

Tax Management Transfer Pricing Report
2014
09/18/2014
Insights

23 Transfer Pricing Report 684

The author suggests looking to what the controlled foreign corporation in a cost sharing arrangement receives after the transfer of intangibles as a way past entrenched positions by both taxpayers and the Internal Revenue Service.

A Way Forward in Cost Sharing: Considering Payments and Benefits From Future Intangibles



By Brian C. Becker, Precision Economics LLC

Brian Becker, Ph.D., is president of Precision Economics LLC in Washington, D.C.

It is no news that the Internal Revenue Service and taxpayers are deeply divided over methods for valuing cost sharing arrangements between U.S. companies and foreign affiliates. Taxpayers have seen, through numerous court cases, that the competing values of such arrangements often differ significantly. One reason for the disparity is that these disputes over cost sharing arrangements are not so much about the methods of valuation as they are about the property that is actually being transferred.

Cost sharing arrangements between a U.S. parent and a controlled foreign cost sharing participant typically involve at least three transactions or definitions of issue:

- the buy-in payment being made by the controlled foreign corporation;
- the definition of, and split determined for, ongoing development costs; and
- the intangibles profits that will be predicted to be transferred from the U.S. parent to the CFC.

Disputes over cost sharing arrangements are common. The IRS has called for the use of an income method that considers the life of intangibles going forward, while taxpayers have tended to insist that their cost sharing arrangements do not include the value of future intangibles.

Effectively, tax authorities are arguing that there is a mismatch between the property received by the

Copyright 2014, The Bureau of National Affairs, Inc.

Reproduction or redistribution, in whole or in part, and in any form, without express written permission, is prohibited except as permitted by the BNA Copyright Policy. <http://www.bna.com/corp/index.html#V>

foreign subsidiary and the value received by the U.S. parent. A common IRS solution to closing the gap—increasing the value of the buy-in payment—did not meet with success in a recent case in U.S. Tax Court.¹

¹ See Gregory, Dolores W., “Overcoming Veritas: Can the IRS Make a Better Argument For the Income Method in Amazon’s \$2.2 Billion Challenge?,” 21 *Transfer Pricing Report* 959, 2/7/13.

This article proposes another way to frame the argument: focusing on what the CFC receives after the transfer. If the cost sharing arrangement includes the payment for only preexisting intangibles, as many taxpayers insist, then such a CFC might be entitled to only preexisting profits.

Valuation Elements

Cost sharing disputes generally have considered only the valuation elements of the buy-in payment: the sale, costs, transferred intangibles, the type of entity, ex-post results, inputs, method and preexisting or future intangibles.

Sale

Practitioners have debated whether the buy-in is the same as the sale of assets. Similarly, practitioners have debated whether asset sale prices (and/or market capitalizations) could be used as comparables. A tension in this debate is between the fact that cost sharing arrangements are in the contractual form of licenses, not sales, and the fact that the CFC typically earns the intangibles profits in perpetuity.²

² Becker, Brian C., “The Economics of Cost Sharing Buy-Ins: Questions and Answers,” 16 *Transfer Pricing Report* 950, 4/24/08.

Costs

Practitioners have debated the relevance of costs as a proxy for the value of intangibles transferred under the buy-in. This includes absolute and relative expenditures and involves the consideration of risk versus the probability of success for early and later stage development, as well as their impact on ex-post value.³

³ Becker, “Valuing In-Process R& D for Acquisitions: Economic Principles Applied to Accounting Concepts,” 9 *Transfer Pricing Report* 323, 9/20/00.

Transferred Intangibles

Debate has continued as to whether only specific intangibles, such as technology, have been transferred to the CFC or whether all intangibles and profits therefrom also have been transferred. This debate has focused principally on how such intangibles affect the buy-in price.⁴

⁴ Becker, "Further Thoughts on Cost Sharing Buy-Ins: The Market Capitalization and Declining Royalty Methods," 10 *Transfer Pricing Report* 195, 7/11/01.

