly for the development of the new 'BALRM', to determine compensation for intangibles of high value. The White Paper requires taxpayers to:

(a) document the methodology used in establishing intercompany transfer pricing prior to filing their return;
(b) provide that documentation to IRS; and
(c) review periodically and continuously up-date pricing support.

The rate of return, or percentage of sales or costs, approach has not been used by the courts, but has nonetheless become the White Paper's primary pricing method when comparables are unavailable. The White Paper acknowledges that the profit split is the method used most frequently by the courts in the absence of comparables, yet relegates the profit split to a secondary position after the rate of return method.

Increasing the compensaton to be collected by US companies for the transfer of valuable intangibles to their foreign operations will encourage other countries to become more aggressive about their transfer pricing. Countries like Japan, UK, Germany and France are surely not going to wait very long before they will want to curb the profit drain that will result once the White Paper proposals have become fully effective.

Companies planning to expand operations in the United States must consider the tax consequences along with economic and business reasons. The effects of Section 482 revisions should not be seen as a disincentive. The US subsidiary would be subject to the same revised standard as are US corporations with foreign operations. To the extent that income is retained in the United States, it will be subject to US tax rates, which might be lower than the effective tax rates abroad. For US subsidiaries to remit fair compensation for intangibles to their foreign parent may also present an opportunity for foreign companies.

According to IRS, the White Paper is a 'pre-proposal'. The proposed revisions to Section 482 may change following public comments submitted to IRS. Input by international corporations, US and foreign, and by foreign governments is important to help reduce the uncertainties created by the White Paper.

Comments and public reactions are invited before 15 February 1989. Treasury/IRS plans to issue final proposals for revised Section 482 transfer pricing rules shortly thereafter.

Section 482 White Paper – Administrative requirements: a look ahead

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Overview

Until the Tax Reform Act of 1986 (1986 Act), Section 482 and its predecessor sections authorizing the Commissioner to reallocate income of commonly controlled organizations had essentially remained unchanged for nearly sixty years. The 1986 Act added a so-called 'superroyalty' one sentence amendment to Section 482 (and to Sections 367(d) and 936(h) (5)) requiring that an affiliate transferring or licensing intangible property to a related affiliate shall receive income which 'shall be commensurate with the income attributable to the intangible'. This amendment was designed to overcome the problems of the Internal Revenue Service in applying the current Section 482 regulations (Treas. Reg. § 1.482-2(d)) to transfers of intangibles and the concern that income attributable to the intangible that should be subject to US tax was being shifted to favorable foreign jurisdictions.

In essence, the IRS administrative difficulty with respect to intangible transfers has been in valuing the transferred intangible as well as determining the arm's length price in an intercompany sale of tangible property which included significant intangibles. In addition, the IRS maintained that it encountered difficulty in obtaining pricing information from taxpayers during an examination, particularly in the case of an examination of a United States subsidiary of a foreign parent.

On 18 October 1988 the US Department of Treasury and the Internal Revenue Service issued their proposed interpretation of that one sentence commensurate with income amendment to Section 482. That interpretation, entitled 'A Study of Intercompany Pricing' (hereinafter White Paper) consists of 129 pages of single spaced text and five appendices, 82 pages in length. One of the appendices contains fourteen examples explaining how the proposed methodologies for determining intangible payments apply in specific situations. The White Paper proposals, as such, have no legal force and effect but probably reflect the positions, subject to modification as a result of comments, to be taken in regulations which are being drafted. Taxpayer comments on the White Paper have been requested by 15 February 1989. There will be further opportunity for taxpayer input, particularly in connection with proposed regulations.

From the standpoint of the administrative requirements, the consistent theme throughout the recommendations is to solve the past audit difficulties of the IRS. These have been experienced in part because of lack of cooperation by taxpayers and in part because of IRS inability to effectively audit these transactions. The means adopted to ameliorate the problem involve imposing additional substantive requirements upon taxpayers to establish prices and, then, imposing additional procedural requirements, such as documentation requirements, along with high standards of proof to prove the case and exposing the taxpayer to potential penalties if audit adjustments are sustained. In summary, the White Paper requires taxpayers to obtain and turn over at the time of audit specific, detailed information utilized when the prices were established (and not information collected at the time of audit) so the IRS audit task is simplified, places an extremely heavy burden of proof upon taxpayers to disprove the need for periodic adjustments to payments to yield income 'commensurate with the income attributable to the intangible' transferred and, then, in order to add an *in terrorem* effect, suggests penalties may be imposed. Presumably, this environment will inhibit taxpayers from attempting to improperly shift profits and from playing the audit lottery.

