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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Steven A. Musher
Branch Chief CC:INTL:BR.6

SUBJECT:

This Field Service Advice responds to your memorandum dated February 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Advanced Systems =
=
Advisor A
Area A =
=
Capability A =
Capability B =
Component(s) A
Country A =
=
Date 1 =
Date 2
Date 3
FMfg A
FMfg B
FSub

=
Products A

Products A-1 =
Products A-2 =
Products A-3 =
Product Market in Which USCorp =
Competes =

Shared Systems
=
Shared System (Model X)
Special Capabilities =
Subassemblies A =
=
Taxable Year 1
Taxable Year 2 =
Taxable Year 3 =
Taxable Year 4 =
Technology A =
=
Technology A (Model X)
Technology B =
Technology C =
Technology D =
=
USCorp
USDiv =
USSub =
USTechCorp =
=
Year 1
Year 2 =
Year 3 =
Year 4 =
Year 5 =
=

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=
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ISSUES:

1. Whether the costs of ongoing research and development ("R&D") on acquired technology are required to be shared under an existing cost sharing agreement.

2. Whether one participant in a cost sharing agreement is required to make a buy-in payment to the other participant when the other participant acquires existing technology for further development.

3. Whether, if a buy-in payment is required, but Examination did not assert this requirement when it examined the taxable year in which the technology was acquired and that taxable year is now closed, Examination may require buy-in payments in the form of periodic payments for open taxable years.

CONCLUSIONS:

1. The portion of the costs of ongoing R&D on the acquired Technology A that relates to the Shared Systems that are developed under the existing cost sharing agreement must be shared. The ongoing R&D on the acquired Technology A also benefitted Advanced Systems and third-party sales of Technology A-based Components A. Only that portion of the R&D costs allocable to Shared Systems is required to be shared under the cost sharing agreement.

2. A participant in a cost sharing agreement is required to make a buy-in payment to the participant that acquires existing Technology A, to account for the non-acquiring participant's share under the cost sharing agreement of the portion of the value of the acquired existing Technology A that relates to the Shared Systems that are developed under the agreement. Again, the buy-in is required only with respect to that portion of the value of the acquired Technology A that is allocable to Shared Systems, and not the portion allocable to Advanced Systems or to the third-party sales of Technology A-based Components A.

3. Examination may require appropriate buy-in payments, in the form of periodic payments in open taxable years, even though Examination did not assert that a buy-in payment was required when it examined the taxable year in which Technology A was acquired and that taxable year is now closed.

FACTS:

A. Background

1. The U.S. Taxpayer and its Products

USCorp, located in the United States, designs, develops and sells Products A with Special Capabilities. During the years being considered, USCorp had two general categories of Products A with Special Capabilities: Advanced Systems and entry systems. Advanced Systems are Products A-1 with Special Capabilities. Entry systems are Products A-2 with Special Capabilities, also referred to herein as "Shared Systems." Since its inception, in Year 1, USCorp been a leader in developing and integrating the four core technologies required for Products A with Special Capabilities. These are: Technology A, Technology B, Technology C and Technology D.

In the period leading up to the transactions at issue in this case, USCorp conducted R&D primarily related to Technologies B, C, and D.[1] These Technologies were developed specifically for use with Technology A, in order to provide the Special Capabilities that were the distinguishing feature of USCorp's Products A. R&D regarding Technology A was conducted largely by an unrelated corporation, USTechCorp.

2. The Controlled Party and its Products

In Year 2, USCorp formed FSub, a Country A corporation. FSub was formed to engage in developing, manufacturing and marketing Shared Systems products in its territory, primarily Area A. FSub's operations in Country A for Shared Systems are similar to USCorp's operations in the United States for Shared Systems. USCorp did not share its business activities related to Advanced Systems with FSub.

3. Technology Agreements

When it formed FSub, USCorp entered into two agreements with FSub to share the intangible property rights related to the Shared Systems. Effective as of Date 1, FSub and USCorp entered into a cost sharing agreement (the "CSA") for

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[1] USCorp was also engaged in some research and development related to Technology A. You may wish to consider developing the facts concerning whether and how the costs of this R&D were shared by the parties to the cost sharing agreement.

the development and ownership within their respective territories of new intangible property related to the Shared Systems. USCorp and FSub also entered into a license agreement (the "License") for the transfer from USCorp to FSub of rights to existing intangible property related to the development, manufacture and sale of Shared Systems in FSub's territory. No agreements were entered into with FSub to share intangible property rights related to Advanced Systems.

<u>a.</u> <u>The Cost Sharing Agreement</u>

The purpose of the CSA was to allow USCorp and FSub to “pool their respective resources for the purpose of conducting research and development in the field of [Shared Systems] and to share the risks and costs of such research and development activity and the intangible property as may be produced therefrom.” The parties declared their “inten[t] to exploit the intangible property developed in accordance with this [CSA] in their respective territories as described herein.” CSA, Recitals. To the extent that any of USCorp's R&D benefitted both its Advanced Systems and the Shared Systems that were subject to the CSA between USCorp and FSub, the overall amount of such R&D costs had to be allocated between the Advanced Systems and the Shared Systems to determine the portion that was subject to the CSA. You may wish to consider developing the facts concerning whether and how this allocation was made.

The CSA provides that it “relates to the sharing of costs . . . in connection with the research and development activities of [USCorp] and [FSub] in the field of [Shared Systems].” CSA, Art. I. “Research Programs” are defined as “all research and development activity conducted pursuant to this [CSA] by the parties.” CSA, Art. II.A.

