



Cost Sharing Workshop: Buy-In Payments

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Agenda

- **General Principles**
 - Definitions (these slides only)
 - Contrast: CSA and buy-in transaction
 - Buy-in transactions
- **Analytical Framework**
 - What is buy-in transaction?
 - How is buy-in transfer structured?
 - What intangible property is transferred?
 - How is buy-in consideration structured?
- **Advice Involving Buy-In Issues**
 - FSA 200001018
 - FSA 200023014
 - FSA 200225009
- **Three Issues (Paper and Discussion by Robert C. Weissler, Senior Counsel, APA)**



General Principles



Definitions (These Slides Only)

- IP: Intangible property
- CSA: Cost sharing arrangement
- CWI: Commensurate-with-income standard in Section 482 implemented by periodic adjustment rules. See Treas. Reg. § 1.482-4(f)(2).
- Covered IP: IP developed within CSA. See Treas. Reg. § 1.482-7(b)(4)(iv).
- Pre-existing IP: IP developed or acquired outside of CSA. See slide number 10 for examples.
- Transferor: Controlled participant that makes pre-existing IP available to CSA (or another controlled participant) for purposes of research under CSA
- Transferee: Controlled participant that acquires, or is treated as acquiring, an interest in pre-existing IP in exchange for buy-in payment



Contrast: CSA/Buy-In Transaction

- CSA is agreement under which parties share costs/risks of IP development in proportion to shares of reasonably anticipated benefits from exploitation of covered IP
 - Each participant bears share of all R&D costs at all relevant stages of development, on unsuccessful and successful products, in intangible development area
 - Each participant obtains specified rights in covered IP
- Buy-in transaction is, or is treated as, controlled transfer of interest in pre-existing IP, in exchange for arm's length consideration (buy-in payment)
 - Buy-in payment compensates transferor for costs/risks undertaken in developing or acquiring pre-existing IP
 - Periodic adjustment rules that implement CWI standard apply to allocations of income with respect to actual or deemed buy-in IP transfers



Buy-In Transactions

- Transferor makes pre-existing IP available to CSA and is treated as having transferred interests in IP to other controlled participants (transferees)
- Transferee pays for right to use pre-existing IP for purposes of research/development, as well as other rights consistent with interest in covered IP
- Amount of buy-in consideration determined under Treas. Reg. §§ 1.482-1 and -4 through -6
 - Arm's length consideration for rights transferred
 - Buy-in transfer subject to periodic adjustment rules that implement commensurate-with-income standard
- “Retroactive cost sharing” approach to buy-in transactions (transferor recovers part of previously incurred R&D costs) rejected in favor of general Section 482 regulations applicable to IP transfers



Analytical Framework



Analytical Framework

- What is buy-in transaction?
 - IP transfer, or deemed transfer
 - In exchange for arm's length consideration
- How is buy-in transfer structured (if imputed, how should it be structured)?
- What IP rights are transferred (or deemed transferred)?
- How is buy-in consideration structured (if contractual terms are imputed, how should consideration be structured)?



IP Transfer

- Transfer of an interest in an intangible for purposes of research/development. Treas. Reg. § 1.482-7(g)(1) and (2).
- An “interest in an intangible” includes any commercially transferable interest the benefits of which are susceptible of valuation. Treas. Reg. § 1.482-7(a)(2).



Intangible Property

- For purposes of Section 482, an “intangible” is defined in Treas. Reg. § 1.482-4(b)
 - Asset that comprises any of the listed items and has substantial value independent of the services of any individual
 - Listed items include, e.g., patents, copyrights, trademarks, and other similar items that derive value not from physical attributes but from intellectual content or other intangible properties
- Commercially transferable interest
 - Buy-in transfer may be deemed
 - Thus, “commercially transferable interest” language not superfluous. Cf. Treas. Reg. § 1.482-4(b) and preamble to T.D. 8552 (7/1/94).