Pending finalization of the White Paper recommendations, there is the question whether any of these changes will be implemented formally or informally to resolve pending cases or audits. In principle some of the recommendations could be implemented by the IRS or Treasury unilaterally and immediately while others would require changes in existing Treasury regulations. The retroactive or prospective application of any change in the regulations must also be resolved. In practice, since pricing methods are classified in the White Paper, it is likely that either the taxpayer or the IRS will apply White Paper pricing methodology if it benefits an existing position, leaving to the other party the argument that the White Paper methods are not presently applicable. This could result in inconsistent treatment for taxpayers absent an IRS or Treasury statement regarding this question.

The White Paper proposes new and, perhaps, onerous burdens. The taxpayer is to be required to document the method it used to determine intercompany transfer prices involving intangibles and describe the method in its tax returns. The contemporaneous documentation supporting prices is to be made available to the IRS upon audit. Four White Paper methods for determining acceptable transfer prices are provided. These methods are not specifically made mandatory, but since they will be described in regulations and will be used by the IRS to check transfer prices, taxpayers practically speaking will be obliged to attempt to apply the White Paper methodology.

Under the White Paper methodology, the manufacturing subsidiary which does not use its own unique intangible property or perform complex manufacturing functions (as distinguished from routine manufacturing know-how) is treated as a contract manufacturer. In essence, this is equivalent to quantifying a 'commensurate' payment to be *all* of the income attributable to the intangible.

Tax planners of US parent corporations must review their intercompany pricing policies in a new light. So too should tax planners of foreign parents with US subsidiaries, since the White Paper principles cut both ways, applying equally to US and foreign parents and to US inbound and outbound transactions. Imposition of penalties are recommended.

The White Paper does not specifically address the effect of implementation of any or all of the recommendations upon the provisions in bilateral income tax conventions and any competent authority negotiations under the applicable convention. The comments by government officials indicate that they feel there is consistency with arm's length principles and no attempt to override treaties. Putting those questions aside, there are still issues of how the administrative requirements discussed in this article apply under treaty provisions. The requirements for periodic adjustments, recordkeeping, and standards of proof are not contained in the treaties.

White Paper methods to determine a 'commensurate' payment

The administrative requirements and challenges confronting a taxpayer can be brought into focus by summarizing the four White Paper methods for determining a 'commensurate' payment. The first of these methods relies on 'exact comparables' and has priority over the other methods (inexact comparable, basic arm's length return method, and profit split addition to basic arm's length return method) which are of equal priority. The pricing method to be applied depends on the particular facts and circumstances involved.

An exact comparable is one in which *identical* intangible property is transferred between unrelated entities under similar circumstances to the related party transfer, is used by the related and unrelated transferees in markets that are substantially similar in size and level of economic development and are likely to yield substantially similar profits. Other circumstances to be taken into account include similar economic risks, functions performed and similar important contractual aspects. The White Paper recognizes that an exact comparable may be very hard to find so that the method may be of infrequent applicability.

Inexact comparables involve intangible property which is similar but not identical to the intangibles under examination and where the economic environment and contractual features parallel those involved in the transaction under examination as closely as possible. Thus, if the market in which the unrelated parties operate is very different from the market of the related parties or if the unrelated party arrangement differs from the related party arrangement and that difference cannot be reflected by a reasonable number of adjustments to achieve comparability, the unrelated comparable cannot be used.

The basic arm's length return method (BALRM) is to be used where one of the affiliates performs only routine functions and has only routine manufacturing know-how that most manufacturers develop through experience. In applying BALRM, it is necessary to determine the rates of return earned by unrelated entities which perform comparable functions, bear comparable risks, and operate in comparable markets. The rates of return may be based on assets on or other appropriate ratios such as gross profit to operating expenses (at times referred to as the Berry ratio), operating income to cost of sales and operating expenses, or pre-tax income to total expenses for a number of comparable unrelated parties. After so determining the related entity's share of combined income, the remainder is assigned to the other related entity and will include compensation for the intangible property which that entity developed.

