

Hazards Ahead: The IRS's Coordinated Issue Paper on Cost-Sharing Buy-In Payments

I. INTRODUCTION

The IRS and the Treasury Department in recent years have devoted considerable attention to the transfer pricing issues raised by cost sharing arrangements. In particular they have examined issues related to the “buy-in” transaction by which a participant makes pre-existing intangible property available for use in the cost sharing arrangement in exchange for compensation from the other participants. This activity reached a fever pitch in the enforcement context with the designation of the buy-in issue as a “Tier I Issue” under the IRS’s Industry Issue Focus program.¹ Pursuant to that designation, the IRS issued an Industry Director Directive² and, more recently, issued a Coordinated Issue Paper (the “CIP”) to provide guidance to its Field Examiners on evaluating the buy-in issue.³ The IRS has indicated that there are dozens of significant disputes involving billions of dollars in proposed adjustments moving through the

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¹ According to the IRS, Tier I issues are of high strategic importance to the Large and Midsized Business Division of the IRS and have significant impact on one or more industries. For background on the Industry Issue Focus program, see D. Blair and G. Hani, *LMSB’s Industry Issue Focus Approach; Applying Lessons Learned from Battling Tax Shelters to Mainstream Tax Issues*, 59 The Tax Executive 237 (May-June 2007).

² Industry Director Directive #1 on Transfer of Intangibles Offshore/§ 482 Cost Sharing Buy-In Payment, LMSB-04-0307-027 (April 5, 2007) (available at <http://ftp.irs.gov/businesses/article/0,,id=169313,00.html>).

³ Coordinated Issue Paper – Sec. 482 CSA Buy-In Adjustments, LMSB-04-0907-62 (Sept. 27, 2007) (available at <http://ftp.irs.gov/businesses/article/0,,id=174320,00.html>). Earlier direction to the Field was provided in 2005 through an audit checklist for cost sharing arrangements. IRS, LMSB Division Prepares Audit Checklist for Cost-Sharing Arrangements, 2005 TNT 153-8, (Aug. 10, 2005) (“Audit Checklist”).

system,⁴ and IRS Appeals is in the process of developing settlement guidelines.⁵ One buy-in case has been docketed in the Tax Court.⁶

For its part, the Treasury Department again identified the buy-in issue as among its most important international tax regulatory priorities in its recent report to Congress on transfer pricing, earnings stripping, and tax treaty abuse.⁷ The Treasury Department has made a priority of finalizing proposed regulations focusing on the buy-in issue.⁸ These regulations, issued in 2005, propose a new model and methods to address the buy-in issue, and have been the subject of considerable criticism.

We review the background to the buy-in issue and the new positions from the CIP that the IRS plans to use in challenging buy-in payments. We then discuss the litigation process and its limitations as a mechanism for implementing new IRS positions such as those put forward in the CIP. With this background, we then identify several potential litigation hazards for the IRS as it moves to apply the CIP to current buy-in disputes. Although the buy-in issue, cost sharing, and transfer pricing in general raise many important economic and substantive policy issues, we

⁴ See, e.g., Tax Management *Transfer Pricing Report*, Vol. 14 No. 12 (October 12, 2005) (referring to \$26 billion at stake in cost sharing disputes, \$23 billion of which relates to “buy-in” payments).

⁵ See *Appeals’ Technical Services Director Discusses Process For Preparing Settlement Guidelines on Cost Sharing Cases*, Tax Management *Transfer Pricing Report*, Vol. 16 No. 17 (Thursday, January 17, 2008).

⁶ *Veritas Software Corporation & Subsidiaries v. Comm’r*, Tax Ct. No. 012075.

⁷ U.S. Department of the Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties (November 2007) (available at <http://www.treas.gov/offices/tax-policy/library/ajca2007.pdf>) (hereinafter the “Study”).

⁸ 70 Fed. Reg. 51,116 (Aug. 29, 2005).

will not attempt to answer those questions.⁹ We write from a tax litigators' perspective about the hazards ahead for the new positions that the IRS has adopted in the CIP.

II. OVERVIEW OF THE BUY-IN DISPUTE

The CIP provides guidance to Field Examiners evaluating the buy-in payments for pre-existing intangible property that is made available to a qualified cost-sharing arrangement. This part provides legal and procedural context for the buy-in dispute, the analysis of which is central to the CIP.

A. The Problem: Transfers of Intangible Property

Historically, the most contentious issues in the transfer pricing context have involved the allocation of income generated by intangible property.¹⁰ These issues historically have arisen in the context of the license or other transfer of intangible property by the developer or owner of the intangible property to a controlled taxpayer.

Under § 482, the IRS may allocate income or other items between or among taxpayers under common control where necessary to prevent tax evasion or to reflect income clearly. In the case of any transfer or license of intangible property, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible. Section 367(d) effectively adopts these standards in the context of outbound transfers of intangible property (other than foreign goodwill and going concern value) in otherwise nonrecognition transactions. For both purposes, intangible property is defined by statute with reference to the list of

⁹ [cite to articles that address these issues]

¹⁰ See, e.g., *Eli Lilly & Co. v. Comm'r*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comm'r*, 88 T.C. 252 (1987); Staff of Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, 1015 (Comm. Print 1987) ("the Bluebook").

intangibles contained in § 936(h)(3)(B).¹¹ Determining a conceptually appropriate allocation of income from intangible property can be challenging, and therefore give rise to disputes, because of the elusive nature of intangible property itself. Estimating the value of an item of intangible property, such as a patent, a trade name, or know-how, can be much more difficult and involve much more speculation than estimating the value of an item of tangible property, such as business equipment, goods, or services.¹²

B. Cost Sharing as a Solution?

As an alternative to a typical royalty arrangement, two or more controlled taxpayers may enter into a cost sharing arrangement. A cost sharing arrangement is an agreement between two or more controlled participants to share the costs of developing one or more intangibles in proportion to their respective shares of reasonably anticipated benefit from these intangibles. Because the participants share the costs and the risks of intangible development, they also are

¹¹ Section 936(h)(3)(B) defines intangible property as follows:

The term “intangible property” means any—

- (i) patent, invention, formula, process, design, pattern, or know-how;
- (ii) copyright, literary, musical, or artistic composition;
- (iii) trademark, trade name, or brand name;
- (iv) franchise, license, or contract;
- (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- (vi) any similar item,

which has substantial value independent of the services of any individual.