Type of Entity

Some practitioners have argued that a buy-in price should be different if the party buying in has no or limited operations.⁵

⁵ Becker, note 2, above.

Ex-Post Results

A buy-in can be in a form where ex-post results explicitly matter, such as royalties, or where they are not relevant, such as an up-front lump sum. Some practitioners have argued that in the latter cases, ex-post results still should apply to potentially update the buy-in value.⁶

⁶ Becker, note 4, above.

Inputs

Buy-in valuations often are computed using inputs that include useful lives and discount rates. Practitioners have debated after-tax, pre-tax or other forms of interest rates as well as the definition and relevance of useful lives. Some valuation methods require fewer inputs and assumptions than others.⁷

⁷ Becker, note 4, above.

Practitioners define useful lives differently using benchmarks that include the product version number, interview results, accounting rules or contemporaneous projections. Rather than discuss those differences here, this article will analyze the common situation where the taxpayer's estimated useful life is far shorter than that implied by contemporaneous projections and the resulting net present value (NPV).

Method

Over the years, practitioners have debated both method names and applicability. This has included the names to be assigned to a valuation approach and whether that approach may be specified in regulations. In addition, some practitioners describe the steps in their valuation methods using names of methods in the U.S. transfer pricing regulations, such as the comparable uncontrolled transaction (CUT)

method and the comparable profits method, while others use the name of the combined method, such as the income method or the market capitalization method.⁸

⁸ Becker, note 2, above.

Preexisting and Future Intangibles

Practitioners also argue over which intangibles transfer from the owners as a result of the buy-in. The debate generally has focused on which intangibles are included in the buy-in price. That is, some practitioners argue that “future” intangibles do not have value yet and that such value can be created only by future intangibles development by the CFC, so that a buy-in would be a double payment. Others argue that value is what one will pay for—typically quantified as contemporaneous cash flow or profit projections. That is, if current projections already show positive intangibles profits in the future net of projected ongoing development costs, then these “future” intangibles that correspond to these years with positive profits have a positive value in the present.⁹ This general concept is the focus of the article, but the focus is not on whether the CFC should pay for only preexisting intangibles or all intangibles with contemporaneous values in a buy-in. Rather, the focus is on which profits the CFC should enjoy in the future if its buy-in covers only preexisting intangibles.

⁹ Becker, note 4, above.

This article considers many of these issues—not from the perspective of the buy-in payment valuation, but rather from the perspective of arm's-length profits available to CFC that makes a buy-in payment for only preexisting intangibles.

Table 1: Intangibles Profits
Contemporaneously Forecasted with 1/1/14 Buy-In

USD Millions	Total	2014	2015	2016	2017	2018	Terminal Value	Formula
Total Regional Gross Intangibles Profits		70	82	94	106	118	1,900	a
Ongoing Cost Sharing Payments		15	17	19	21	23	400	b
Net Intangibles Profits		55	65	75	85	95	1,500	c = a-b
NPV	<u>1,000</u>	50	50	50	50	50	750	d = NPV(c)

Example

In many cases, a cost sharing dispute focuses on a U.S. parent receiving a buy-in payment from a CFC for the rights to an intangibles profit stream within a specific region of the world. Often, such cases include the taxpayer's submission of a schedule summarizing the taxpayer's contemporaneous forecasts of the intangibles profits¹⁰ at issue over the region covered by the CFC. Translating the projected

intangibles profits to the date of the buy-in provides—with discount rates—NPV calculations of *all* intangibles profits. These profits define what an entity would expect to receive in net if it incurred all of the operating costs *and* all of the ongoing development costs for this region in each year in the future.¹¹ A hypothetical example of such a case is provided in Table 1, below.

¹⁰ Of course, there can be disagreement over what method to use to define or value intangibles profits, including the comparable profits method, the comparable uncontrolled transaction method and others.

¹¹ This article defines intangibles profits as profits remaining after paying all of the ongoing operating costs (for example, manufacturing, distribution and services) *and* ongoing cost sharing payments.