The last method is the profit split addition to the basic arm's length return method. It applies where each of the two entities utilize unique intangibles or engages in complex manufacturing functions (which the White Paper would consider to be equivalent to a unique intangible) and

comparable intangible transactions are not available. In these circumstances, a profit is determined under BALRM for the activities of each of the related entities which do not involve significant intangible assets. A reasonable division of the remaining income (attributable to intangibles) on the basis of the contributions of the intangible assets of each entity is recognized in the White Paper as being difficult and possibly a matter of judgment.

Risks

The White Paper acknowledges that the return of each related entity under the White Paper methodologies should take into account the degree of economic risk which each entity bears because the marketplace rewards the risk taker. Consequently, an appropriate comparable should reflect that the economic activity of the unrelated party is about equivalent in riskiness to the activity of the affiliate involved. However, the White Paper cautions that in a related party arrangement the risks which each related entity properly bears depends upon the economic functions that each performs.

Documentation of pricing methods

As the foregoing reflects, the White Paper sets out Treasury's tentative position on the way in which the amount of income attributable to an intangible is to be determined. But the White Paper does not stop there. As noted, Treasury proposes that the taxpayer must determine and document contemporaneously intercompany prices involving intangibles (presumably attempting to use the appropriate White Paper methodology), report income on that basis and include in the filed income tax return a description of how intercompany prices were determined and an attestation that the records required to be maintained reflecting the determination of intercompany prices were available when the return was prepared and will be produced at the start of an IRS examination.

In sum, the White Paper approach for policing taxpayer compliance in this area is to cast the burden on taxpayers to justify their transfer pricing policies and tax return positions by obtaining appropriate third party comparables up front. The question is whether the White Paper proposals are feasible, practical and can be complied with. If the taxpayer's task is impossibly severe, the road ahead may be lined with controversies.

The new methodology and documentary requirements are major departures from current Section 482 regulatory provisions and practices. The White Paper summarizes the basis for imposing these new administrative and procedural provisions, as follows:

1. 'The failure of the taxpayer to document the methodology used to establish transfer prices under the Section 482 regulations and delays or failure by taxpayers in supplying information to IEs (IRS International Examiners) are significant problems that hamper the IRS in its administration of Section 482. (WP 25)[1]
2. The Section 482 regulations are deficient in not requiring taxpayers to document intercompany pricing policies and to supply information upon examination. The Section 482 regulations should be amended to require taxpayers to document the methodology used to establish transfer prices prior to filing the tax return and to provide such documentation during examination within a reasonable time after requires. The documentation should include references to any comparable prices or transactions, rates of return, profit splits or other information or analysis used by the taxpayer in arriving at the transfer price. (WP 25)
3. Forms 5471 and 5472 should be revised to include: (a) summary information describing how intercompany prices were determined; and (b) an attestation that the documentation described in paragraph 2, *supra*, was available at the time of preparation of the return and will be made available at the start of an IRS examination. (WP 26)
4. IEs experiencing difficulties in obtaining transfer pricing information have failed to deal with noncompliant taxpayers through the issuance of Section 982 requests and administrative summonses. The Service should more aggressively pursue noncompliant taxpayers that delay, without justification, in producing relevant pricing information by using the Section 982 and administrative summons procedures. (WP 26)
5. The assertion of appropriate penalties is a necessary but often ignored element of transfer pricing compliance. In conjunction with the Service's broadbased review of penalties, the Government should determine whether existing penalties are sufficient to: (a) compel taxpayers to provide thorough and accurate information as set forth in paragraphs 2 and 3 *supra*; and (b) deter taxpayers from setting overly aggressive and unjustified transfer prices that are inconsistent with the commensurate with income standard. If it is felt that existing penalties are inadequate, legislative solutions should be pursued. The Service and Treasury encourage comments in this area, including the type of penalty, such as a transaction based penalty, that might be proposed.' (WP 26)

[1] For brevity, the letters WP will be used when citing to pages in the White Paper.