Examples of Pre-Existing IP

- Work-in-process technology (IPR&D)
IP that relates to anticipated product or process
(generally has not been commercially exploited)
- Product IP
IP that relates to existing product or process
(generally has been commercially exploited)
- Marketing IP
IP that relates to marketing, distribution or sale of
anticipated or existing product or process
- Pre-existing IP may be acquired or developed outside
of cost sharing. See Treas. Reg. § 1.482-7(d)(1) (price
paid for acquired IP not intangible development cost;
rather, acquired IP subject to buy-in provisions).

Structure of Actual IP Transfer

Actual Transfer	Rights Transferred In Buy-In Transaction (Within CSA)	Rights Transferred Outside of CSA
<p>Express license: Express grant of rights in pre-existing IP (e.g., in IP license and/or cost sharing agreement)</p>	<ul style="list-style-type: none"> • Rights to use pre-existing IP for purposes of research under CSA • Rights to use pre-existing IP for other purposes consistent with licensee's interests in covered IP (e.g., to use, manufacture and sell derivative products) 	<p>May or may not include rights to use pre-existing IP for other purposes as well (e.g., to manufacture and sell existing products)</p>
<p>Implied license: Implied grant of rights as evidenced by facts (e.g., US makes pre-existing IP available to foreign controlled participant's R&D group without any written (or oral) IP license agreement)</p>	<ul style="list-style-type: none"> • Rights to use pre-existing IP for purposes of research under CSA • Rights to use pre-existing IP for other purposes consistent with licensee's interests in covered IP (e.g., to use, manufacture and sell derivative products; this category of rights may be implied by use consistent with description of interest in covered IP, and/or expressly granted by agreement) 	<p>May or may not include other rights, as evidenced by facts and circumstances (e.g., to manufacture and sell existing products)</p>

Structure of Deemed IP Transfer

Deemed Transfer	Rights Transferred In Buy-In Transaction	Rights Transferred Outside of CSA
<p>Controlled participant that makes pre-existing IP available to CSA is treated as having transferred interest in IP to other controlled participants (e.g., U.S. controlled participant makes pre-existing IP available to its own R&D group)</p>	<ul style="list-style-type: none"> • Rights to use pre-existing IP for purposes of research under CSA • Rights to use pre-existing IP for other purposes consistent with transferee's interests in covered IP (e.g., to use, manufacture and sell derivative products; this category of rights may be included within express or implied grant of rights) 	<p>Deemed transfer of interest in pre-existing IP may be concurrent with express and/or implied license under which other rights are granted to transferee (e.g., right to manufacture and sell existing products)</p>

- Can CUT method be best method if comparables do not include grant of research/derivative rights? See Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1) and (2).



Compare Other IP Transfers

- License granting commercial exploitation rights concurrently with, or in absence of, cost sharing
 - Licensor owns pre-existing product IP it developed or acquired outside of cost sharing
 - Licensor grants to licensee right to use pre-existing product IP, e.g., right to manufacture, distribute and sell existing product, in exchange for periodic royalties
 - Licensee compensates licensor for right to use pre-existing product IP, e.g., in form of sales-based royalties
- Section 367(d) outbound IP transfer
 - U.S. person transfers IP to foreign corporation in section 351 or 361 transaction (e.g., USP transfers IP to CFC in exchange for 100% of stock or as contribution to capital)
 - Section 367(d) treats outbound IP transfer as sale of IP in exchange for annual payments contingent on productivity, use or disposition (amount of deemed annual payments determined under Section 482 regulations)



Terms of Buy-In Transaction

- Buy-in transaction likely to be express or implied IP license or deemed IP transfer
- If express IP license, are contractual terms consistent with substance of buy-in transaction?
 - Does IP license grant right to use pre-existing IP for purposes of research and/or development?
 - Does IP license grant other rights to use pre-existing IP consistent with licensee's interest in covered IP (licensee's interest in covered IP specified in cost sharing agreement)?
 - Are terms of buy-in payment structure consistent with substance of rights granted in buy-in IP transfer?
 - If express terms not consistent with economic substance of buy-in transaction, contractual terms must be imputed
- Similarly, terms of implied license or deemed transfer must be imputed based on economic substance, i.e., facts and circumstances analysis