This list is reproduced in almost identical form in Regs. § 1.482-4(b).

considered to have joint economic ownership of the intangibles. Thus, each participant can exploit the intangible in its business without paying a royalty to the other participants or to another controlled taxpayer. Because there is no need to undertake the difficult and speculative economic determinations necessary to determine a royalty, cost sharing arrangements historically have been thought to provide an antidote to the contentiousness that plagues this area.

C. The Buy-in Issue

Although cost sharing arrangements avoid the royalty issues endemic to the typical license or other transfers of intangible property, they raise similar and perhaps more vexing issues related to the utilization of pre-existing intangibles to the intangible development effort. To ensure that cost sharing participants share in all of the costs and risks of intangible development, the regulations require buy-in payments for pre-existing or acquired intangibles made available by a controlled participant in the cost sharing arrangement. The mechanism by which the regulations require such a payment is by treating the contributing participant as having transferred an interest in the intangible property to the other controlled participants.¹³ Thus, the regulations provide that “[a] controlled participant that makes intangible property available to [the arrangement] will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it.”¹⁴ As a result, the other controlled participants must make a buy-in payment to the

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¹² Cf. H.R. Rep. No. 99-426, at 424, 99th Cong., 1st Sess. (1985) (observing that industry norms for transfers of less profitable intangibles frequently are not realistic comparables for transfers of so-called “high profit” intangibles for which arm’s length comparables often do not exist).

¹³ Regs. § 1.482-7(g)(1).

¹⁴ Regs. § 1.482-7(g)(1).

contributor of the intangible property.¹⁵ If a controlled participant fails to make this buy-in payment, the IRS may make reallocations to reflect an arm's length consideration for the transfer.¹⁶

The amount of each other controlled participant's buy-in payment is equal to "the arm's length charge for the use of the intangible under the rules of Regs. §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits" from the arrangement.¹⁷ The referenced regulations govern the determination of an arm's length charge in connection with the transfer of intangible property. They provide that the "best method" must be selected and applied based on the nature of the controlled transaction, the property involved, and the availability and quality of data with which to determine and evaluate the arm's length charge. They also provide specified methods for this purpose (namely the comparable uncontrolled transaction (CUT) method, the comparable profits method (CPM), the comparable profit split method (CPSM), and the residual profit split method (RPSM)), and note that unspecified methods may also be used if they provide more reliable results than the specified methods under the facts and circumstances. In general, data based on the results of transactions between unrelated parties provide the most reliable basis for determining whether the results of a related party transaction are consistent with this arm's length standard.¹⁸ These rules are flexible in nature in light of the fact-specific analysis required; there is no hierarchy of methods, for

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Regs. § 1.482-7(g)(2).

¹⁸ *See, e.g.*, Regs. §§ 1.482-1(b)(1) and -1(c)(2).

example, and the taxpayer's choices regarding the contractual terms of the transaction and the form of payment are afforded considerable deference.¹⁹

D. IRS Enforcement Activity and the CIP

As noted in the Introduction, the IRS has devoted considerable enforcement resources in recent years to the transfer pricing issues raised by cost sharing arrangements, in particular buy-in issues. There are dozens of significant disputes involving billions of dollars in proposed adjustments, IRS Appeals is in the process of developing settlement guidelines, and one case has been docketed in the Tax Court. Although the IRS intends the 2005 Proposed Regulations (if finalized) to provide it with enhanced enforcement tools on a prospective basis, the current disputes must be assessed and resolved on the basis of the currently applicable law.

By its own terms, the CIP “provides guidance to IRS personnel concerning methods that may be applied to evaluate” the buy in payment. It is not authority itself; rather, it is the IRS’s interpretation of existing law, in particular the current regulations, by the IRS’s Large and Midsized Business Division and the IRS Chief Counsel’s Office. As such, it effectively represents the litigating position of the IRS the with respect to the buy-in issue.²⁰ Further, because the buy-in issue has been designated as a Tier I Issue, IRS Field Examiners must examine all material buy-in transactions and may not resolve any issues in a manner that is inconsistent with the CIP. Although IRS Appeals is developing settlement guidelines and

¹⁹ See Regs. §§ 1.482-1(f)(2)(ii)(A) (IRS must assess the actual arrangement or transaction) and -7(g)(7) (buy-in payment may be structured as a lump sum, installment payments, or contingent payments).

²⁰ The positions taken in the CIP have been developed over many years and were foreshadowed in informal guidance as well as the 2005 proposed regulations. See R. Femia and M.Kirmil, *The Proposed Cost Sharing Regulations and Their Impact on Current Issues Related to Buy-In Transactions*, 21 Tax Management Memorandum __ (2005).

technically is not bound by the CIP in making an independent assessment of the hazards facing the IRS generally or in any particular case, there is some concern that IRS Appeals will give undue weight to the positions in the CIP.

III. THE CIP – KEY POSITIONS

The CIP provides guidance to Field Examiners evaluating the buy-in payments for pre-existing intangible property that is made available to a cost-sharing arrangement. This part focuses on two key aspects of the paper that may be particularly difficult for the IRS to sustain in a litigation context. First, the section describes the assertion in the CIP that one of two *unspecified* transfer pricing methods, the income method and the acquisition price method, generally will constitute the best method in certain paradigm factual scenarios. Second, the section describes the explicit and implicit expansion in the scope of the pre-existing intangible property that is the purported subject of the buy-in payment under the CIP.

A. Assertion of Non-Specified Methods as the Best Method.

Among the more remarkable aspects of the CIP is the assertion that one of two transfer pricing methods not specified by the regulations nevertheless generally will constitute the best method in most cases. The CIP describes two paradigm factual scenarios – the “initial buy-in” scenario and the “subsequent acquisition buy-in” scenario. It then prescribes the income or forgone profits method as the best method for determining an initial buy-in, and the so-called acquisition price method as the best method for determining a subsequent acquisition price buy-in. Finally, the CIP rejects the two transfer pricing methods specified by the regulations that typically were used by taxpayers to determine the buy-in, the CUT method and the RPSM.