Documentation requirements

As noted, the requirement that taxpayers must determine and document intercompany intangible pricing prior to the filing of a tax return and describe in the return how the intercompany prices were set are completely new concepts. The stated reasons for suggesting this recordkeeping requirement is the difficulty the IRS has had in obtaining the taxpayer's basis for establishing intercompany prices and because many aggressive taxpayers have not used regulatory methods to arrive at transfer prices. If imposed, the IRS will no longer be in the position where it commences an audit, reviews an invoice or accounting entry reflecting a transfer price and nothing further, thereby requiring *it* to marshall facts, comparables, economic statistics and expert opinion to justify its proposed audit adjustments.

The search for comparables must begin before the intercompany intangible transfer price is established. Documentation in support of prices could include third party comparable prices or transactions and third party rates of return on assets or return on costs, profit splits, royalties for intangibles or other information or analyses used by the taxpayer in determining prices. The White Paper expectation that information of this nature is readily obtainable (and even in time to set intercompany prices) is questionable. Competitors ordinarily are not overcooperative, particularly in disclosing nonpublic data to facilitate another's pricing burdens. Will an overcooperative competitor (assuming that likelihood) raise possible antitrust problems? Will public data about a competitor's financial results and circumstances contain adequate detail to determine comparability?

It can be anticipated that controversies will result with respect to comparables selected by the taxpayer. Data with respect to return on assets or on costs involving a number of companies can be expected not to be consistent but to vary over a significant range. The question will arise which companies and which data are to be used. Once the decision is made by the taxpayer in selecting a comparable, will the IRS be entitled to obtain all the material relating to the internal process of selecting that comparable, including draft reports, potential comparables not utilized and other material which would be classified as work product not available to the IRS if proposed in the context of litigation.

Additionally, will taxpayers be able to comply effectively in selecting comparables, particularly where there are many different products or groups of products involved and where because of competitive conditions the return on each product is not uniform?

Full compliance in setting intercompany prices under the White Paper methods would appear to require information about comparable intangible transfers between related entities and/or backup financial information such as balance sheets and income statements of unrelated companies which may be comparable and to obtain that information prior to the time the intercompany price is established or at least during the year involved. This is a formidable task to say the least. It may be advisable (or necessary) for the taxpayer to buttress the transfer price with an expert's opinion. Furthermore, monitoring transfer prices during and at the end of the year and making adjustments during or after year-end becomes more necessary where the methodology used to arrive at the transfer price is dependent upon overall financial results of the entity which may not be known until after year-end, such as a return on investment or ratio of gross profit to operating costs, as compared to a royalty on an intangible or product by product basis.

At present, Treas. Reg. § 1.6001 imposes only a general obligation on taxpayers to keep records 'sufficient' to establish income but does not specify what such records must be. Will new IRS Section 482 regulations (which are expected in due course) specify in detail what would be acceptable compliance with a recordkeeping requirement and the specific records which must be kept as a minimum to reflect what was done in establishing transfer prices? The more stringent the recordkeeping requirement the easier will be the audit examination as the IRS will be able to review and modify the information as compared to starting from the beginning to construct an arm's length price (which is often the case today).

It is not clear how these proposed new rules will relate to the current burdens of proof in litigation. Presently, either the taxpayer or the Government can introduce evidence, theory, or

expert testimony different than the basis upon which the transfer price was established, or, in the case of the Government, the basis on which the additional examination adjustment was proposed. Query, whether the taxpayer will be precluded from utilizing factual or economic information or opinions not within the scope of material utilized at the time the price was established.

Penalties

The White Paper notes that the IRS is considering whether existing penalties on deficiencies, including the Section 6661 substantial understatement of liability penalty, are adequate or whether new penalties are needed. The suggestion that penalties, particularly the 25 per cent understatement penalty, be imposed in transfer pricing cases could be quite draconian because of the inherent difficulty in reaching a 'correct' result. If penalties are proposed in cases other than the abusive circumstances, there is a substantial risk of governmental over-reaching. In connection with these proposed recordkeeping requirements, the question also occurs whether different penalties are to be asserted for failure to obtain (and retain) such information at the time the transfer price was established. The proposed recordkeeping requirements will likely entail refinement of taxpayer transfer pricing policies and documentation to ease and facilitate an IRS transfer pricing examination.