Documented Transaction - Hypo

- After executing cost sharing agreement, U.S. controlled participant conducts cost-shared R&D using pre-existing IPR&D and product IP
- Written IP license agreement
 - Grants foreign controlled participant right to use pre-existing product IP to manufacture and sell existing products
 - Consideration structured as contingent sales-based royalties
- Should transaction be respected as buy-in transfer?
 - See Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1) and (f)(2)(ii)(A) (IRS will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance)
 - Are contractual terms of IP license agreement consistent with economic substance of underlying transaction?
 - Grant of IP rights
 - Sales-based contingent payment structure



Undocumented Transaction - Hypo

- U.S. controlled participant in ongoing CSA makes newly acquired IP available to its R&D group for further R&D within cost sharing
- No written IP license agreement
- Impute contractual terms of deemed buy-in transfer consistent with economic substance
 - See Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2) (in absence of written agreement, IRS may impute contractual agreement between controlled taxpayers consistent with economic substance of transaction)
 - Grant of right to use pre-existing IP for research, as well as other rights consistent with interest in covered IP
 - Obligation to pay arm's length consideration for rights



Buy-In Payment Structure

- Arm's length consideration under IP transfer regulations, multiplied by benefit share
- Taxpayers may choose form of consideration
 - Lump sum
 - Installments over period of use
 - Royalties or other payments contingent on use
 - Use in follow-on R&D leading to product sales?
 - Use in follow-on R&D not leading to product sales?
 - Use in form of access to pre-existing IP (no follow-on R&D, but better-informed R&D decisions, saved costs, etc.)?
- Nevertheless, payment structure must be consistent with economic substance of buy-in transaction
 - Is sales-based royalty payment structure consistent with economic substance of buy-in transaction?
 - Insight from Economists?



Commensurate-With-Income

- Section 482, second sentence:
“In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”
- Congress intended to address specific abuse, *i.e.*, transfers of high-profit IP for substantially less than arm’s length consideration
- Arm’s length consideration for controlled IP transfer must reflect income (and/or cost savings) attributable to IP, as well as economic activities and risks of both transferor and transferee (before and after transfer)



Buy-In Payment and CWI - Hypo

- U.S. controlled participant grants to foreign controlled participant right to use IPR&D for research within CSA in exchange for annual royalties contingent on sales of covered IP (U.S. participant conducts R&D for CSA)
- Is buy-in payment required in Year 1, if there are no sales of product based on covered IP in Year 1?
- What payment structures are consistent with substance of buy-in transaction and CWI?



Advice Involving Buy-In Issues

- FSA 200001018 (October 6, 1999)
- FSA 200023014 (February 29, 2000)
- FSA 200225009 (March 7, 2002)

- Acronyms in following slides:
 - U.S. controlled participant (“USP”)
 - Foreign controlled participant (“FSub”)



FSA 200001018 – Facts

- USP owned pre-existing IP related to both Shared Systems and Advanced Systems
- USP acquired USTechCorp, which owned pre-existing IP related to Shared Systems, Advanced Systems and other uses
- USP made pre-existing IP available to CSA, but only with respect to Shared Systems
- USP expressly granted to FSub right to use pre-existing IP for research and commercial exploitation (e.g., to further develop, enhance or improve IP, and to use, manufacture or sell current or future products incorporating IP)



FSA 200001018 – Conclusions

- USP and FSub must share portion of cost of further developing acquired pre-existing IP
 - Development costs related in part to Advanced Systems, Shared Systems and other uses
 - Portion of costs related to Shared Systems must be included in cost pool and shared within CSA
- FSub must make buy-in payment to USP for interest in acquired pre-existing IP
 - Total value of acquired pre-existing IP must be allocated on basis similar to that used for costs
 - Only portion of total value attributable to Shared Systems forms base for determining appropriate amount of buy-in payment from FSub to USP



FSA 200023014 – Facts

- USP owned pre-existing IPR&D and pre-existing product IP
- USP granted to FSub right to use pre-existing product IP to manufacture/sell existing products in exchange for sales-based royalties (“license fees”)
- USP made pre-existing IPR&D available to CSA in exchange for royalties on sale of new products that used IPR&D or covered IP (“buy-in royalties”)
- Cost sharing agreement described participants’ interests in covered IP
 - Manufacturing rights (USP/North America // FSub/R-O-W)
 - Selling and use rights (each assigned worldwide rights)



FSA 200023014 – Conclusions

- Governing regulations
 - CSA: 1993 temporary cost sharing regulations (same as 1968 cost sharing regulations)
 - Buy-in transaction: 1994 final transfer pricing regulations applicable to IP transfers (sections -1 and -4 through -6)
- TP's chosen form of buy-in consideration will generally be respected, if consistent with economic substance of buy-in transaction
 - TP structured “license fees” and “buy-in royalties” as royalties; that form of consideration should be respected, unless it does not reflect economic substance of respective transactions. See Treas. Reg. § 1.482-1(f)(2)(ii)(A) (IRS will evaluate results of transaction as actually structured by TP, unless its structure lacks economic substance). See also Treas. Reg. § 1.482-1(d)(3)(ii)(B).
 - However, amount of royalties may be adjusted to properly reflect arm's length standard and CWI requirement



FSA 200023014 – Conclusions

- There is no general requirement that transfer pricing methodology for determining buy-in payment for given year must estimate net present value of pre-existing IP made available to CSA
- But, estimated NPV calculation or other evidence of FMV may be relevant to application of TPMs
 - Under CUT method, comparable IP must have same or similar profit potential, which is most reliably measured by calculation of NPV of anticipated benefits (income to be realized or costs to be saved)
 - Unspecified method may use estimate of NPV as evidence of realistic alternative to controlled transaction. See Treas. Reg. § 1.482-4(d)(1).
 - Under RPS method, external market benchmarks that reflect FMV of IP may be used to measure relative contributions of IP in second step
- Market capitalization method may provide more reliable measure of arm's length result than TP's purported RPS method
 - Market cap method uses data based on results of transactions between unrelated parties and, therefore, may provide more objective basis for determining arm's length result than TP's method
 - Market cap method provides market evidence of value of pre-existing IP; certainly, any inconsistency between that market evidence and taxpayer's results should be considered in best method analysis



FSA 200023014 – Conclusions

- If buy-in payment must be in form of royalty (because TP chose royalty form and that form is consistent with substance of transaction), it should equal amount of royalty in stream of CWI royalties extending over life of IP made available to CSA
- Lump sum payment rules define equivalence between lump sum form of consideration and royalty form of consideration. See Treas. Reg. § 1.482-4(f)(5).
- Amount of buy-in payment royalty for given year in stream of CWI royalties over useful life of IP likened to “equivalent royalty amount” in lump sum payment rules (ERA derived from actual lump sum payment; buy-in royalty may be derived from lump sum value)



FSA 200225009 – Facts

- USP owned pre-existing IPR&D and pre-existing product IP that it developed internally and acquired from third parties outside of cost sharing
- USP granted to FSub right to use pre-existing IPR&D and pre-existing product IP to manufacture, sell and otherwise commercially exploit existing products in exchange for sales-based royalties
- USP made pre-existing IPR&D and pre-existing product IP available to CSA for further research
- USP granted to FSub non-exclusive, royalty-free license to commercially exploit covered IP

USP and FSub amended their cost sharing agreement once and their IP license agreement at least three times. To simplify our discussion, these slides do not address various effective date and retroactive application issues related to the amendments; no inference is intended by this omission.



FSA 200225009 – Conclusions

- Buy-in payments represent arm's length consideration for controlled transfer of IP
 - Buy-in transaction distinguishable from CSA
 - Amount of buy-in payment determined under general rules applicable to controlled transfers of IP
- FSub must make buy-in payments to USP that reflect arm's length consideration for all pre-existing IPR&D and all pre-existing product IP made available to CSA
 - Obligation to make buy-in payment is not contingent on use of pre-existing IP in covered IP or in CSA research activity
 - Obligation to make buy-in payment is contingent on actual or deemed transfer of right to use pre-existing IP
 - Same rules apply to pre-existing IP acquired by USP from third parties and made available by USP to CSA



Three Issues
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Q&A Discussion Session