The CIP sets out two factual paradigms – the initial buy-in scenario and the subsequent acquisition buy-in scenario. In the initial buy-in scenario, an established U.S. group with

significant self-developed intangibles and R&D capacity enters into a cost sharing arrangement with a controlled foreign corporation (“CFC”) to further develop the group’s intangible property. The CFC typically does not own intangible assets that are made available or related to the cost sharing arrangement, does not perform R&D with its own employees or facilities, and does not own intangible assets (such as local marketing intangibles) that may be exploited in conjunction with the cost shared intangibles. The CIP acknowledges that there are variations on this stark fact pattern in which, for example, the CFC (or affiliated CFCs) have more mature local operations outside the United States and may own pre-existing intangible property related to such operations. The subsequent acquisition buy-in scenario involves the acquisition of the intangibles to be made available to the cost sharing arrangement in an asset or stock acquisition from a third party. The CIP notes that this scenario is especially prevalent in the high-technology sector.

The CIP then prescribes the income method as the best method for determining an initial buy-in, and the so-called acquisition price method as the best method for determining a subsequent acquisition price buy-in. The income method is a discounted cash flow method that determines the aggregate value of the buy-in payment and royalties for make-sell rights as the present discounted value of the stream of projected profits of the CFC net of projected cost sharing payments and a routine return. Although the income method is consistent with a method included in the 2005 proposed cost sharing regulations, it is not based on any of the specified methods in the current regulations. The reliability of the income method is based on the two subjective inputs: (1) the ex ante projections of profits from the intangible property to be developed by the cost sharing arrangement, and (2) the discount rate applied to such projected profits to determine a net present value. The exhibits to the CIP illustrate the application of the

income method in various cases. They include, for example, a case in which projected profits are derived from actual profits rather than ex ante expectations. They also include an example applying the income method outside of the typical initial buy-in scenario by accounting for a return to the CFC to compensate it for its local marketing intangibles. Finally, the CIP promotes the “market capitalization” method as a corroborating method to evaluate the initial buy-in payment.

The acquisition price method determines the buy-in payment by reference to the acquisition price of the contemporaneous acquisition of the relevant intangible property in an asset or stock acquisition from a third party. Like the income method, the acquisition price method is consistent with a method included in the 2005 proposed cost sharing regulations. Under current law, the acquisition price method is appropriately categorized as a modified CUT method, albeit a CUT method that likely would not meet the regulatory standards for applying the CUT method. Under the acquisition price method, a buy-in payment is determined by determining the extent to which the acquisition price in the third-party transaction relates or is allocable to the intangible property made available to the cost sharing arrangement. Thus, significant adjustments are necessary to ensure that the buy-in payment does not include value attributable to tangible property or to intangible property that is not made available to the cost sharing arrangement.

Finally, the CIP rejects the two transfer pricing methods specified by the regulations that were typically used by taxpayers to determine the buy-in, the CUT method and the residual profit split method RPSM. The CIP asserts that the CUT method as typically utilized by taxpayers in the buy-in context raises “serious reliability concerns” because the CUTs utilized are materially different from the buy-in transaction. The CIP asserts that royalties with respect to exploitable

intangible property cannot serve as CUTs because the license of a fully developed transaction is materially different to the making available of intangible property for the purpose of future development. Similarly, the CIP asserts that payments made in the context of third-party intangible co-development agreements cannot serve as CUTs because such co-development agreements typically are of a different nature than cost-sharing agreements. For example, third-party co-development agreements may contemplate joint exploitation of intangible property to be developed, whereas cost sharing agreements contemplate separate exploitation.

The CIP reserves even stronger language for the RPSM often utilized by taxpayers in the buy-in context. Under the RPSM, the U.S. Group and the CFC share the residual profits from the foreign exploitation of the developed intangible on the basis of the relative value of the pre-existing intangibles that are the subject of the buy-in transaction and the relative value of intangibles that are developed in the cost sharing arrangement. The relative value of the pre-existing intangibles declines over time based on assumptions or observations regarding useful life or amortization/decay rate, while the relative value of the developed intangible increases over time based on the continuing funding of the costs of research and development. Thus, the buy-in payment determined under this methodology declines significantly over time. The CIP argues that this application of the RPSM is unreliable because it equates the past risks undertaken by the U.S. Group to the future risks to which the CFC has committed under the cost sharing arrangement. The CIP also casts doubt on the reliability of assumptions regarding various key inputs into the RPSM including useful life and amortization rate.

- B. Scope of Pre-Existing Intangible Property Potential to Sweep In Goodwill, Going Concern, Workforce in Place, and Other Intangibles That Fall Outside 482's Scope

The CIP argues that items not listed in section 936(h)(3) or the regulatory section 482 definition of intangibles nevertheless should be treated as assets for which a buy-in payment is required. The CIP does this explicitly by simply asserting that items that can be separately identified as distinct from goodwill or going concern value – including any rights to exploit foreign markets, intangibles, research workforce in place, and any business synergies arising from the interaction of such assets – constitute intangible property that must be compensated by the buy-in payment. More importantly, the CIP implicitly reaches this result through the adoption of “full value” methods such as the income method and the acquisition price method that are intended to capture the value of all of these items and in fact leave no value allocable to goodwill or going concern.²¹

The CIP asserts that items that can be separately identified as distinct from goodwill or going concern value constitute intangible property that must be compensated by the buy-in payment. Although the CIP acknowledges that a U.S. taxpayer may transfer foreign goodwill and going concern value to a CFC without giving rise to any buy-in obligation,²² it cautions that the “value of such foreign goodwill or going concern value, to the extent it exists, does not include substantial residual intangible value associated with the right to exploit foreign markets that, instead, belongs to other identified intangibles.” The CIP then proceeds to identify various items “that may have some resemblance to what may colloquially be called goodwill or going concern value” but nevertheless may be separately identified and thus must be accounted for by

²¹ See D. Bowen, *Full Value Methods: Has the IRS Finally Hurlled the Holy Hand Grenade*, *Tax Management International Journal*, at 7 (2008).