The “R&D Costs” of a party that are shared under the CSA are defined to mean and include:

> . . .all costs incurred by a party in connection with the Research Program:
>
> 1. All direct and indirect costs and expenses incurred by a party for the conduct by it for the Research expenditure as defined under US Financial Accounting Standard #2 entitled “Accounting for Research and Development Costs”; and
>
> . . . .

> 3. Any and all Technology purchased or otherwise acquired by [USCorp].

CSA, Art. II.H. The CSA excludes from this definition, and therefore from the pool of shareable costs, the royalties payable by FSub under the License for the transfer of rights to existing intangible property. *Id.*

"Technology" is defined broadly, as:

> representing any secret and confidential know-how, trade secret information, data (including commercial and clinical data), customer lists, specifications, marketing approvals, designs, manufacturing techniques and descriptions, whether or not in documentary form, relating to engineering, manufacturing, testing, quality control, application, sale and use of [Shared Systems] . . . developed under this [CSA] after [Date 1].

CSA, Art. II.C.2.

Projected sales of Shared Systems products were used as the basis for sharing costs under the CSA. The CSA provides that Aggregate Allocable R&D Costs

> shall be shared by the parties based on the potential sales projected as of the date of this [CSA] which may be derived by each party from products or services utilizing the Developed Technology in their respective territories as provided herein, Periodically, the parties will review actual and projected sales, licenses and provisions of services utilizing the Developed Technology and will negotiate in good faith to amend the percentages . . . if such actual and projected sales, licenses and provisions of services so warrant, or to provide different percentages on a product-by-product basis, at the option of the parties, if significant product-by-product variations arise.

CSA, Art. IV.B.

The CSA provides for “respective rights of ownership and interest in and to any and all Improvements arising during the term of this [CSA],” and gives each party “the exclusive and perpetual right within [its] Territory to manufacture, use and sell [Improvements arising during the term of the CSA].” CSA, Art. VI.

b. The License Agreement

Under the License, USCorp granted FSub a Research and Development License (the "R&D License") and a Commercial Exploitation License (the "Exploitation License"), both of which applied to the Licensed Technology. License, §§ 2.1 & 2.2.

"Licensed Technology" was defined to mean

> [USCorp's] Proprietary Rights existing on the date hereof that are necessary or useful for the development and manufacture, or the commercialization in the Territory, of one or more of the Products that have been sold, are being sold, or is currently under development.

License, § 1.3.

"Products" were defined to mean "[Shared Systems], excluding those covered by the [CSA], as listed in [a schedule] of this [License] as of the date of this [License] that have been sold, that are being sold, and that are currently under development." License, § 1.6. Thus, the License and the royalties payable under the License applied to existing intangible property related to Shared Systems and the CSA applied to intangible property that would be developed. For products that would be developed on the basis of a combination of existing and newly developed technology, the License provided that "[a] Royalty shall be paid to [USCorp] on any new Products sold in the territory which are covered under the [CSA] to the extent they encompass the Licensed Technology." Amendment No. 1 to the License, effective as of the date of the License.

Under the R&D License, USCorp granted to FSub

> a nonexclusive, perpetual license, to practice the Licensed Technology, and to further develop, enhance, modify and improve the Licensed Technology, exclusively under the terms of the [CSA] but solely for the purposes of making or having made the Products in [FSub's] Territory or using and selling the Products in [FSub's] Territory.

License, § 2.1.

The Exploitation License granted to FSub

> a nonexclusive right to manufacture, use, or sell any current or future products incorporating the Licensed Technology, but does not grant to [FSub] any right to license to third parties to practice, or to sublicense others to practice, the Licensed Technology or any portion thereof for any purpose other than in connection with the development or manufacture of the Products worldwide and the use and sale of the Products in [FSub's] Territory. . . .

License, § 2.2.

The License provided that "[FSub] shall pay to [USCorp] [specified percentages] of Net Sales in [FSub's] Territory for five years from the date [of the License]." License, § 4.0. The specified percentages declined in each successive year. *Id.* "Net Sales" were defined to mean "the commercial sales in [FSub's] Territory by [FSub] after the date of this [License] to independent or related parties in bona fide arm's length transactions, less [specified deductions related to sales]." License, § 1.5.

B. USCorp's Acquisition of USTechCorp

1. Component A Transactions Before the Acquisition

USTechCorp, before it was acquired by USCorp, licensed the Technology A that it developed to unrelated manufacturing companies, such as FMfg A and FMfg B. These unrelated companies manufactured and sold Components A based on Technology A. FMfg A and FMfg B contributed to USTechCorp's cost of developing Technology A. They also paid royalties to USTechCorp based on their sales of Technology A-based Components A.

USCorp purchased Technology A-based Components A for use in Shared Systems from these manufacturers. USCorp then sent such Components A, as well as other components, to an independent assembler for placement on Subassemblies A. USCorp used some of these Subassemblies A in the manufacture of Shared Systems and transferred others to FSub, at transfer prices equal to USCorp's costs, including its costs for purchasing Technology A-based Components A from the manufacturers. FSub used the Subassemblies A that it received from USCorp in the manufacture of Shared Systems. Thus, the costs incurred by USCorp and FSub for acquiring Components A and Subassemblies A for use in the manufacture of Shared Systems were the same.