Periodic adjustments

The White Paper notes that in line with Congressional intent, if appropriate payment for an intangible is to be commensurate with the income attributable to that intangible, it follows that such payment should be adjusted periodically for changes in the income attributable to the intangible.[2] Accordingly, the White Paper provides that the transfer payments must be adjusted when there are substantial changes in the income stream attributable to the intangible, or when there are substantial changes in the economic activities performed, in the assets employed, and in the economic costs and risks borne by the related parties involved. In practice, this requirement for periodic adjustment could become administratively quite burdensome because changes in intangible charges under different methods require marshalling of different factual and economic evidence. The examples described below as well as others reveal these changes could be required often and within years of each other.

Examples of periodic adjustment

The White Paper offers examples of a change in functions or profitability which would require periodic adjustment. Example 13, reflecting a change in functions, involves a US corporation which manufactures and markets widgets in the US and its subsidiary in Country X which manufactures and markets the widgets in Europe. The US parent believes that employees at its Country X subsidiary are best suited for the time-consuming and expensive job of developing a process, which will be a major breakthrough, to produce a new super-widget. It is expected in 1988 at the time of the decision, that the development process will be completed in 1994 when full-scale assembly style production would be completed. An inexact comparable could not be found and BALRM was not feasible because neither party performed only standardized functions. Therefore, a profit split analysis was used and a 50/50 profit split arrangement was adopted, based on the relative returns earned by unrelated parties jointly developing a risky product. At the end of 1988, the parent determined that the product is being successfully mass-produced at a volume close to that which was originally predicted for 1994. And that the subsidiary had, in fact, contributed no unique intangibles. The example concludes that the decrease of five years in the time expected to reach an acceptable 1994 production level constituted

[2] The intent of Congress is indicated in the *General Explanation of the Tax Reform Act of 1986*, Staff of the Joint Committee on Taxation, 99th Cong., FL 99-514, 1016 (1986) (the so-called Blue Book) which explains: 'Congress did 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. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus, Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in income attributable to the intangible. The Act is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible'.

a significant change requiring an adjustment. Transfer prices were adjusted to a BALRM analysis of the subsidiary.

Example 14 illustrates a change in the indicators of profitability. In this example, a patent for a drug developed by a US parent is transferred to its foreign subsidiary to manufacture and market worldwide. The royalty was set on the expectation that the drug would capture fifteen per cent of the market. In the first year the drug has an eight per cent market share but continued growth is indicated. At the end of the second year market share is sixteen per cent and at the end of the third year it is 21 per cent. The parent has used the inexact comparable method based on third party licenses for similar drugs. At the end of the fourth year the drug has 50 per cent of the market, far beyond that of third party licensees. As a result, it can no longer be assumed that the level of profitability for the product licensed to the related party is similar to that for the products licensed to unrelated parties. Since a 50 per cent share of the market may indicate that a higher markup can be charged than that of a competing product with a fifteen per cent market share, the inexact comparable is no longer valid and the basic arm's length return method is used to determine what the subsidiary should earn.

Arm's length dealings involve periodic adjustments

The White Paper explains that the requirement for periodic adjustments reflects arm's length dealings. It is asserted that contractual arrangements between unrelated parties are not entered into on a long term basis without an adjustment mechanism 'if the profitability of the intangible is significantly higher or lower than anticipated' and that this is so particularly in the case of high profit intangibles (WP 63). Also, it is maintained that 'as a matter of long term business strategy unrelated parties may renegotiate contractual arrangements *even absent* explicit renegotiation provisions ...' (Emphasis supplied, WP 63).

The White Paper interprets the Congressional directive that payments for intangibles be adjusted to reflect changes in the income attributable to the intangible[3] as a legislative rejection of *R. T. French* v. *Commissioner*, 60 TC 836 (1973), which adopted the view that a long-term fixed rate royalty agreement could not be adjusted based upon unknown subsequent events at the time of establishment of the rate.

Exceptions to requirements for periodic adjustments

There are certain instances in which periodic adjustments would not be required. A fixed royalty will not be subject to periodic adjustment where the taxpayer establishes that it has comparable 'long-term, non-renegotiable contractual arrangements with third parties ...' (WP 64). The White Paper concedes that consistency with the arm's length standard requires this limited exception to the periodic adjustment rule. However, the taxpayer is cautioned that where a high profit intangible is involved, the third party transaction generally must be an exact comparable to escape periodic adjustment. In this regard, it should be recalled that the test for an exact comparable is an exacting one, likely to be met infrequently.[4]

The question occurs whether the IRS would find acceptable a comparable transaction between two unrelated parties not including either the taxpayer or an affiliate which involved a fixed royalty. Also, note that the White Paper requirement quoted above uses the plural in referring to the taxpayer's nonrenegotiable contractual arrangements with third *parties*. Does this mean that more than one comparable is required?