²² Cite 367(d) regulations and relevant legislative history.

the buy-in payment. These items include marketing intangibles related to the foreign markets, the research team workforce in place, and any business synergies related to such assets.

The CIP's narrow construction of foreign goodwill and going concern value, which may be transferred tax free under §§ 367(a) and (d), provides a foundation for the application of so-called full value methods such as the income method and the acquisition price method. These methods begin from the premise of the investor model set out in the 2005 Proposed Regulations: that all of the expected cash flow or present value from the intangibles to be developed must be allocated to the participant contributing the intangible property in the buy-in transaction. The remaining participants thus are entitled to a normal return from future funds expended in the development project as well as a share of any unanticipated profits from the intangibles to be developed. The CIP's legal conclusion that the value of foreign goodwill, going concern value, business synergies, research workforce in place, and the like either is minimal or should be included in the buy-in payment provides a basis for the conclusion that the income method and the acquisition price method provide reliable ways of determining the buy-in payment.

IV. OBSERVATIONS ABOUT USING THE LITIGATION PROCESS TO EFFECT CHANGES IN POLICY

Over the years, various IRS Chief Counsel have stated that they will avoid using litigation as a means to pursue new policies and positions.²³ Instead, Chief Counsel would issue new guidance quickly to address emerging issues, and use litigation to address transactions that involved factual issues or constituted clear abuses under existing law. Underlying this approach was a recognition that litigation is inherently retroactive and therefore ill-suited for

²³ See, e.g., Statement of B. John Williams Before the Senate Finance Committee, (Nov. 15, 2001) (“Enforcement is a tool to assure even-handed application of the law, not a means to obtain new interpretations of unclear law.”).

pursuing new legal theories, and perhaps even that the IRS may fare badly when it pursues litigation based on new legal theories that have little basis in pre-existing legislation, regulations, or case law.

A. Litigation Is Retrospective Enforcement of Laws Applicable to Past Years, and Is Ill-Suited as a Mechanism for Patching Holes in the Statute and Regulations, or Announcing Changes or Refinements to IRS Policy. (E.g., *Xilinx*; *Gitlitz*)

Litigation is by its nature retrospective. Indeed, courts are not permitted to give advisory opinions on prospective transactions.²⁴ In litigation, the IRS and taxpayers ask the courts to resolve disputes over the application of tax laws to events that occurred in prior years.

Taxpayers have already planned and implemented their transactions, and there is no going back to change the facts in light of new IRS legal theories. Because litigation is retrospective, it is poorly suited as a means for the government to establish a new tax policy. Taxpayers may reasonably argue that they had no notice of the IRS's new policy at the time that they planned and implemented the transactions and, therefore, it is fundamentally unfair to hold them to the new policy.

The IRS has not fared well when it has tried to use the courts to establish new policies, or fix inconsistencies or holes in the statute and regulations. The IRS is bound by the statute and by its own regulations -- even where the regulations lead to odd results.²⁵ The same is true of less authoritative guidance, such as revenue rulings and revenue procedures. For example, in *Eli Lilly Co. v. Comm'r*, the Seventh Circuit criticized the IRS for adopting a litigation position that

²⁴ See *Thomas v. Union Carbide Ag. Prods. Co.*, 473 U.S. 568, 580-81 (1985); *AIC Ltd. v. MAPCO Petroleum Inc.*, 711 F. Supp. 1230, 1240 (D. Del. 1989).

²⁵ See, e.g., *Guardian Indus. Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007) (intersection of foreign tax credit and check-the-box regulations permitted taxpayer to claim credits without inclusion of
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appeared to conflict with an earlier revenue procedure. “[N]either a belated reassessment of the scope of the Commissioner’s power under section 482 nor belated alarm at the cost to the Treasury of recognizing transfers of intangibles to Puerto Rican manufacturing affiliates should allow the Commissioner to evade [a revenue procedure’s] effect here.”²⁶

Where the IRS tries to escape from the implications of the statute or regulations, it gives the taxpayer an opportunity to put the IRS on trial, and the results are often ugly for the IRS. The Tax Court’s decision in *Xilinx v. Comm’r*,²⁷ provides an example of how a taxpayer can use the IRS’s own regulations to attack a new IRS position. In *Xilinx*, the taxpayer entered into a cost-sharing arrangement with its Irish subsidiary governing the development of new technology. The IRS took the position that, under section 482 and the regulations governing cost-sharing arrangements, the taxpayer had to include employee stock options in the pool of shared costs. The IRS had issued new regulations to mandate the inclusion of stock options as shared costs, but those regulations did not apply to the years at issue. In the litigation, the taxpayer argued that the IRS’s position was inconsistent with section 1.482-1(b)(1) of the regulations, which provides that in determining the true taxable income of a controlled taxpayer for purposes of section 482, “the standard to be applied in every case is that of a taxpayer dealing at arm’s-length with an uncontrolled taxpayer.”²⁸ The IRS’s own expert agreed that unrelated parties do not include employee stock options in their cost-sharing contracts because of the difficulty of agreeing on

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related foreign income); *Woods Investment Co. v. Comm’r*, 85 T.C. 274 (1985) (court refused to help IRS impose fix on basis adjustment rules in consolidated return regulations to prevent “double deduction”).

²⁶ 856 F.2d 855, 865 (7th Cir. 1988).

²⁷ 125 T.C. 37 (2005).

²⁸ *Xilinx*, 125 T.C. at 54 (citing Treas. Reg. § 1.482-1(b)(1)).

values for such options and the tenuous connection between the value of options and the value of the joint R&D. This left the IRS to argue that its cost-sharing regulations required taxpayers to include stock options in shared costs -- notwithstanding the section 1.482-1(b)(1) mandate to follow the arm's-length standard. This IRS argument failed to convince the Tax Court.²⁹

There is a long list of cases where the IRS has found itself on trial for adopting legal positions that deviate from pre-existing law. Often, courts have concluded that it is up to Congress to amend the statute or Treasury to amend the regulations.³⁰ Moreover, the current Supreme Court has shown little tolerance for IRS litigating positions that attempt to cure problems with tax legislation. In *Gitlitz v. Comm'r*,³¹ the Court faced an intersection of the basis rules under the S-corporation provisions with the discharge of indebtedness (“DOI”) rules that allowed the taxpayers to claim previously suspended losses based on DOI income that was excluded from income under section 108. To avoid the technical problem created by the statute, the IRS moved among a number of technical arguments, but none was ultimately successful. Finally, the IRS made the policy argument that the taxpayer should not be permitted to claim a double benefit of using the DOI income to claim additional basis and free up previously suspended losses at the same time that they excluded the DOI from taxable income. In an 8-1 decision, the Supreme Court refused the IRS’s plea to place a patch on the statute and thereby

²⁹ The *Xilinx* case is on Appeal. See *Xilinx v. Comm'r*, Docket No. _____ (9th Cir.). If the Ninth Circuit upholds the Tax Court’s decision and rationale, it may place a cloud over the cost-sharing regulations that the IRS issued in 2006, which required taxpayers to include employee stock options in shared costs. See *Treas. Reg. § 1.482-7(d)(2)* (2006).