2. Acquisition Transactions

On or around Date 2, USCorp acquired USTechCorp by merger, with USTechCorp becoming a wholly-owned subsidiary of USCorp. On or around Date 3, USCorp liquidated USTechCorp into USCorp. USCorp thereafter transferred USTechCorp's technology to a newly formed USCorp subsidiary named USSub. The former employees of USTechCorp were assigned to a separate division of USCorp, identified as USDiv.

3. Reasons for USCorp's Acquisition of USTechCorp

In the time leading up to the acquisition, USTechCorp was experiencing financial difficulties and was considering a change in strategy. The new strategy would focus on developing technology designed for use in Products A-3. Products A-3 offered a wider market than Products A-2, including USCorp's Products A-2 with Special Capabilities. As a result, USTechCorp was expected to reduce the resources it would apply to develop the Technology A that was required for the Components A that were essential to USCorp's entire product line.

The uncertain financial condition of USTechCorp and the possibility of delay or of failure to develop the next generation of Technology A-based Components A for inclusion in future Shared Systems products threatened the continuing viability of USCorp and FSub. USCorp engaged Advisor A to investigate what USCorp could do to secure the next generation of Technology A-based Components A. Advisor A proposed as one alternative that USCorp acquire USTechCorp and its Technology A.

From the time it acquired USTechCorp, USCorp has acknowledged that by acquiring Technology A and continuing its development, it has been able to maintain its ability to improve and sell its products. According to USCorp's Year 3 Annual Report, its "

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Three years later, USCorp again stated that "

" USCorp's Year 5 Form 10-K. Illustrating this point, USCorp stated:

USCorp's Year 4 Annual Report.

C. Operations Following USCorp's Acquisition of USTechCorp

We understand that after acquiring USTechCorp, USCorp continued operations regarding Technology A in much the same form as USTechCorp had conducted such operations before it was acquired. USCorp continued to license, under preexisting contracts with unrelated manufacturers, existing fully developed Technology A. USCorp continued to receive royalty payments from these manufacturers, based on their sales of Components A manufactured under these licenses. USCorp also continued to purchase Technology A-based Components A for use in Shared Systems from these manufacturers; to send these Components A, with other components, to an independent assembler for placement on Subassemblies A; and to use such Subassemblies A in the manufacture of Shared Systems or to transfer them, with transfer prices equal to USCorp's costs, to FSub for use in the manufacture of Shared Systems.

Similarly, with respect to the form of USCorp's operations regarding further development of Technology A, we understand that FMfg A and FMfg B may have continued to share, or may plan to share, the cost of developing future Technology A by making payments to USCorp. We understand also that USCorp anticipates that it will license newly developed Technology A to unrelated manufacturers and will receive royalty payments based on their sales of newly developed Technology A-based Components A.

Thus, the circumstances under which Technology A is now being used and further developed have remained, in form, quite similar to those that pertained before USCorp acquired Technology A. However, significant differences in the substance of the related party transactions between USCorp and FSub involving Technology A have come about as a result of USCorp’s ownership of Technology A.

The costs of acquiring and of further developing Technology A were incurred by USCorp for the primary purpose of maintaining and improving USCorp’s leadership in the field of Products A with Special Capabilities. This included the leadership of USCorp and FSub in the field of Shared Systems, where such leadership was expected to enhance the profitability of both companies from the manufacture and sale of Shared Systems.

With this objective foremost, USCorp did not expect that royalties from licensing Technology A to unrelated manufacturers would be sufficient to allow USCorp to recover its costs for acquiring and further developing Technology A. Nor did USCorp anticipate that cost contributions from manufacturers would offset more than a small part of such costs. Rather, USCorp understood that by “ ” (USCorp’s Year 5 Form 10-K), it would recover its costs primarily through the manufacture and sale of improved Products A with Special Capabilities. This is illustrated by USCorp’s statement that its continuing development of Technology A had resulted in “ ” USCorp’s Year 4 Annual Report.

We note that USCorp, after acquiring USTechCorp, amended its license agreement with FMfg A, which was originally entered into between USTechCorp and FMfg A. The amendment eliminated the need for FMfg A to pay royalties to USCorp with respect to its sales to USCorp of Components A that would use a specified new generation of Technology A that was being developed by USCorp. We are not aware of any amendment to the license agreement with FMfg B. However, we understand most of the Components A used in the Shared Systems are purchased by USCorp from FMfg A. To the extent that this amendment applies to future transactions, FSub will acquire Components A based on Technology A that has been developed at the expense of USCorp without even partially or indirectly compensating USCorp for that technology, unless FSub shares in the cost of its development.

D. Prior and Current Examinations

In USCorp's Taxable Years 1 and 2, USCorp did not require FSub to share, under the CSA, the cost of ongoing R&D related to Technology A. In examining these years, Examination adjusted the pool of costs under the CSA, to include this cost. USCorp agreed to this adjustment, which increased its income by the amount of the cost sharing payments from FSub. Examination, however, did not adjust USCorp's income by requiring a buy-in payment from FSub for its share of the value of the existing Technology A that USCorp acquired in USCorp's Taxable Year 1. USCorp's Taxable Years 1 and 2 are now closed.

In the current examination of USCorp's Taxable Years 3 and 4, Examination intends again to take the position that the cost of ongoing R&D related to Technology A must be included in the pool of costs to be shared under the CSA. Examination also intends to maintain that FSub was required to make a buy-in payment, in the form of periodic payments over five years, for its share of the value of the existing Technology A that USCorp acquired in USCorp's Taxable Year 1. Examination intends to adjust USCorp's income for Taxable Years 3 and 4, to include buy-in payment amounts due from FSub in those years.