Under the example, at the time of the cost sharing arrangement, the region of the world at issue through the buy-in would have \$1 billion of projected intangibles profits being transferred to an entity that would incur, either directly or through others, the cost of operations and the costs of ongoing development from 2014 forward.

The forecasts of Table 1 are simplified, but are of a form commonly seen throughout transfer pricing and many other financial applications. That is, they include annual forecasts, terminal values and NPV computations. Cost sharing buy-ins often have an additional unique aspect to their contemporaneous forecasts of intangibles profit. That is, some practitioners divide the forecasted profits into two sections: preexisting and future intangibles profits.¹² While the distinction in these two groupings sometimes is tied to a product or technology's version number (for example, versions 11.0 and 12.0 of the product), it also often is translated to years. That is, a common approach is to define preexisting intangibles as those that generate the intangibles profit for the next X number of years, and the future intangibles being responsible for later intangibles profits.¹³ That distinction is incorporated into the example above, where the life of the preexisting intangibles is two years.

¹² A number of terms—including base and platform intangibles—also have been used in this context. See Bronson, Mark, "The Income Method: What are the Useful Lives of Platform Contributions?" National Association for Business Economics Transfer Pricing Roundtable, slides 3-9 (6/24/10); and Wright, Delores R., Brandon Heriford, Harry A. Keates, and Heather Lamoureux, "US Cost Sharing: Current Issues and Court Cases," *International Transfer Pricing Journal*, pp. 203-211 (July/August 2013).

¹³ This example is an oversimplification. Varying levels of preexisting and future intangibles profits can be assigned in the same year, for example. But the translation of these data to a specific number of years, x, of preexisting intangibles profits often is possible.

Table 2:
Intangibles
Profits Divided
into Preexisting,
Future
Intangibles

USD Millions	Total	Preexisting Intangibles		Future Intangibles			Terminal Value	Formula
		2014	2015	2016	2017	2018		

Total Regional Gross Intangibles Profits	70	82	94	106	118	1,900	a
Ongoing Cost Sharing Payments	15	17	19	21	23	400	b
Net Intangibles Profits	55	65	75	85	95	1,500	c = a-b
NPV	50	50	50	50	50	750	d = NPV(c)
Preexisting Intangibles	<u>100</u>						e = NPV(d ₂₀₁₄ , d ₂₀₁₅)
Future Intangibles	<u>900</u>						f = NPV(d _{2016=>})
Total Intangibles	1,000						g = e+f

Traditional Arguments

The type of separation shown in Table 2 above is instructive in showing the differences in how the buy-in can be presented and valued. Situations like this have led some practitioners to value buy-ins of this type at \$100 million to cover the NPV of preexisting intangibles only, by arguing that the cost sharing arrangement does not include future intangibles, based on law, the wording within the arrangement and other factors.

In the author's experience, others have argued that the U.S. parent forecasts that it will enjoy:

- \$1 billion of value if it does not enter the arrangement either by operating the business itself or selling the business, and
- \$0 in value if it does.

Thus, the buy-in payment would need to be \$1 billion at arm's length to compensate for the fact that the U.S. parent loses all preexisting intangibles profits *and* future intangibles profits. Those making this argument contend that regardless of the wording of the cost sharing arrangement or interpretations that may help to define the *form* of the transaction, the *substance* of the transaction is clearly that both preexisting and future intangibles profits will never be earned by the U.S. parent in the future and all such profits will be earned by the CFC. Thus, if the CFC receives both preexisting and future intangibles profits, it would pay the contemporaneous value (NPV) of both at arm's length, as these values are *not* of future expenditures for development.