³⁰ See, e.g., *Eli Lilly Co. v. United States*, 856 F.2d 855 (7th Cir. 1988) (rejecting IRS attack on outbound transfer of intangibles in a 351 transaction); *The Limited, Inc. v. Comm'r*, 286 F.3d 324 (6th Cir. 2002) (reversing Tax Court decision that altered the definition of “banking business” under an exclusion from section 956 treatment, saying lower court used policy considerations to act as “über-legislature”).

³¹ 531 U.S. 206 (2001).

prevent the taxpayers from claiming a double benefit. The Court stated, “Because the Code’s plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.”³² Moreover, it placed responsibility for the taxpayer-favorable result squarely on Congress. In the Supreme Court’s view, it was not the responsibility of the courts to fix problems that Congress created when drafting the statute.³³

B. Where the IRS Stakes Out Positions that Push the Envelope of Current Law, Some Taxpayers Will Litigate.

Taxpayers may choose to litigate rather than abandon their settled expectations as to how the law applied to their facts. Where the taxpayer’s advisors (and auditors) have signed off on the transaction in prior years based on then-existing law and IRS guidance, the advisors also may see no reason to change their previous conclusions simply because the IRS has adopted a new litigating position. As the tax stakes increase, as often is the case in multi-year transfer pricing disputes, there is even more pressure on taxpayers to fight a new IRS position. The ultimate call on litigation versus settlement depends on the relative strength of the IRS and taxpayer positions. Where the IRS is attempting to push the envelope of current law to pursue a new litigating position, it will affect the taxpayer’s assessment of litigation hazards and make settlement more difficult to achieve.

C. Courts Often Disagree With the IRS and Among Themselves, Leaving Taxpayers with Mixed Messages.

The history of transfer pricing litigation demonstrates that it is a poor mechanism for pursuing reform. Often, courts do not provide a clear victory to either side, leaving the next

³² *Id.* at 220.

³³ *See id.* at 220 n. 10.

generation of advisors and taxpayers trying to extract meaningful principles from the opinions. This was especially true of the generation of transfer pricing cases that began in the 1980s, where the courts delivered long opinions raising a variety of factual and legal points that cut for or against the taxpayer and then found a way to give both sides a piece of the case.³⁴

Transfer pricing cases are typically highly factual, involve transactions that extend over multiple years, and involve extensive data and expert testimony. The courts must try to unravel the contending factual assertions and decide which side's story accurately portrays the facts, which side's experts have properly interpreted the economic and other expert issues, and then apply the law to the facts as found. When a complex case is presented in this way, the courts often make numerous findings and rulings, some of which favor one side, and some of which favor the other.

Subtle differences in the facts, presentation, and litigation tactics can be outcome determinative in a particular transfer pricing case. The highly factual nature of each case gives future generations of tax lawyers plenty of material with which to distinguish the courts' decisions from later transactions. Depending on how the case develops, the court may not even address the policy questions that the IRS seeks to answer through litigation. The role of the courts is to decide the cases brought before them, and judges are appropriately reluctant to

³⁴ See, e.g., *DHL Corp. v. Comm'r*, 285 F.3d 1210 (9th Cir. 2002) (upholding 482 adjustments based on revaluation of transferred trademark, but imposing offsetting adjustment under developer assister regulations); *Eli Lilly*, 856 F.2d at 866, 872 (ruling for taxpayer on 351 issue, but upholding pricing adjustments based on marketing expenditures and intangibles); *Bausch & Lomb, Inc. v. Comm'r*, 92 T.C. 525, 607 (1989) (court rejected 482 adjustment to price paid Irish subsidiary for contact lenses, but went on to increase the royalty payable to U.S. parent for use of lens technology); *Hospital Corporation of Am. v. Comm'r*, 81 T.C. 520, 601 (1983) (rejecting IRS attempt to sham offshore subsidiary, but reallocating 75 percent of income as compensation for U.S. parent's services and intangibles). More recently, the Tax Court has issued some more digestible cases in the transfer pricing area, which may mark the beginning
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address more issues than necessary to resolve the particular case. Moreover, if a court reaches out to make a broad statement where that statement is unnecessary to the holding, lawyers in future cases can criticize the statement as dicta that should have no binding effect in a later case.

D. Changes in Legal Theories Can Present Problems of Proof for Both Sides.

Where the IRS asserts a legal theory after taxpayers have structured and implemented a transaction, it may be difficult to develop the evidence necessary to respond to the new IRS argument. These problems of proof tend to fall more heavily on taxpayers than on the IRS, because taxpayers bear the burden of proof. However, the IRS also can find itself at a loss for evidence to support its case.³⁵

This problem becomes acute in the cost-sharing area because the regulations require taxpayers to structure their cost-sharing arrangements based on reasonably anticipated benefits from the intangible to be developed.³⁶ Post-hoc analyses are decidedly second-choice under the regulations,³⁷ but there may be no other way to address a new IRS theory for measuring the value of pre-existing intangibles and anticipated benefits. The potential for a novel IRS theory to

(footnote continued from previous page)

of a helpful trend. *See, e.g., Compaq Computer, Inc. v. Comm'r*, T.C. Memo 1999-220; *Xilinx*, 125 T.C. 37.