LAW AND ANALYSIS:

A. Section 482 and the Arm's Length Standard

Section 482 provides that the Service "may distribute, apportion or allocate gross income, deductions, credits or allowances" among controlled businesses if "necessary in order . . . clearly to reflect the income" of such businesses. The arm's length standard has long been applied to determine whether an allocation is required under section 482. *See, e.g.*, Treas. Reg. § 1.482-1 (b)(1) (1968), which provided, in part, as follows:

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer . . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Specific guidance for applying the arm's length standard to transfers of intangible property was added to the section 482 regulations in 1968. 33 Fed. Reg. 5848 (April 16, 1968). These intangible property regulations included a regulation related to cost sharing agreements. The regulation provided:

> Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect

> each participant's arm's length share of the costs and risks of developing the
> property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.

Treas. Reg. § 1.482-2(d)(4) (1968)[2].

B. The Commensurate With Income Standard of Section 482

The Tax Reform Act of 1986 ("1986 TRA"), Pub. L. 99-514, 100 Stat. 2085, 2561, *et. seq*., 1986-3 C.B. (Vol. 1) 1, 478, amended section 482 to add a requirement that, where there is a transfer or license of intangible property between controlled parties, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." This amendment was prompted by Congressional concern that "major changes in profitability of the intangible after the transfer" be taken into account. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-637 (1986) [hereinafter "1986 Conf. Rep."].

The conferees stated that they did "not intend to preclude the use of certain bona fide research and development cost-sharing arrangements," provided that "the income allocated among the parties reasonably reflect[s] the actual economic activity undertaken by each." *Id*. The conferees observed that "[u]nder such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant stages would be included." *Id.*

C. Regulatory Developments

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[2] These 1968 final regulations followed a notice of proposed rule making, 30 Fed. Reg. 4256 (April 1, 1965), which was withdrawn and replaced by a new notice of proposed rule making, 31 Fed. Reg. 10384 (August 2, 1966).

In response to a Congressional recommendation, *id*. at II-638, the Treasury Department and the Service conducted and published for comment a study of intercompany transfer pricing. Notice 88-123, 1988-2 C.B. 458 (the "White Paper"). After considering comments, the Service proposed amendments to the section 482 regulations. 57 Fed. Reg. 3571 (January 30, 1992), 1992-1 C.B. 1164. These 1992 proposed regulations included general regulations on the transfer of intangible property and regulations for cost sharing. Prop. Treas. Reg. §§ 1.482-2(d) & 1.482-2(g) (1992). They were to be generally effective for taxable years beginning after December 31, 1992, except with respect to transfers or licenses to foreign persons before November 17, 1985 and transfers or licenses to others before August 17, 1986 (hereinafter collectively referred to as "pre-1986 TRA excluded transfers or licenses"). The 1992 proposed regulations also provided that the commensurate with income standard under the second sentence of section 482 added by the 1986 TRA was generally effective for post-1986 taxable years, and taxpayers were required to apply that standard using any reasonable method not inconsistent with the statute for years prior to 1993. The preamble to the 1992 proposed regulations stated that "[f]or the period prior to the proposed effective date of these regulations, the final sentence of section 482 [the commensurate with income standard] shall be applied using any reasonable method" and that "a method that applies these proposed regulations or their principles [is] a reasonable method." 1992-1 C.B. 1164, 1165.

In 1993, temporary section 482 regulations were issued. 58 Fed. Reg. 5263 (Jan. 21, 1993), 1993-1 C.B. 90. These 1993 temporary regulations included general regulations for the transfer of intangible property and a regulation for cost sharing. Temp. Treas. Reg. §§ 1.482-4T & 1.482-7T (1993). The temporary cost sharing regulation was the same as the 1968 cost sharing regulation. These 1993 temporary regulations became generally effective for taxable years beginning after April 21, 1993. While generally effective for post-April 21, 1993 taxable years, the temporary regulations carved out the pre-1986 TRA excluded transfers or licenses from the scope of their application. The 1993 temporary regulations also provided that, for the period prior to their effective date, the commensurate with income standard under the second sentence of section 482 must be applied using any reasonable method not inconsistent with the statute and "a method that applies these [temporary] regulations or their general principles [is] a reasonable method." Temp. Treas. Reg. § 1.482-1T(h) (1993).

On July 8, 1994, the Service published final section 482 regulations. 59 Fed. Reg. 34975 (July 8, 1994), 1994-2 C.B. 93. These 1994 final regulations included general regulations for the transfer of intangible property. Treas. Reg. §§ 1.482-1, 1.482-4, 1.482-5 & 1.482-6 (1994). These regulations became generally effective for taxable years beginning after October 6, 1994. Treas. Reg. § 1.482-1(j)(1) (1994).[3] While generally effective for post-October 6, 1994 taxable years, the final regulations carved out the pre-1986 TRA excluded transfers or licenses from the scope of their application. Also, for the period prior to the effective date of these regulations, "a method that applies these [final] regulations or their general principles [is] a reasonable method" for applying the commensurate with income standard of section 482. Treas. Reg. § 1.482-1(j)(3) (1994).

A cost sharing regulation was not included in the 1994 final regulations. Instead, "the temporary regulations [Temp. Treas. Reg. § 1.482-7T (1993)], which incorporate the text of the 1968 regulations, continue[d] to apply." 1994-2 C.B. 93,112.