The White Paper concedes that under the arm's length standard adjustment to price should not be required where it is clear increased profitability was not anticipated. In such case, three conditions would have to be met which, quoting from the White Paper, (WP 65) are:

1. that events had occurred subsequent to the license agreement that caused the unanticipated profitability;
2. that the license contained no provision pursuant to which unrelated parties would have adjusted the license; and

[3] *See* H. R. Rep. No. 426, 99th Cong., 1st Sess. 425 (1985).

[4] Guidelines to determine whether an exact comparable is involved could include (1) the same intangible property; (2) transferred under similar circumstances; (3) the related and unrelated parties will use the intangible in markets substantially similar in size, level of economic development and likely to yield substantially similar profits from a substantially similar transaction; (4) economic risks, functions performed and important contractual aspects are similar; and (5) substantially similar important contractual aspects (for example, amount and form of compensation and provision for technical assistance and training (*see* pp. 88-90).

3. that unrelated parties would not have included a provision to permit adjustment for the change that caused the unanticipated profitability.

The White Paper suggests that the taxpayer be required to establish these conditions by 'clear and convincing evidence' (the standard of proof required in a civil fraud case). This standard is more difficult to satisfy than the normal standard in a civil tax audit of proving your case by a 'preponderance of the evidence'. Thus, this could be an almost impossible standard for a taxpayer to satisfy, particularly in light of the evident difficulty to prove what unrelated parties would have done under comparable circumstances. Finally, there is a further impediment to the unanticipated profit rule. The exception for unanticipated profitability will not be available 'if inexact comparable licenses with no provision for periodic adjustments cannot be found in the marketplace' (WP 65). Since it will be most difficult to comply with these standards, it appears that a taxpayer who relied upon this exception and was subsequently proved in error would increase the exposure to the penalties previously described.

How often and when must the royalty rate be adjusted?

The White Paper's elliptical response (WP 71) is that 'Taxpayers should review transfer pricing arrangements relating to transferred intangibles as often and as thoroughly as necessary to assure that income is reported over time in a manner consistent with the commensurate with income standard'.[5] Certainly an annual review could provide the shield to deflect an IRS attempted transfer pricing adjustment. In turn, it could indicate early on the appropriateness of an adjustment favorable to the taxpayer.

As noted previously, annual adjustments are not required where there are only minor variations in intangible income but are to be made where there are 'substantial changes in intangible income' (WP 66). This points up that the term 'substantial' should be clarified or defined by regulation. Perhaps the White Paper did not attempt the definition because of concern that it would be too difficult.

Instead, the White Paper suggests that the Internal Revenue Manual list factors with respect to which a substantial change in one or more thereof would indicate an examination to determine if a change in the royalty rate is required. The factors offered include:

(1) the size and number of markets penetrated;
(2) the product's market share;
(3) the product's sales volume;
(4) the product's sales revenue;
(5) the number of uses for the technology;
(6) improvements to the technology;
(7) marketing expense;
(8) production costs;
(9) the services provided by each party in connection with the use of the intangible;
(10) the product's profit margin or the process' cost savings (WP 67).

Where the IRS is seeking to make an adjustment under the commensurate with the income standard, the White Paper takes the position that the IRS should *not* have to establish that there is an identifiable change in intangible income compared with a prior year. The IRS seeks to avoid this burden by rationalizing that such a requirement would present proof problems irrelevant to the issue whether the adjustment is appropriate.

The White Paper suggests that at most consideration should be given only to requiring the IRS to (i) support its adjustment based upon the methodology in the White Paper, and (ii) propose an adjustment which involves a substantial increase in the amount of income, as compared to the amount reported in the return, but only after the first in-depth audit after 1986.

This raises the question of the proper standard which should be applied in future years where the IRS has conducted an in-depth audit and agreement is reached for the audit year. Should the IRS be precluded from using a different methodology in a subsequent year if the taxpayer relies on the earlier audit method for determining intangible income for the subsequent years? Under such circumstances, should a higher burden be placed on the IRS, such as a 'clear and convincing' standard, to sustain the making of an adjustment for a future year.