When one practitioner is valuing preexisting intangibles only—two years, for example, of forecasted intangibles profits—and the other is valuing intangibles profits in perpetuity,¹⁴ it is no surprise that the competing values often differ significantly. In fact, this distinction alone often trivializes or incorporates all of the other disputes listed above. While this observation is not news in this field, it is interesting to note that the primary discussions of cost sharing buy-in disputes tend to focus on valuation *methods*. In reality, often the parties are arguing less over valuation approaches, techniques or comparables and more over what is, or should be, transferred. Effectively, the tax authorities are arguing that there is a mismatch when the U.S. parent receives a buy-in covering only preexisting intangibles but loses the value of both preexisting and future intangibles. Typically, tax authorities have chosen to fix this mismatch by *moving the taxpayer's proposal down one square* as presented in the matrix below in Table 3.¹⁵ The tax authority would *agree* to allow the CFC to earn all—that is, preexisting and future—intangibles profit, but would *disagree* that the CFC's buy-in would pay for the current value of only preexisting intangibles, and not the current value of future intangibles as well.

¹⁴ In some cases the practitioners value gross intangibles profits when valuing preexisting intangibles.

¹⁵ The matrix below has not to the author's knowledge been used in cost sharing disputes; it is simply a graphical presentation for this article.

Table 3:
Traditional Distinction Between IRS and Taxpayers Over Future Intangibles

		Profits Allowed in CFC After Buy-In	
		Preexisting Intangibles	ALL Intangibles
Rights Transferred (Paid For)	Preexisting Intangibles		Taxpayer
	ALL Intangibles		↓ (Higher buy-in payment by the CFC) ↓ IRS

The practical aspect of this standard argument is a difference of opinion associated with the buy-in payment at the time it is made. In the example above, the U.S. parent would face a \$900 million adjustment because it recorded only \$100 million in 2014 on its buy-in, while the tax authorities might claim an arm's-length buy-in of \$1 billion to cover the rights to *both* preexisting and future intangibles. See Table 4 and the discussion below.

Table 4:
Standard Approach to Adjusting the Buy-In from U.S. Parent's Perspective

USD Millions	Total	1/1/2014	2014	2015	2016	2017	2018	Terminal Value	Formula
Net Intangibles Profit with Cost Sharing		100							a

Arrangement at Proposed Buy-In									
Net Intangibles Profit w/o Cost Sharing Arrangement		55	65	75	85	95	1,500	b	
Gain (Loss) to U.S. Parent from Proposed Arrangement	100	-55	-65	-75	-85	-95	-1,500	c = a-b	
Buy-In Adjustment	900							d	
Total Gain (Loss) to U.S. Parent from Cost Sharing	1,000	-55	-65	-75	-85	-95	-1,500	e = c+d	
NPV of Gain (Loss) to U.S. Parent from Cost Sharing	0	1,000	-50	-50	-50	-50	-750	f = NPV(e)	

The standard techniques employed above lead to adjustments based on a different interpretation of what was transferred as opposed to differences in valuations per se. That is, both parties employ an NPV technique—but they value different (shorter versus longer) profit streams. Another framework is presented below to consider in cases like this.¹⁶

¹⁶ The documentation below is a broad description, requiring further information and details before implementing in an actual cost sharing dispute.

Alternative Approach

The traditional methods have focused on the buy-in value, but largely ignore the profits allowed to be booked by the CFC. That is, if the arrangement covers only the transferred rights to preexisting intangibles and the CFC merely pays for these, then one could opine that the CFC's buy-in should only be allowed to *receive* the preexisting intangibles profits. The logic would lead to the opinion that the CFC should not receive any more intangibles profits after the preexisting intangibles' lives end. All future intangibles profits would be booked by the U.S. parent. That is, fixing the mismatch by *moving to the left* in the matrix as seen in Table 5, below.

**Table 5:
Alternative Approach to Distinguish Future and Pre-Existing Intangibles**

		Profits Allowed in CFC After Buy-In	
		Preexisting Intangibles	ALL Intangibles
Rights Transferred (Paid for)	Preexisting Intangibles	Alternative Approach	Taxpayer (Shorter profit stream for the CFC) ←
	ALL Intangibles		

Under this approach, each of the two different assets—preexisting and future intangibles—can be analyzed separately by the parties:

- **Preexisting intangibles:** The parties generally agree that preexisting intangibles *are* transferred and they both generally agree that such assets would be valued using a cash flow (NPV) approach. That is, a buy-in of \$100 million in the example.