On December 20, 1995, the Service published final cost sharing regulations, based on its 1992 proposed regulations. 61 Fed. Reg. 7157 (Dec. 20, 1995); 1996-1 C.B. 85. These regulations became effective for taxable years beginning on or after January 1, 1996. Treas. Reg. § 1.482-7(k) (1995). A transition rule provided that pre-existing cost sharing agreements that met the requirements of the temporary regulations needed to be conformed to the final regulations by December 31, 1996.

D. Applicable Regulations

This case addresses the requirements concerning ongoing sharing of R&D costs under the CSA and the requirements concerning periodic payments with respect to a buy-in for the Taxable Years 3 and 4 under examination. The 1993 temporary regulations govern USCorp's Taxable Years 3 and 4. As discussed, these temporary regulations incorporate the prior 1968 cost sharing regulations, which provide requirements with regard to prospectively developed intangibles pursuant to a cost sharing arrangement. By their terms, they address only acquisition of intangible property to the extent developed pursuant to, and while a participating party in, the cost sharing arrangement: "Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property . . . ." Temp. Treas. Reg. § 1.482-7T (1993).

The "buy-in" requirements with regard to any preexisting intangible property, or any intangible property developed outside the cost sharing arrangement and

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[3] Taxpayers may elect to apply all of the provisions of these regulations for any open taxable year. Treas. Reg. § 1.482-1(j)(2) (1994). We are not aware that the taxpayer in this case has made such an election.

acquired from another, are governed by the general rules applicable to transfers or licenses of intangible property set forth in the 1993 temporary regulations.[4] It is immaterial that the acquisition occurred in Taxable Year 1, prior to the general effective date of the 1993 temporary regulations. The 1993 temporary regulations govern the periodic consideration due with respect to previously transferred or licensed intangibles, with the sole exception of pre-1986 TRA excluded transfers or licenses. Also, prior to the effective date of the 1993 temporary regulations, as confirmed by the regulations, the commensurate with income standard under the second sentence of section 482 had self-executing effect pursuant to any reasonable method (which includes a method that applies the principles of the temporary regulations). The cost sharing and buy-in issues in this case are discussed in sections E and F, below.

<u>E.</u> <u>The Cost Sharing Issue</u>

We consider first whether USCorp's cost of ongoing R&D related to Technology A is required to be shared under the CSA.

<u>1.</u> <u>Reasons for the CSA</u>

USCorp created FSub as a controlled corporate entity, with which USCorp would share its future business activities regarding Shared Systems on the basis of geographical territories. Because the Shared Systems products are largely based on intangible property rights, USCorp and FSub had to allocate or transfer such rights to accomplish their geographical sharing of the Shared System business activities. The CSA was intended to allocate rights to intangible property that had not yet been developed, without the need for determining value that arises when

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[4] The 1968 regulations provided that, except where intangible property rights are determined by application of a bona fide cost-sharing arrangement,

> where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities . . . to another member of the group . . . for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use.

Treas. Reg. § 1.482-2(d)(1)(i) (1968). This distinction was also recognized and carried forward when new cost sharing regulations were proposed in 1992 and when they were adopted in 1995. *See, e.g.*, Prop. Treas. Reg. §§ 1.482-2(g)(1)(i) (1992) & 1.482-2(g)(4)(iv) (1992); Treas. Reg. §§ 1.482-7(a)(2) (1995) & 1.482-7(g) (1995).

there is a transfer of existing intangible property between related parties. The License supplemented the CSA, by transferring rights to existing intangible property. The License required FSub to pay royalties based on the value of the intangible property that USCorp licensed FSub to use in its territory. The License applied during a 5-year transitional period, during which the value of existing intangible property was expected to decline as it was supplanted by newly developed technology.

2. Requirements of the Cost Sharing Regulation

A cost sharing agreement among related parties must meet certain requirements before it can have its intended effect, for purposes of section 482, of allocating rights to intangible property developed under the agreement without the need to apply transfer pricing principles to a transfer of intangible property. It must be a "bona fide cost sharing arrangement," which is, in essence, "an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced." Temp. Treas. Reg. § 1.482-7T (1993).

3. Application of the Cost Sharing Regulation to the CSA

The key requirements for having a bona fide cost sharing arrangement are that the "costs and risks of developing intangible property" be shared and that such sharing must be "in return for a specified interest in the intangible property that may be produced." *Id*. Whether the CSA meets these substantive requirements[5] is related to the issue of whether the parties provided in their CSA for sharing the cost and risk of ongoing R&D of Technology A in return for an interest in intangible property related to Technology A that may be produced.

a. Costs and Risks to be Shared

We believe the parties intended to include ongoing R&D related to Technology A within the scope of the CSA and that the terms of the CSA reflect this intent. Under the CSA, the "costs, risks and rights" to be shared by USCorp and FSub are those "in connection with the research and development activities of [USCorp and FSub] in the field of [Shared Systems]." CSA, Art. I. The costs to be shared specifically include "[a]ny and all Technology purchased or otherwise

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[5] We note that the CSA meets the administrative requirements of the regulation, as it is "in writing" and is "between two or more members of a group of controlled entities." *Id*.

acquired by [USCorp]." CSA, Art. II.H.3. USCorp has made very clear that its objective in acquiring Technology A and in pursuing its continued development was to assure the continuing commercial success of the Shared Systems. *See, e.g.*, quoted portion USCorp's Year 4 Annual Report, *supra*.