[5] H. Rep. 99-426, 99th Cong., 1st Sess. 425, 426 (1985) provides that 'the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The bill is not intended to require annual adjustments when there are only minor variations in revenue. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible'.

The White Paper concludes that a periodic adjustment under the commensurate with the income standard generally should be prospective. In other words, if 1990 is being audited, the adjusted prices would apply to 1990 and forward (but not to unaudited 1988 or 1989), unless a substantial change occurs in a subsequent year in intangible income and other relevant facts. It should be noted that no position is taken as to the application of the proposed standards and methods to years between 1987 and finalization of White Paper recommendations.[6]

Application of the commensurate with the income standard would seem to require further clarification. The White Paper states that the 'arm's length standard would require only that the transfer price be commensurate with actual income – i.e., that the transfer price be changed only as the intangible income changes', unless third parties would have negotiated a different arrangement based on expectations and circumstances as of the date of the transfer (WP 68). Several questions occur. Does 'actual income' mean net profit? If a subsidiary which deals in several products and is involved in several business activities does not earn an overall net profit, can a royalty for one profit earning product be adjusted?

Downward adjustments

Although generally the White Paper does not expand on when downward adjustments may be made, it is clear enough that changed conditions can warrant not only upward adjustments but also could warrant downward adjustments. In fact, the White Paper notes the statutory amendment 'applies to all related party transfers of intangibles, both inbound and outbound [fn. omitted] without quantitative or qualitative restrictions' (WP 50). Since the commensurate with the income standard applies to royalty payments by US subsidiaries to their foreign parents, there may be an incentive for the IRS to make downward adjustments in these circumstances. It will be recalled that under the commensurate test, downward adjustments would be indicated where there is a reduction in income attributable to the intangible, or where there are substantial decreases in economic activities, assets, costs or risks.

In like manner, a US parent can make a downward adjustment as an intangible transferred to its foreign subsidiary becomes less valuable. This would afford planning opportunities. (Of course, the IRS could attempt to argue that no downward adjustment is warranted if it could establish that a long-term nonadjustable royalty arrangement would have been entered into by unrelated parties negotiating at arm's length.)

The time when an adjustment is to be made may present an issue. May upward or downward adjustments be made by the taxpayer during the taxable year; before year end; prior to filing return after year end;[7] in an amended return before audit; after audit?

Set offs

The White Paper acknowledges that a royalty rate could be too large in some years and too small in other years under the commensurate with the income standard and that the IRS could therefore make an adjustment in some years without making allowances for the excess royalty in another year. Nevertheless, the White Paper concludes that because of problems which would result from an open transaction approach, multi-year set-offs should be prohibited. This, the White Paper maintains, is in line with Treas. Reg. § 1.482-1(d) (3) which provides the general rule that intra-year set-offs only are permitted.[8] The White Paper attempts to justify the harsh effect of its proposed rule by maintaining that periodic adjustments generally are to be made only where there are substantial changes in circumstances and, consequently, that taxpayers will have an incentive

[6] In this regard, the White Paper states (WP 46) that the Section 482 commensurate with the income amendment 'is a clarification of prior law. Accordingly, it should not be assumed that the Service will cease taking positions that it may have taken under prior law'.

Where Section 482 or 367(d) is being applied to a transferred intangible, the commensurate with the income amendment applies to transfers for years beginning after 31 December 1986 with respect to transfers after 16 November 1985, except that with respect to intangible transfers which are not to foreign persons, the commensurate test applies to transfers after 16 August 1986. Where Section 936 is involved, the commensurate test applies to taxable years beginning after 31 December 1986 without regard to when any transfer (or license) was made.

[7] In Example 13, the taxpayer realizes at the end of 1989 while it is filing its 1989 returns that a substantial change had occurred. The price was established for 1988, so that an upward adjustment would be required for 1990. However, the example states that the taxpayer is cautious and feels that since it might be difficult to sustain 1989 it also modifies its 1989 prices, after year end. Thus, for 1988 it uses profit split, 1989 rate of return and 1990 basic arm's length return.

[8] On the other hand the White Paper cites Treas. Reg. § 1.482-2(d) (1) (ii) (d), Ex. 3 'as appearing to allow an inter-year set off' (WP 71).