³⁵ *See, e.g., Lilly*, 856 F.2d at 860 (“Where the evidence shows that neither side is correct, we think it would be unreasonable to restrict the court to acceptance or rejection of the Commissioner’s position in its entirety, rather than allowing the court to reallocate ‘in a manner the evidence . . . demonstrates to be correct.’”); *Xilinx*, 125 T.C. at 59 (finding that IRS did not present any credible evidence that unrelated parties engaged in cost-sharing arrangements implicitly share the costs of stock options); *Bausch & Lomb*, 92 T.C. at 607 (rejecting testimony of both taxpayer and IRS experts on arm’s-length royalty rate); *Hospital Corp. Of Am.*, 81 T.C. at 596-97 (noting that neither side had introduced much evidence on the value of services and intangibles that the U.S. parent made available to foreign subsidiary).

³⁶ *See* Treas. Reg. § 1.482-7(f).

³⁷ *See id.*

create problems of proof is yet another factor weighing against using litigation to pursue new tax policies.

V. WHAT ARE THE IRS'S LITIGATION HAZARDS WHEN THEY BRING THE CIP POSITIONS TO THE COURTS

- A. One size fits all will not work in the transfer pricing context. Factual variations among taxpayers make it difficult to apply templates to individual cases.

As highlighted above, a remarkable aspect of the CIP is its categorization of most buy-in cases into two scenarios, the initial buy-in and the subsequent acquisition buy-in, and its prescription of a method as the best method in each case. The courts have recognized the inherent factual complexity of transfer pricing issues and resolve each case on the basis of its facts and without resort to broad frameworks or theories. In light of this, the IRS must assess the hazards of litigation, and appropriately calibrate settlement offers, based on the actual facts before it in any particular case, and not on the stylized fact patterns and analysis set out in the CIP.

The cost sharing rules are only one aspect of the U.S. transfer pricing rules, which are based on the arm's length principle. A transaction or arrangement between related parties is consistent with the arm's length principle if the results of the arrangement are consistent with the results that would have been realized if unrelated parties had engaged in the same arrangement under the same circumstances. In order to evaluate whether the results of an arrangement are consistent with the arm's length principle, the facts and circumstances of the specific arrangement at issue must be analyzed carefully.

Given the fact-intensive nature of a transfer pricing analysis, the application of the transfer pricing rules to multinational enterprises is inherently difficult and resource intensive. It

is not susceptible to templates.³⁸ This is particularly the case in the context of arrangements, including cost sharing arrangements, involving intangible property. Such arrangements are difficult to analyze because of the lack of reliable market data on the value of intangible property; such property is unique or virtually unique and multinational enterprises in some industries do not typically engage in transfers of their valuable intangible property outside their controlled group.

Notwithstanding these difficulties, the courts historically have resisted efforts to apply “rule of thumb” analyses, recognizing that each arrangement must be analyzed on its own merits.³⁹ As noted above, this is particularly appropriate in the cost sharing context because the subject of such arrangements is intangible property.

The courts will resolve each case involving the buy-in issue on the basis of its specific facts. Two superficially similar arrangements in fact may be quite different. For example, the analysis of an initial buy-in transaction may depend heavily on the following factors: the value of existing generation technology to a specific taxpayer or within an industry; the expected cycle time for new technology or product development; the relative value of globally-applicable technology vs. market-specific technology; and, perhaps most importantly, the precise point in the technology development cycle corresponding to the initial buy-in transaction. None of these variables is highlighted in the CIP. An arrangement cannot be assessed without a thorough

³⁸ Note that the CIP itself acknowledges this.

³⁹ See, e.g., *Bausch & Lomb*, 92 T.C. at 610 (rejecting rule of thumb for determining profit split in favor of allocation based on the unique facts of the case); *DHL Corp.*, 285 F.3d at ___ (reversing lower court and reallocating a portion of trademark’s value abroad under developer-assister theory); *Xilinx*, 125 T.C. at 59 (facts failed to establish that arm’s length cost-sharing arrangement would have included stock options as a shared cost).

understanding of the facts of the arrangement, including the nature of the intangible property existing at the time of the buy-in transaction and the expectations regarding further development.

In this sense, the CIP attempts to bypass the fact-intensive nature of transfer pricing cases by pushing the cases into two neat paradigms. Given the stakes in these cases, taxpayers have strong incentives to resist the IRS's effort to use broad paradigms to dispose of individual cases. Moreover, the history of section 482 litigation and court decisions with long, intensive factual disputes is an indication that such a neat approach may not be possible in this area.

- B. The CIP places first priority on unspecified methods, which may be seen as a departure from the detailed regulations on how to apply the best method rule.

Another remarkable aspect of the CIP is its prescription of one of two methods not specified in the regulations, the income method and the acquisition price method, as the best method in most cases. While the regulations clearly allow the use of unspecified methods, their wholesale adoption by the CIP in the buy-in context raises at least two issues for the IRS. First, the application by the IRS of unspecified methods as default methods may be seen as unfair in light of the higher standards placed by the transfer pricing documentation and penalty regime on taxpayer use of unspecified methods. Second, many of the weaknesses identified by the IRS in its repudiation of specified methods applied by taxpayers arguably apply equally to the unspecified methods endorsed by the IRS, providing significant ammunition to taxpayers.

Although the transfer pricing regulations identify and describe specific methods that may be applied to determine the arm's length charge in certain contexts, they also explicitly contemplate and allow the use of unspecified methods. As the CIP notes, both specified and unspecified methods stand before the best method rule on equal footing; in each case, the

technical question is whether the method selected and applied provides the most reliable result. There is no hierarchy of methods.

That said, the use of specified methods is favored by the transfer pricing documentation and penalty regime, thereby providing taxpayers with a significant incentive to use specified methods instead of unspecified methods. Under these rules, a taxpayer faces significant penalties on transfer pricing adjustments unless it has prepared contemporaneous documentation that shows that it was reasonable in its selection and application of an applicable transfer pricing method. Although a taxpayer selecting a specified method must make a responsible effort to evaluate the potential applicability of the other specified methods,⁴⁰ the IRS has acknowledged that it might be reasonable to conclude that a particular specified method is likely to be the most reliable with virtually no consideration of other potentially applicable methods.⁴¹ Further, if a taxpayer uses a specified method, it is not required to consider the applicability of a method that is not specified in the regulations.⁴² A taxpayer selecting an unspecified method, on the other hand, must reasonably conclude that, given the available data, none of the specified methods is likely to provide a reliable measure of the arm's length charge.⁴³ Further, the taxpayer must give some consideration to whether the unspecified method selected was selected and applied in a

⁴⁰ Regs. § 1.6662-6(d)(2)(ii).