- **Future intangibles:** The parties agree that there is a \$0 value for the buy-in for future intangibles. While agreeing to the \$0 value, the parties would disagree over what profits the \$0 payments entitles the CFC to in the future. In that sense, the parties would disagree over whether the CFC could enjoy such future intangibles profits (in 2016 and beyond) or whether such profits would be booked by the U.S. parent.

In the case of future intangibles, it should be noted that intangibles profits are defined as *after* the ongoing cost sharing payments. Mathematically, this method would have the CFC pay these costs in 2014 and 2015 and net projected profits of \$55 million and \$65 million, respectively. Thus, the CFC would receive compensation that covered all of its costs plus \$55 million and \$65 million, respectively. After that, the CFC generally would have no role in paying costs on recurring profits.

One could argue that if these 2014 and 2015 expenditures increased the value of the intangibles—for example, actual intangibles profits in 2016-18 exceeded the projected \$75, \$85, and \$95 million levels—that the CFC should receive compensation for some portion of the increase. Obviously, such a result would be case-specific and require further economic analysis (including whether to extend it to declines in value), but in the author's experience, increases to projected profits in cost sharing arrangements have not been significant relative to the overall valuation magnitude of the cost sharing disputes.

Returning to the example, \$100 million valuation of the *preexisting* intangibles buy-in would be accepted, as would the \$0 buy-in for future intangibles. However, the \$900 million of future intangibles profit being booked at the CFC (from 2016 onward) would be denied. See Table 6, below.

Table 6:
Alternative
Approach to
Adjusting the
Cost Sharing
Arrangement
from U.S.
Parent's
Perspective

USD Millions	Total	1/1/2014 100	Preexisting Intangibles			Future Intangibles			Terminal Value	Formula
			2014	2015	2016	2017	2018			
Net Intangibles Profit with Cost Sharing Arrangement at Proposed Buy-In										a
Net Intangibles Profit w/o Cost Sharing Gain (Loss) to U.S. Parent from Proposed Arrangement Buy-In Adjustment			55	65	75	85	95	1,500		b
Future Intangibles Profit Adjustment			—	—	75	85	95	1,500		e
Total Gain (Loss) to U.S. Parent		100	-55	-65	-75	-85	-95	-1,500		c = a-b
NPV of Gain (Loss) to U.S. Parent	0	-100	50	50	0	0	0	0		g = NPV(f)
					0	0	0	0		f = c+d+e

The net (NPV) effect of the adjustment would be the same as the current approach that argues over the buy-in value (an NPV adjustment of \$900 million), but it moves the dispute into different concept areas and years. For example, it would allow one to consider whether the CFC would gain future intangibles profits if it did not pay anything for them up front. That is, if the cost sharing arrangement is intended to be only a rental type of mechanism for a specific time period—a useful life—one can question whether, at arm's length, the renter still would earn the profits on the assets after the rental period expired.¹⁷ Second, it would remove or minimize the need to debate useful lives, discount rates, valuation benchmarks, distinctions between preexisting and future intangibles, and the substance versus the form of the

transaction. Finally, it provides a second conceptual framework to coordinate the assets being paid for with the assets over which the CFC can enjoy profits.

¹⁷ This oversimplifies the issues a bit. In the example, the CFC gains access to “future” intangibles that already have a value (on July 1, 2014) of \$75 million of profits in 2016, \$85 million in 2017, \$95 million in 2018, and terminal value of \$1.5 billion. The CFC would not be paying for this value, but would have a role in trying to increase those profits through its 2014 and 2015 cost sharing payments.

This type of analysis would place additional pressure on contemporaneous projections. That is, some practitioners argue that future intangibles development expense create all of the intangibles profit in later years. Others argue that such ongoing expenditures create only incremental value or decline in value incrementally when the entity generates more or less profit than was contemporaneously projected at the time of the buy-in.