We recognize that USCorp may receive contributions from unrelated manufacturers toward the cost of its ongoing R&D regarding Technology A; that it may license newly developed Technology A to unrelated manufacturers; and that such manufacturers may sell Technology A-based Components A to unrelated parties. These circumstances do not affect our conclusion that, as a factual matter, the substance of USCorp's ongoing R&D regarding Technology A must be regarded as primarily for the purpose of improving USCorp's Products A with Special Capabilities, including the Shared Systems. Accordingly, we do not believe that treating USCorp's ongoing R&D regarding Technology A as outside the scope of the CSA, or regarding USCorp as engaged in such R&D primarily for the purpose of realizing royalty income from licensing fully developed Technology A to unrelated manufacturers, would be consistent with the substance of the transactions in question.

We believe, however, that adjustments must be made to USCorp's total cost of ongoing R&D related to Technology A, in order to determine the appropriate amount for inclusion in the pool of costs to be shared under the CSA. Such adjustments include those necessary to account for cost contributions made by the manufacturers; for the portion of the costs allocable to benefits that USCorp anticipates receiving from using Technology A in its Advanced Systems; and for the portion of the costs allocable to benefits USCorp anticipates receiving from licensing Technology A to unrelated manufacturers. These adjustments reduce the costs of ongoing R&D related to Technology A that are shared under the CSA. By making these adjustments, only the portion of the overall costs that is incurred for the purpose of maintaining leadership in the field of Shared Systems (hereinafter referred to as the R&D costs related to "Technology A for Shared Systems") is subject to the CSA.

We recognize that making these adjustments may raise factual issues. The adjustments should be made by using a reasonable method or methods, consistently applied. Some R&D costs related to Technology A may be specifically identified with particular future applications: namely, in the field of Advanced Systems, for use in Components A to be used by unrelated parties, or in the field of Shared Systems. These costs can be directly allocated to the appropriate area. Other costs of R&D related to Technology A may be of potential benefit in more than one of these areas. One reasonable method of allocating such costs would be to do so on the basis of the projected benefits to be realized in each of the areas of potential application, with only that portion that relates to benefits anticipated from use in Shared Systems included under the CSA. The benefits in each area of application should be estimated on a consistent basis.

We note in this regard that it appears that the parties to the CSA have had to make cost allocations for purposes of the CSA since its inception. They have had to exclude from the CSA a portion of R&D costs related to Technologies B, C, and D. This has been necessary in order to reflect the expected benefits such R&D would provide for USCorp's Advanced Systems, which were not subject to the CSA. Only the portion of the overall costs of such R&D that reflected expected benefits for USCorp's Shared Systems is appropriately subject to the CSA. We are not aware of the method used by USCorp to make this allocation. Some costs of R&D related to Technologies B, C, and D may have been specifically related only to their use in Advanced Systems or in Shared Systems. Other such costs, however, may have been expected to benefit both Advanced Systems and Shared Systems. Allocating such costs between Advanced Systems and Shared Systems would need to be done on some reasonable and consistent basis. A reasonable estimation on a consistent basis of the future benefits to be received from the use of the technology in the respective Systems would be one such reasonable method of making the allocation. You may wish to consider developing the facts concerning whether and how this allocation was made.

As noted above, even before USCorp acquired Technology A, it was incurring costs for R&D related to Technology A.[6] To the extent that these costs were for technology that would benefit both Advanced Systems and Shared Systems, USCorp would have been required to allocate R&D costs related to Technology A based on anticipated benefits for use of the technology in the respective systems.[7] You may

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[6] USCorp was developing an advanced version of the USTechCorp-designed Components A then being used in USCorp's Products A with Special Capabilities, to add more advanced Capability A and Capability B functionality to the Components A.

[7] We note also that, when the 1995 final cost sharing regulations were adopted, they recognized that costs might need to be allocated in order to arrive at those appropriate for inclusion under a qualified cost sharing arrangement. The 1995 final cost sharing regulation states, in part:

> If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of

wish to consider developing the facts concerning whether and how the costs of R&D related to Technology A were shared by the parties.

Our conclusion that the cost of ongoing R&D related to Technology A for Shared Systems must be included among the costs shared under the CSA is consistent with the requirement that a bona fide cost sharing arrangement include "all the costs and risks of development." Temp. Treas. Reg. § 1.482-7T (1993). The reason for this requirement is clear. Unless all of the relevant costs are included under a cost sharing agreement that allocates the intangible property rights developed as a result of those costs, a shifting of income would occur. The income of the participant in the cost sharing arrangement that bore any unshared costs attributable to the development of shared intangible property would be reduced. And the income of the participant that received the benefits of the intangible property developed as a result of those unshared costs, without bearing its proportionate share of those costs, would be increased. Such income shifting, which is inconsistent with the requirements of section 482, would clearly be the result here, if USCorp were allowed to bear all of the cost of ongoing R&D related to Technology A for Shared Systems. Clearly, both USCorp and FSub benefitted from the technology produced as a result of that R&D, by their continuing leadership in the field of Shared Systems.

b. <u>Specified Interest in the Intangible Property that May be Produced</u>

"[I]n return" for sharing the cost of development, a participant in a bona fide cost sharing arrangement must receive "a specified interest in the intangible property that may be produced." Temp. Treas Reg. § 1.482-7T (1993). As in the case of the costs to be shared, the CSA clearly includes intangible property rights developed as a result of ongoing R&D related to Technology A for Shared Systems among "any and all Improvements arising during the term of [the CSA]," as to which the participants in the CSA receive "respective rights of ownership and interest" in their territories. CSA, Art. VI.