⁴¹ See preamble to the 1996 final regulations, T.D. 8656, 1996-1 C.B. 329, 330.

⁴² Regs. § 1.6662-6(d)(2)(ii).

⁴³ Regs. § 1.6662-6(d)(3)(ii)(B).

way that would likely provide a reliable measure of the arm's length charge, presumably including some consideration of other unspecified methods that may be applicable.⁴⁴

A court could weight this thumb on the scale in favor of specified methods against an attempt by the IRS to apply unspecified methods in the buy-in context. Although there is no technical hierarchy of methods, a court may view the IRS's rejection of a specified method used by the taxpayer in favor of an unspecified method as inconsistent with the framework and spirit of the current regulations. The current regulations, promulgated in the mid-1990s, were viewed as a watershed development in part because they provided such detailed guidance on the application of specified methods. The specificity of the rules was thought to provide a common framework to the IRS and taxpayers and thereby facilitate better compliance and fewer disputes. The documentation and penalty regime reinforce and make explicit the primacy of specified methods, and provide significant incentives for taxpayers to utilize specified methods where possible. Given the volume of the guidance on specified methods, the natural inclination of taxpayers to find comfort in applying methods sanctioned by the regulations, and the incentives created by the documentation and penalty regime, a court may justifiably question the merit of applying unspecified methods where specified methods would do. For example, in the context of another highly specific regulatory regime -- the consolidated return regulations -- the court has declined to invoke broader tax policy considerations to justify a departure from the words of the regulations.⁴⁵

⁴⁴ Regs. § 1.6662-6(d)(3)(ii).

⁴⁵ See *Woods Investment*, 85 T.C. at 281-82.

The CIP appears to acknowledge the potential difficulties faced by the IRS in prescribing unspecified methods by providing significant discussion of why specified methods often used by taxpayers in the buy-in context lead to unreliable results. Specifically, the CIP attacks the use of the CUT method and the RPSM. The CIP attacks the CUT method on the basis that the CUTs utilized, including transfers in the context of co-development arrangements and licenses of the same or similar intangible property, are materially different from the buy-in transaction. The CIP attacks the RPSM on the basis that the RPSM equates risks on past investments with future risks and that the RPSM is overly reliant on subjective factors.

The weaknesses identified by the IRS in its repudiation of specified methods applied by taxpayers, however, arguably apply equally to the unspecified methods endorsed by the IRS, providing significant ammunition to taxpayers. The weaknesses identified by the IRS with the CUT analysis apply equally to the acquisition price method, which after all under the current regulations basically is a modified CUT. Although the third-party reference transaction in the acquisition price method involves the same intangible as the buy-in transaction, the context for the two transactions may be very different. For example, the third-party acquisition may be made with stock, whereas the buy-in payment would be made in cash. Further, the adjustments required to ensure that goodwill, going concern value, and U.S. intangibles are not included in the buy-in payment may be at least as problematic as the adjustments required under the CUTs criticized by the IRS. Finally, it may not be entirely clear in any specific case why the acquisition of a business is more similar to a buy-in transaction than a license, or why the acquisition of a business is more similar to a buy-in transaction than a co-development agreement is to a cost sharing arrangement. Similarly, some of the weaknesses identified by the CIP with the RPSM apply equally to the income method. Although it is fair to criticize the

RPSM as overly reliant on subjective factors such as useful life or decay rate, it must be acknowledged that the income method is at least equally reliant on equally subjective factors such as projected profits and the discount rate.

- C. Adopting the CIP's income method at this late date will lead to problems of proof for taxpayers and the IRS. Given the passage of time, courts may hesitate to change the standard and then simply hold taxpayers to their burden of proof.

The CIP advocates the unspecified income method as the best method for determining the initial buy-in. However, both theoretical and practical problems with imposing this method years after the fact may lead the courts in other directions. First, as a theoretical matter, application of the income method relies upon accurate ex ante projections of cash flows anticipated from the intangible to be developed. These projections must be made at the time of the buy-in transaction in order for the income method to be applied reliably. In most cases such projections were not prepared by the taxpayer for any business purpose, and were not prepared for tax purposes because the taxpayer applied a specified transfer pricing method that did not require the preparation of projections. Under the CIP, however, in the absence of ex ante projections necessary to apply the income method Field Examiners are to “develop projections,” which may be based on “actual experience.”⁴⁶ Such after-the-fact determinations are, by their very nature, not projections of anticipated benefits and therefore are not appropriate in the context of the income method. Indeed, the use of actual results seems at odds with the

⁴⁶ See CIP at part IV, C(2).

underlying premise of a cost sharing regulations that the parties may share development costs in proportion to their reasonably anticipated benefits from the developed intangible.⁴⁷

Second, as a practical matter there may be no ex ante projections available to a court for purposes of conducting an analysis under the income method. By attempting to apply this method in the first instance at the examination stage or in litigation, the IRS sets the stage for the type of failure of proof discussed above. As noted above, the CIP suggests that Field Examiners may generate such post-hoc “projections” by substituting actual experience for the ex ante projections. Once the case is in court, the IRS may have difficulty arguing for an unspecified method based on ex ante projections when the only evidence available is ex post results.⁴⁸ As discussed above, in similar situations courts have sought a middle ground.⁴⁹

- D. The CIP’s unspecified methods may sweep into the analysis intangibles that are not intangible property under the Code and regulations.

Others have observed that the IRS’s proposed method has the effect of sweeping into the buy-in payment intangible transfers that do not require compensation under section 482, including potentially aspects of goodwill, going concern value, and workforce in place.⁵⁰ As discussed above, the income and acquisition price methods advocated by the CIP (as well as the

⁴⁷ See Treas. Reg. § 1.482-7(a)(1). Although the regulations anticipate comparison of projections with actual results, that does not condone a wholesale substitution of the latter for the former. See Treas. Reg. § 1.482-7(f)(3)(iv).

