MEMORANDUM

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

*by Rocco V. Femia and David Blair**

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 Directive [2] 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 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 will not attempt to answer those questions.[9] We write from a tax litigator's perspective about the hazards ahead for the new positions that the IRS has adopted in the CIP.

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

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[1] According to the IRS, Tier I issues are of high strategic importance to the Large and Mid-Size Business Division of the IRS and have significant impact on one or more industries. For background on the Industry Issue Focus program, see Blair and 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 (4/5/07) (available at http://www.irs.gov/businesses/article/0,,id=169313,00.html).

[3] Coordinated Issue Paper — Sec. 482 CSA Buy-In Adjustments, LMSB-04-0907-62 (9/27/07) (available at http://www.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").

[4] *See, e.g.*, "Green Describes Role in IRS Cost Sharing Projects, Says Arbitration Should be 'Standard' in U.S. Tax Treaties," 14 *Tax Mgmt. Transfer Pricing Rpt.*, No. 12 (10/12/05) (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," 16 *Tax Mgmt. Transfer Pricing Rpt.*, No. 17 (1/17/08).

[6] *Veritas Software Corporation & Subsidiaries v. Comr.*, 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*).

[8] REG-144615-02, 70 Fed. Reg. 51,116 (8/29/05).

[9] *See, e.g., ABA Comments on Proposed Cost Sharing Regulations*, 2005 *TNT* 241-24 (11/28/05); Bowen, "Full Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade," 37 *Tax Mgmt. Int'l J.*, No. 1 at 7 (1/11/08); Morgan, "What's Wrong with the Investor Model?" 14 *Tax Mgmt. Transfer Pricing Rpt.*, No. 23 (3/29/06); Wills and Brist, "The Economic Flaw in the Investor Model," 15 *Tax Mgmt. Transfer Pricing Rpt.*, No. 10 (9/27/06).

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cost sharing arrangement. This part provides a legal and procedural context for the buy-in dispute, the analysis of which is central to the CIP.

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 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 (as defined in §936(h)(3)(B)), 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 (which, under Regs. §1.367(d)-1T(b), explicitly excludes 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 intangibles contained in §936(h)(3)(B).[11] Determining a conceptually appropriate allocation of income from intangible property can be challenging, and therefore gives 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]

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 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.

At this point an example may be in order. Assume a U.S. company that is part of a U.S.-based multinational group, USCo, wishes to develop intangible property for use in a new line of business in both domestic and foreign markets. USCo could agree to an arrangement with FCo, its controlled foreign corporation, whereby each company would fund the intangible development project in proportion to its relative expected benefits from the project. The relative expected benefits would be determined on the basis that USCo would exploit the intangible property in domestic markets and FCo would exploit the intangible property in foreign markets. If the project is successful, then each company could exploit the intangible property in its local market without any obligation to pay royalties to the other company.

The Buy-in Issue

Although cost sharing arrangements avoid the royalty issues endemic to the typical license or other

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[10] *See, e.g., Eli Lilly & Co. v. Comr.*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comr.*, 88 T.C. 252 (1987); IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute, IR-2006-142 (9/11/06) (available at http://www.irs.gov/newsroom/article/0,,id=162359,00.html); Staff of Joint Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, 1015 (Comm. Print 1987).

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

> The term "intangible property" means any —
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> (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).

[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).

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transfers of intangible property, they raise similar and perhaps more vexing issues related to the utilization of pre-existing intangibles in 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 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 buy-in rules are necessary to ensure that U.S.-based intangible property does not migrate out of the U.S. tax net for less than arm's length compensation.

Building on the example above, assume that the arrangement is for the development of intangible property in an existing line of business, and moreover that USCo has existing intangible property that will be used in developing the new intangible property. The buy-in rules require FCo to make a buy-in payment to USCo with respect to the deemed transfer of the pre-existing intangible property.

The amount of each 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, the comparability between the controlled transaction and any uncontrolled comparable transactions, and the availability and quality of data with which to determine and evaluate the arm's length charge.[18] They also provide specified methods for this purpose (including the comparable uncontrolled transaction (CUT) method,[19] the comparable profits method (CPM),[20] the comparable profit split method, and the residual profit split method (RPSM)),[21] and note that unspecified methods may also be used if they provide more reliable results than the specified methods under the facts and circumstances.[22] 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.[23] These rules are flexible in nature in light of the fact-specific analysis required; there is no hierarchy of methods, for example, and the taxpayer's choices regarding the contractual terms of the transaction and the form of payment are afforded considerable deference.[24]

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 Mid-Size Business Division and the IRS Chief Counsel's Office. As such, it effectively represents the litigating position of the IRS with respect to the buy-in issue.[25] Further, because the buy-in issue has been designated as a Tier I Issue, IRS

[13] Regs. §1.482-7(g)(1).
[14] *Id*
[15] *Id.*
[16] *Id.*
[17] Regs. §1.482-7(g)(2).
[18] *See generally* Regs. §§1.482-1(b), (c), (d).
[19] Regs. §1.482-4(c).
[20] Regs. §1.482-5.
[21] Regs. §1.482-6(c)(3).
[22] Regs. §1.482-4(d).
[23] *See, e.g.*, Regs. §1.482-1(b)(1), (c)(2).
[24] *See* Regs. §§1.482-1T(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).
[25] The positions taken in the CIP have been developed over

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Field Examiners must examine all material buy-in transactions and may not resolve any issues in a manner that is inconsistent with the CIP.

Issuance of the CIP also means that IRS Appeals will include the issue in its Technical Guidance Program and assign an Appeals Technical Guidance Coordinator, and develop settlement guidelines.[26] The CIP effectively amounts to the input of LMSB and the Chief Counsel's Office on the settlement guidelines, and IRS Appeals officials likely were involved in the development of the CIP.[27] IRS Appeals also has taken rather extraordinary steps to solicit broad taxpayer and practitioner input on the settlement guidelines. On December 11, 2007, IRS Appeals hosted a meeting to solicit such input from private sector organizations including the Tax Executives Institute, the Silicon Valley Tax Directors Group, the American Bar Association, and the American Institute of Certified Public Accountants,[28] and IRS Appeals has followed up with questions for the attendees.[29]

The traditional role of IRS Appeals is to resolve each case based on the case-specific facts and circumstances, taking into account the adequacy of the factual support for the proposed adjustment as well as the hazards facing both the government and the taxpayer. As such, individual IRS Appeals officers typically have tremendous flexibility to resolve cases equitably. In the transfer pricing area, IRS Appeals historically has sustained a low percentage of proposed adjustments; further, based on available data, the sustention rate has declined over time, with a sustention rate of 17.5% in transfer pricing cases resolved in 2002.[30]

The development of IRS Appeals settlement guidelines and the requirement to follow review and concurrence procedures with the Appeals Technical Guidance Coordinator will constrain the authority of individual IRS Appeals officers to resolve buy-in cases in a manner that is considered inconsistent with the guidelines.[31] In some contexts, such as marketed tax shelters, IRS Appeals has been successful in adopting standard settlement positions and settlement guidelines that permitted relatively little leeway for factual differences among transactions to affect the bottom line settlement. Moreover, where taxpayers rejected Appeals settlement positions or guidelines, taxpayers typically lost in court.[32] However, it is not clear that the standardized approach that works against a cookie-cutter tax shelter will work in the far more fact intensive issue of a buy-in payment. Further, although IRS Appeals technically is not bound by the CIP in making an independent assessment of the hazards facing the IRS in the context of the development of settlement guidelines,[33] there is some concern that IRS Appeals will give undue weight to the positions in the CIP. IRS Appeals personnel have asserted publicly that they are considering both the CIP and taxpayer input.[34]

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.

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many years and were foreshadowed in informal guidance as well as the 2005 proposed regulations. *See* Femia and Kirmil, "The Proposed Cost Sharing Regulations and Their Impact on Current Issues Related to Buy-In Transactions," 46 *Tax Mgmt. Memo* 451 (10/17/05).

[26] *See* IRM §8.7.3.2.1 (12/11/07).

[27] *See* Blair and Hani, "LMSB's Industry Issue Focus Approach; Applying lessons Learned from Battling Tax Shelters to Mainstream Tax Issues," *The Tax Executive* 237, 239 (May-June 2007) (describing consultation with Appeals on Tier I issues).

[28] *See* Moses, "Appeals Should Avoid Approach in CIP in Preparing Settlement Guidelines, TEI Says," *Tax Mgmt. Transfer Pricing Rpt.*, No. 16 (12/13/07).

[29] "IRS Questions to Stakeholders After 12/11/07 Appeals Meeting On Cost Sharing Settlement Issues," 16 *Tax Mgmt. Transfer Pricing Rpt.*, No. 17 (1/17/08).

[30] *See* U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482*, Appendix C (1999) (reporting a sustention rate of 34.2% for proposed transfer pricing adjustments by IRS Exam resolved by IRS Appeals in 1998) and U.S. Department of the Treasury, IRS, *Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service*, p. 11 (2003) (reporting a sustention rate of 17.5% for proposed transfer pricing adjustments by IRS Exam resolved by IRS Appeals in 2002).

[31] *See* IRM §8.7.3.4 (11/1/04) (IRS Appeals Officers must complete review and concurrence procedures with the Appeals Technical Guidance Coordinator on the coordinated issue).

[32] For example, taxpayers that rejected Appeals restrictive settlement guidelines for contingent liability capital loss transactions lost the issue in court. *See* Appeals Coordinated Industry Paper and Settlement Guidelines, *§351 Contingent Liability Capital Loss Transactions*, available at *http://www.irs.gov/pub/irs-utl/asg_cont_liab__final__20040504_redacted.pdf*; *Coltec Indus. v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006).

[33] *See* IRM §8.7.3.2.1 (12/11/07) (Appeals will use the CIP as a resource, but is not required to follow it).

[34] *See* Moses, "Appeals Still Considering the Direction of Cost Sharing Guidance," 16 *Tax Mgmt. Transfer Pricing Rpt.*, No. 20 (2/28/08) (indicating that IRS Appeals is considering both IRS and taxpayer positions).

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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 applicable regulatory standards. 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 RPSM. The CIP asserts that the CUT method as typically utilized by taxpayers in the buy-in context raises "serous 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 intangible is materially different from 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 is even more forceful in its criticism of the RPSM often utilized by taxpayers in the buy-in con-

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text. 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 with 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.

Scope of Pre-Existing Intangible Property Has Potential to Sweep in Goodwill, Going Concern, Workforce in Place, and Other Intangibles that Fall Outside the Scope of §482

The CIP argues that items not listed in §936(h)(3) or the regulatory §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, global marketing 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.[35]

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,[36] 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 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. In effect, the CIP attempts to shift the legal paradigm of the buy-in issue from the transfer of discrete items of intangible property to the transfer of a bundle of interrelated rights, capabilities, and opportunities, and then asserts the applicability of full-value methods developed in the context of the valuation of a going concern.

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[35] *See* Bowen, "Full Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade," 37 *Tax Mgmt. Int'l J.*, No. 1 (1/11/08).

[36] *See* Regs. §1.367(d)-1T(b) (excluding the transfer of foreign goodwill and going concern value from §367(d), thereby allowing the transfer of these items in nonrecognition transactions); Regs. §1.367(a)-1T(d)(5)(iii) (defining foreign goodwill and going concern value, and providing that the value of the right to use a corporate name in a foreign country shall be treated as foreign goodwill or going concern value).

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OBSERVATIONS ABOUT USING THE LITIGATION PROCESS TO EFFECT CHANGES IN POLICY

Over the years, various IRS Chief Counsels have stated that they will avoid using litigation as a means to pursue new policies and positions.[37] Instead, the general policy of the Office of Chief Counsel has been to 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 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.

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

Litigation is by its nature retrospective. Indeed, courts are not permitted to give advisory opinions on prospective transactions.[38] 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 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.[39] The same is true of less authoritative guidance, such as revenue rulings and revenue procedures. For example, in *Eli Lilly Co. v. Comr.*, the Seventh Circuit criticized the IRS for adopting a litigation position that 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." [40]

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. Comr.*,[41] 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 §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 Regs. §1.482-1(b)(1), which provides that in determining the true taxable income of a controlled taxpayer for purposes of §482, "the standard to be applied in every case is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer."[42] 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 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 Regs. §1.482-1(b)(1)

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[37] *See, e.g.*, Statement of B. John Williams before the Senate Finance Committee (11/15/01) ("Enforcement is a tool to assure even-handed application of the law, not a means to obtain new interpretations of unclear law."). *But see U.S. Department of the Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties* 45-46 (November 2007) (describing strategy for using litigation as a component of the IRS's overall compliance effort).

[38] *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).

[39] *See, e.g., Guardian Indus. Corp. v. U.S.*, 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 related foreign income); *Woods Investment Co. v. Comr.*, 85 T.C. 274 (1985) (court refused to help IRS impose fix on basis adjustment rules in consolidated return regulations to prevent "double deduction").

[40] 856 F.2d 855, 865 (7th Cir. 1988).

[41] 125 T.C. 37 (2005).

[42] *Xilinx*, 125 T.C. at 54 (citing Regs. §1.482-1(b)(1)).

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mandate to follow the arm's-length standard. This IRS argument failed to convince the Tax Court.[43]

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.[44] Moreover, the current Supreme Court has shown little tolerance for IRS litigating positions that attempt to cure problems with tax legislation. In *Gitlitz v. Comr.*,[45] 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 §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 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." [46] 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.[47]

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 between whether to litigate or settle 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.

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 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.[48]

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.

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[43] The *Xilinx* case is on Appeal. *See Xilinx v. Comr.*, Docket No. 06-74246 (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* Regs. §1.482-7(d)(2).

[44] *See, e.g., Eli Lilly Co. v. U.S.*, 856 F.2d 855 (7th Cir. 1988) (rejecting IRS attack on outbound transfer of intangibles in a 351 transaction); *The Limited, Inc. v. Comr.*, 286 F.3d 324 (6th Cir. 2002) (reversing Tax Court decision that altered the definition of "banking business" under an exclusion from §956 treatment, saying lower court used policy considerations to act as "überlegislature").

[45] 531 U.S. 206 (2001).

[46] *Id.* at 220.

[47] *See id.* at 220 n. 10.

[48] *See, e.g., DHL Corp. v. Comr.*, 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. Comr.*, 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. Comr.*, 81 T.C. 520, 601 (1983) (rejecting IRS attempt to sham offshore subsidiary, but reallocating 75% 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 of a helpful trend. *See, e.g., Compaq Computer, Inc. v. Comr.*, T.C. Memo 1999-220; *Xilinx*, 125 T.C. at 37.

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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 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.

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.[49]

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.[50] *Post-hoc* analyses are decidedly second-choice under the regulations,[51] 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 create problems of proof is yet another factor weighing against using litigation to pursue new tax policies.

[49] *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).

[50] *See* Regs. §1.482-7(f).

[51] *See id.*

THE IRS'S LITIGATION HAZARDS WHEN THEY BRING THE CIP POSITIONS TO THE COURTS

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 tight frameworks or theories. In light of this, the IRS must asses 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. 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. 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 often 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

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must be analyzed on its own merits.[52] 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 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 §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.

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,[53] 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.[54] 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.[55] 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.[56] Further, the taxpayer must give some consideration to whether the unspecified method selected was selected and applied in a 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.[57]

A court could weigh this thumb on the scale in favor of specified methods against an attempt by the IRS to apply unspecified methods in the buy-in con-

[52] *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 1220 (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).

[53] Regs. §1.6662-6(d)(2)(ii).

[54] *See* preamble to the 1996 final regulations, T.D. 8656, 1996-1 C.B. 329, 330.

[55] Regs. §1.6662-6(d)(2)(ii).

[56] Regs. §1.6662-6(d)(3)(ii)(B).

[57] *Id.*

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text. 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 justifiably may 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 Tax Court has declined to invoke broader tax policy considerations to justify a departure from the words of the regulations.[58]

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 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 in the context of 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. These weaknesses would be exacerbated by the use of a market capitalization method.

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.

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 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." [59] 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 re-

[58] *See Woods Investment Co. v. Comr.*, 85 T.C. at 281-82.

[59] *See* CIP at part IV, C(2).

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sults seems at odds with one of the underlying premises of the cost sharing regulations that the parties may share development costs in proportion to their reasonably anticipated benefits from the developed intangible.[60]

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.[61] As discussed above, in similar situations courts have sought a middle ground.[62]

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 methods have the effect of sweeping into the buy-in payment intangible transfers that do not require compensation under §482, including potentially aspects of goodwill, going concern value, and workforce in place.[63] As discussed above, the income and acquisition price methods advocated by the CIP (as well as the 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.[64]

Courts have rejected IRS attempts to expand the transfer pricing regime beyond discrete items of rights or attributes property of the type listed in §936(h)(3)(B) and thereby sweep in other undeniably valuable rights or attributes. For example, in *Hospital Corp. of America v. Comr.*,[65] 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, although 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. U.S.*,[66] the IRS asserted that certain attributes, including an "affiliate structure," a "pricing mechanism structure," and a "group wide planning 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." [67] 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." [68] The Claims Court concluded that the attributes identified by the IRS were not recognized as embodying rights to property and therefore did not constitute for transfer pricing purposes intangible property with independent value. The Claims Court further concluded that no allocation of income was appropriate.[69]

Given that the CIP's proposed income and acquisition price methods may sweep in intangible transfers that fall outside the scope of §482, the courts may re-

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[60] *See* Regs. §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* Regs. §1.482-7(f)(3)(iv).

[61] *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).

[62] *See, e.g., Bausch & Lomb*, 92 T.C. at 607 (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).

[63] *See* Bowen, "Full Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade," 37 *Tax Mgmt. Int'l J.*, No. 1 (1/11/08).

[64] *See* Code §936(h)(3)(B) and Regs. §1.482-4(a) and (b); Bowen, *Tax Mgmt. 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).

[65] 81 T.C. 520 (1983).

[66] 24 Cl. Ct. 73 (1991).

[67] 24 Cl. Ct. at 85.

[68] 24 Cl. Ct. at 88.

[69] *See also H Group Holdings, Inc. v. Comr.*, 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).

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quire that the IRS remove these intangibles from their §482 adjustment. However, because the CIP's preferred methods rely on the use of a broadly inclusive, aggregate approach to valuation, it may be difficult to remove certain intangibles without undermining the integrity and reliability of the estimate. The excluded intangibles are of uncertain value, and their removal creates a residual §482 adjustment that is of questionable reliability.

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 Regs. §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.[70]

It seems harsh to propose a penalty under circumstances where a taxpayer adopted a specified method and produced documentation as required by the regulations,[71] 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.[72] 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 a punishment for a failure to anticipate the legal positions that the IRS may later adopt.

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.[73] Accordingly, it is not clear what the IRS gained by proposing penalties in the first place.

CONCLUDING OBSERVATIONS

As discussed herein, the CIP sets forth a litigating position that may encounter hazards when presented to a court. Many of these hazards stem from the CIP's advocacy of new positions that are not clearly set forth in the current regulations and its attempt to apply standard analytical paradigms to fact-intensive cases. In our view, notwithstanding any merits of these positions from a broader policy perspective, these elements give rise to substantial hazards for the government's position, and these hazards should be assessed by IRS Appeals in its development of settlement guidelines.

Although we have been critical of the positions taken in the CIP from a litigation perspective, it is clear that litigation has been and will continue to be one of the tools the IRS uses to encourage compliance with the transfer pricing rules. Further, the problem of the migration of intangibles outside of the United States raises significant tax policy and tax administration issues, and there is little doubt that incorrectly priced buy-in payments could facilitate such transfers. Not all buy-in cases are of equal merit. In our view, the IRS may reduce the hazards created by the CIP if it adopts a litigation strategy that emphasizes case selection and avoids arguments that appear to push the courts to break new ground and resolve problems with the current regulations.

With regard to case selection, and even with the CIP in place, LMSB and IRS Chief Counsel have substantial influence over which cases wind up in court and in what order. They can develop case selection procedures that identify the most abusive situations early and begin to develop these cases for litigation. The IRS also can avoid those cases where the underlying disagreement is a product of inadequacies in the current regulations. Once the IRS has selected a case for litigation, it could set aside the paradigms set out in the CIP and focus on the facts of that specific case.

By selecting cases that involve clear-cut violations of the current regulations or the economic principles on which they are based, the IRS can maximize its chance of prevailing in court, thus getting "more bang for the buck" in terms of enforcement resources. Such an approach could reduce the power of taxpayer arguments that the IRS is trying to change the rules after

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[70] *See* CIP at Part VII. Note that the penalty proposal must go the Penalty Oversight Board.

[71] *See* Regs. §1.6662-6(d)(2)(iii).

[72] *See* Regs. §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).

[73] *See Veritas Software Corp.*, Stipulation of Settled Issues (4/10/07).

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the fact. At the same time, the IRS could still deliver the message that it is willing to litigate when faced with abuses under the current law.

It remains to be seen whether the IRS will proceed in arguing the positions taken in the CIP notwithstanding the significant hazards ahead.

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