The fact that USCorp may continue to license newly developed Technology A to unrelated manufacturers and that such manufacturers may sell newly developed Technology A-based Components A to unrelated purchasers might be viewed either

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> such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

Treas. Reg. § 1.482-7(d)(1) (1995).

as inconsistent with the requirements of the CSA, or as indicating that Technology A is not subject to the CSA. However, we do not believe that such an approach would properly reflect the substance of the related party transactions.

As a factual matter, we believe FSub receives intangible property rights under the CSA with respect to newly developed Technology A for Shared Systems that are different and more valuable than the intangible property rights that may be transferred to unrelated manufacturers by USCorp, or that may be embedded in Components A produced by such manufacturers and sold to unrelated purchasers. Only FSub has the right to use the newly developed intangible property related to Technology A and incorporated in Components A in the manufacture and sale of Shared Systems. Such Shared Systems have been developed under the CSA as integrated systems, which incorporate Technologies B, C, and D and can only provide Special Capabilities when used with Technology A-based Components A. Technologies B, C and D are not available to any unrelated parties for use, with Technology A-based Components A, in the integrated Shared Systems. Thus, in our view, the intangible property rights related to the use of Technology A in Shared Systems is appropriately vested in FSub, provided that FSub shares in the portion of the cost of developing Technology A that is appropriately allocated to the CSA as related to Shared Systems.

Thus, we believe that FSub receives under the CSA a ”specified interest” in the intangible property related to newly developed Technology A “in return” for sharing that part of the cost of ongoing R&D related to Technology A for Shared Systems. This is consistent with the regulatory requirement for qualification of the CSA as a bona fide cost sharing arrangement. Temp. Treas. Reg. § 1.482-7T (1993).

c. The Arm’s Length Standard

The validity of our conclusions regarding application of the CSA to the cost of ongoing R&D related to Technology A for Shared Systems is confirmed by considering the ultimate issue under the cost sharing regulation, whether the “terms and conditions” of the CSA are “comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.” *Id*.

In this case, a U.S. corporation has agreed with a foreign corporation to share the costs and risks of developing a product with special capabilities, and to share the benefits of manufacturing and selling that product based on a geographical allocation of the world market. The product depends upon interrelated core technologies for its special capabilities. Although one of these technologies was originally developed largely by an unrelated party, the U.S. corporation had to step in and take over the continuing R&D regarding this technology in order to maintain its leadership in the field in which its products compete. A portion of this ongoing R&D relates to benefits to be derived by the U.S. corporation from licensing the newly acquired technology to unrelated manufacturers. However, licensing revenues are not anticipated to cover the development costs. Rather, most of these costs will be recovered through revenues from sales of the product jointly developed under the cost sharing agreement. This agreement defines the research and development costs and the intangible property rights to be shared in very broad terms, as all of the costs and intangible property rights related to the product with special capabilities that is the subject of their cost sharing agreement.

If this situation involved unrelated parties, we cannot imagine that the U.S. corporation would allow its cost sharing agreement with a foreign corporation to omit from the costs shared the costs for ongoing R&D on one of the core technologies necessary to maintain leadership with respect to the product that is the subject of their agreement. Unless the U.S. corporation required such costs to be shared, it would be allowing a portion of its income to be shifted to the unrelated foreign corporation because the foreign corporation would be able to sell the products that benefitted from the U.S. corporation's R&D bearing its share of the expense of developing the products.

d. The Commensurate With Income Standard

We find further support for our conclusion in the commensurate with income standard of section 482. Although the conferees on the law that added this standard stated that they did "not intend to preclude the use of . . . cost-sharing arrangements," they expected that "the income allocated among the parties [to such an agreement] reasonably reflect[s] the actual economic activity undertaken by each." 1986 Conf. Rep. at II-638. The conferees added that "[u]nder such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant stages would be included." *Id.*

We believe that FSub must bear a share of the cost of ongoing R&D related to Technology A for Shared Systems, so that the income FSub receives from the sale of Shared Systems will "reasonably reflect the actual economic activity undertaken by each [of the parties to the cost sharing arrangement]." *Id*. Similarly, we believe that unless FSub shares in this R&D cost, it could not be regarded as "bear[ing] its portion of *all* research and development costs . . . within *an appropriate product area*. . . ." *Id*. (emphasis added). We believe that, considering all of the facts and circumstances, the “appropriate product area” is the Shared Systems, and that “all” R&D costs must include the costs of R&D related to Technology A that was undertaken for the purpose of maintaining leadership in the field of Shared Systems.

e. Cost Sharing Conclusion

In conclusion, we believe that the CSA applies to the costs of ongoing R&D related to Technology A for Shared Systems and that, consistent with the cost sharing regulation, Examination may make such allocations “as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property [*i.e.*, the Shared Systems].” Temp. Treas. Reg. § 1.482-7T (1993).

We note that if the CSA were not to be viewed as applying to the costs of ongoing R&D related to Technology A for Shared Systems, we believe the CSA would fail to meet the requirements of the cost sharing regulation for bona fide cost sharing arrangements and of the section 482 commensurate with income standard. The consequence of such a failure would be that intangible property rights relating to the Shared Systems were transferred from USCorp to FSub and the consideration for such transfer would need to be determined under the general regulations that apply to the transfer of intangible property, including the commensurate with income standard of section 482.