⁴⁸ See, e.g., *Xilinx*, 125 T.C. at 58-59 (failure to present proof consistent with the arm’s-length standard of the regulations undermined IRS position on cost-sharing arrangements).

⁴⁹ See, e.g., *Bausch & Lomb, Inc.*, 92 T.C. at 607 (1989) (court rejected 482 adjustment to price paid Irish subsidiary for contact lenses, but went on to increase the royalty payable to U.S. parent for use of lens technology).

⁵⁰ See D. Bowen, *Full Value Methods: Has the IRS Finally Hurlled the Holy Hand Grenade*, *Tax Management International Journal*, at 7 (2008).

market capitalization method as a corroborating method) leave little room for separate goodwill and going concern value. Instead, they tend to sweep in all of the intangibles associated with a business. By comparison, the statute and regulations require compensation only for certain specific types of intangible property.⁵¹

Courts have rejected IRS attempts to expand the transfer pricing regime beyond intangible property listed in section 936(h)(3)(B) and thereby sweep in other undeniably valuable intangibles. For example, in *Hospital Corp. of America v. Commissioner*,⁵² the IRS asserted that the negotiation of a contract by a U.S. company (“HCA”) that was subsequently entered into and executed (with substantial assistance from HCA) by a foreign subsidiary (“LTD”) constituted the transfer of intangible property. The IRS asserted that the unexecuted contract, or the business opportunity to enter into the contract, was intangible property that was transferred from HCA. The Tax Court rejected the position of the IRS. The Tax Court concluded that while the activities of HCA in negotiating the contract and in discovering and making available the business opportunity were services provided by HCA to LTD, there was no transfer of intangible property. The Tax Court based its conclusions on the fact that HCA did not transfer to LTD any “legally enforceable right in specific property.”

Similarly, in *Merck & Co. v. United States*,⁵³ the IRS asserted that certain attributes, including an “affiliate structure,” a “pricing mechanism structure,” and a “group wide planning

⁵¹ See § 936(h)(3)(B) and Regs. § 1.482-4(a) and (b); Bowen, Tax Management Int’l J. at 9-17 (reviewing lack of authority under the statute, regulations, and legislative history for imposing 482 on transfers of goodwill, going concern value and workforce in place).

⁵² 81 T.C. 520 (1983).

⁵³ 24 Cl. Ct. 73 (1991).

structure,” constituted intangible property transferred from a U.S. company (“Merck”) to its Puerto Rican subsidiary (“MSDQ”). According to the IRS, among the attributes of this intangible property was the “delivery of a ready made group of captive customers, ready, willing, and able to pay MSDQ high prices established by Merck.”⁵⁴ The Claims Court rejected the position of the IRS, characterizing its argument as “essentially . . . no more than a recognition that Merck is the parent of the foreign affiliates and MSDQ. A parent corporation may create subsidiaries and determine which among its subsidiaries will earn income.”⁵⁵ The Claims Court concluded that the attributes identified by the IRS are not recognized as embodying rights to property and therefore do not constitute for transfer pricing purposes intangible property with independent value. The Claims Court further concluded that no allocation of income was appropriate.⁵⁶

Given that the CIP’s proposed income and acquisition price methods may sweep in intangible transfers that fall outside the scope of section 482, the courts may require that the IRS remove these intangibles from their 482 adjustment. However, because the CIP’s preferred methods rely on the use of broadly inclusive, aggregate approach to valuation, it may be difficult to remove certain intangibles without undermining the integrity and reliability of estimate. The excluded intangibles are of uncertain value, and their removal creates a residual 482 adjustment that is of questionable reliability.

⁵⁴ 24 Cl. Ct. at 85.

⁵⁵ 24 Cl. Ct. at 88.

⁵⁶ See also *H Group Holdings, Inc. v. Commissioner*, T.C. Memo 1999-334 (reassignment of an employee (or a group of employees) within a controlled group does not give rise to a transfer of intangible property).

E. The Role of Penalties in cases where taxpayers produced contemporaneous documentation.

The CIP instructs Field Examiners handling buy-in cases with regard to the application of penalties. Under the CIP, a taxpayer that used a specified method and produced documentation, still may be at risk for a penalty. If the Field disagrees with the taxpayer's specified method and adopts one of the unspecified methods that the CIP advocates, the CIP directs the Field to examine whether under the facts and circumstances the taxpayer reasonably concluded that application of the specified method was the best method under section 1.482-1(c). The CIP states that in some cases, it may not be possible for a taxpayer to demonstrate the basis for making such a conclusion. In these instances, the CIP directs the Field to follow the procedures for proposing a penalty.⁵⁷

It seems harsh to propose a penalty under circumstances where a taxpayer adopted a specified method and produced documentation as required by the regulations,⁵⁸ simply because the IRS subsequently determines that an unspecified method would have been better. Indeed, as discussed above, the penalty regulations seem to place a thumb on the taxpayer's side of the scale in these circumstances.⁵⁹ Where the IRS is seeking to establish a new legal position after the years in question, and after the taxpayer has prepared its return, penalties serve no useful purpose. Penalties are a disincentive to violations of established law, not for a failure to anticipate the legal positions that the IRS may later adopt.

⁵⁷ See CIP at Part VII. Note that the penalty proposal must go the Penalty Oversight Board.

⁵⁸ See Treas. Reg. § 1.6662-6(d)(2)(iii).

⁵⁹ See Treas. Reg. § 1.6662-6(d)(2) (it is not necessary for a taxpayer to conclude that its specified method is more reliable than any unspecified method).

Moreover, proposing penalties can be counterproductive; it provides the taxpayer with more incentive to challenge the IRS's position in court. For example, the notice of deficiency at issue in Veritas Software included over \$300 million in penalties over two years, which likely made the taxpayer's decision to litigate much easier. Ironically, once the case got to court, the IRS conceded the penalties.⁶⁰ Accordingly, it is not clear what the IRS gained by proposing penalties in the first place.

VI. CONCLUSION

⁶⁰ See *Veritas Software Corp.*, Stipulation of Settled Issues (April 10, 2007).