F. The Buy-in Issue

A further issue raised by this request is whether FSub should be required to make a buy-in payment to USCorp for FSub’s share of the value of the existing intangible property related to Technology A that was acquired by USCorp for the purpose of maintaining leadership in the field of the Shared Systems.

Since the first cost sharing regulation was adopted, the regulations have distinguished the acquisition of “an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property” and other transfers of intangible property or interests therein. Only the former are governed by the cost sharing regulations. The latter are governed by the general rules applicable to the transfer of existing intangible property.

Transfers of interests in existing intangible property related to Shared Systems that was not developed under the CSA, and hence not acquired as a participating party in a bona fide cost sharing arrangement, therefore are governed under the general regulations.

The need for a buy-in payment in this case is therefore clear. The principal issues regarding such a payment relate to determining the value of the existing intangible property that USCorp acquired for the purpose of maintaining leadership in the field of the Shared Systems and the form that a buy-in payment should take.

a. Value of the Existing Intangible Property that USCorp Acquired for the Purpose of Maintaining Leadership in the Field of Shared Systems

We have not been asked to advise on the methods that will be used to determine the value of Technology A acquired by USCorp for the purpose of maintaining leadership in the field of the Shared Systems. We only note, therefore, that this will undoubtedly involve factual issues and recommend that the following factors need to be taken into account.

Determining the portion of the overall value of acquired Technology A that relates to the Shared Systems involves issues similar to those that exist for determining the appropriate amount of ongoing R&D costs to be shared under the CSA. Thus, the overall value of Technology A must be adjusted to account for the portion of the value that relates to third-party sales of Technology A-based Components A and for the portion of the value that relates to Advanced Systems.

By making these adjustments, only the portion of the overall value of the existing Technology A acquired from USTechCorp that relates to the Shared Systems is subject to a buy-in payment from FSub to USCorp. The buy-in payment must compensate USCorp for a percentage of this value that is the same as the percentage of costs that FSub is required to bear under the CSA, because this is the percentage of the value that is transferred to FSub when it is made available by USCorp for the benefit of FSub under the CSA.

b. Form of Buy-in Payment

Examination believes the arm's length consideration for the transfer from USCorp to FSub of existing intangible property related to Technology A for Shared Systems should be in the form of a royalty, payable over five years, with periodic payments based on declining percentages of FSub's sales of Shared Systems. Where a taxpayer fails to provide for a form of payment, the standard to be applied by the Service in making an adjustment is what unrelated parties would do in similar circumstances. The 1993 temporary regulations provide:

> An arm's length consideration for the transfer of intangible property must be in a form that is consistent with a form that would be adopted

> in transactions between uncontrolled taxpayers under comparable circumstances. If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty unless a different form is demonstrably more appropriate.

Temp. Treas. Reg. § 1.482-4T(e)(1) (1993).[8]

Thus, the ultimate determination will depend on the facts, including the economic life of the existing intangibles and their continuing value over time. We note that Examination's proposal to require a five-year declining royalty may gain support from the fact that it reflects the form of consideration that USCorp and FSub used for the transfer of existing technology when they entered into their CSA.

G. Effect of Closed Years on Requirement for Buy-in Payments

We have concluded that FSub is required to make a buy-in payment for its appropriate share of the value of the existing intangible property acquired in USCorp's Taxable Year 1 for the purpose of maintaining leadership in the field of the Shared Systems. USCorp's Taxable Years 1 and 2 were examined and closed

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[8] Similarly, under the 1968 regulations, the "arm's length consideration" for the transfer of intangible property between related parties was required to be

> consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms: (a) royalties based on the transferee's output, sales, profits, or any other measure; (b) lump-sum payments; or (c) any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them. However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

Treas. Reg. § 1.482-2(d)(2)(i) (1968).

without an assertion by Examination that a buy-in payment was required. Notwithstanding this fact, we have concluded that periodic payments under such a required buy-in payment that are due to be paid in USCorp's Taxable Years 3 and 4, which remain open, may be required by Examination.

There is no equitable doctrine that precludes the Service from correcting in an open taxable year a mistake of law made in a closed taxable year. The Service may correct an error even where a taxpayer has relied to its detriment on the mistake. *Dixon v. United States*, 381 U.S. 68, 73 (1965). This general principle has particular force here, where there is no suggestion of any estoppel claim. As far as we are aware, no one maintains that the Service, in examining the USCorp's Taxable Years 1 and 2, misrepresented its position to the taxpayer, or in any way led the taxpayer to believe that its position on the buy-in payment was immutable. Consequently, the Service may assert a requirement for such buy-in payments insofar as they pertain to open taxable years.[9]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We recommend that you consider looking into the possibility of whether the taxpayer would consider referring the transfer pricing issues in this case to the Advance Pricing Agreement (APA) Program under the Early APA Referral Program. *See* Memorandum from Assistant Commissioner (International), Assistant Commissioner (Examination) and Associate Chief Counsel (International) for Regional Chief Compliance Officers (April 25, 1997). The complexity, significance, and continuing relevance of the transfer pricing issues in this case to future taxable years suggest that substantial taxpayer and Service resources could be saved if the ultimate resolution of these issues could be facilitated through the APA process.

If you have any further questions, please call (202) 874-1490.

STEVEN A. MUSHER
Chief, Branch 6
Associate Chief Counsel (International)

[9] *See, also*, Treas. Reg. § 1.482-4(f)(2)(i) (1999), which relates to periodic adjustments in the consideration for transfers of intangible property and provides that, with certain exceptions, "[a] periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes."