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Transfers of Intangible Property under Section 482

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Definition of Intangible Property

Categories of Intangible Property

In Income Tax Regulations section 1.482-4(b) the final section 482 regulations[1] define an intangible as an asset with substantial value "independent of the services of any individual," and as comprising any of the following six categories:

- Patents, inventions, formulae, processes, designs, patterns or know-how,
- Copyrights and literary, musical or artistic compositions,
- Trademarks, trade names or brand names,
- Franchises, licenses or contracts,
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data and
- Other "similar" items. An item is considered "similar" if it derives its value not from "physical attributes," but from its "intellectual content or other intangible properties."

The final regulation definition of intangible property does not include language from the temporary regulation[2] definition which required intangible property to be "commercially transferable." See *Income Tax Regs. § 1.482-4T(b)* and *Merck & Co. Inc. v. United States,* 24 Cl. Ct. 73 (1991), 91-2 U.S.T.C. (CCH) ¶ 50456 at 89,732-33 (parent-subsidiary "organizational structure" held not to qualify as intangible property under 1968 regulations). Despite the omission of this language, *Merck* probably still has value as precedent as the final regulation definition of intangible property does not materially differ from the 1968 regulation definition.

Transfers of "Know-How" in Connection with the Performance of Services

A reoccurring transfer pricing issue concerns whether intangibles such as "know-how" may be transferred in connection with the performance of services. This issue may arise where technical personnel employed by a U.S. company provide technical assistance to a foreign related entity. As noted above, Income Tax Regulations section 1.482-4(b) defines an intangible as an asset that has "substantial value independent of the services of any individual." This language indicates that an employee using "know-how" in providing services to a related party does not necessarily thereby transfer an intangible. In such a case, the "know-how" may have little value to the related party apart from the services.

However, if the employee reduces the knowledge to writing in the form of designs, formulas, processes or other written forms, the Internal Revenue Service (the "Service" or "IRS") might argue that a transfer of an intangible has occurred. Under such facts, the employee arguably has transferred an intangible even though services were also performed. Otherwise, such intangible rights could be transferred without arm's-length compensation simply by transmitting the intangibles via the memory of an employee.

The Treasury Department Technical Explanation of the United States-Australia Income Tax Treaty provides some guidance on this point. The explanation of Article 12, paragraph 4, states that the term "royalty" implies a "property right as distinguished from personal services." The explanation includes the example of an engineer or architect who prepares a design for a customer and is therefore treated as performing personal services, rather than transferring intangibles. However, the explanation includes a counter example of an engineer or

[1] Unless otherwise indicated, all references to regulation sections are to the final section 482 regulations which generally became effective for taxable years beginning after October 6, 1994.

[2] The Internal Revenue Service published temporary and proposed section 482 regulations on January 21, 1993. *T.D. 8470,* 1993-1 C.B. 90.

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architect supplying pre-existing designs or blueprints. Under such circumstances, the engineer or architect is described as furnishing knowledge or information and therefore transferring an intangible. Thus, the Technical Explanation implies that no transfer would result if the engineer or architect had developed a new design or blueprint as opposed to simply supplying a pre-existing design or blueprint from memory or otherwise.

The Treasury Department Technical Explanation of the United States Model Income Tax Convention, at Article 12, paragraph 2, provides similar guidance in its description of the term "royalties":

> "The term 'royalties' also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software, development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 14 (Independent Personal Services) or Article 15 (Dependent Personal Services) . . . "

Interestingly, the final regulations on the classification of transactions involving computer software provide that the provision of information with respect to the transfer of a computer program will be treated as the transfer of "know-how" only if the information is, among other requirements, (i) furnished under conditions preventing unauthorized disclosure, specifically contracted by the parties and (ii) "subject to trade secret protection." *Income Tax Regs. § 1.861-18(e).* See also *Income Tax Regs. § 1.861-18(h), Example 16.*

Public statements from Service officials indicate that the transfer of "know-how" through the provision of services may be discussed in the revisions, now underway, to the services regulations.

Coordination with Tangible Property Rules

Embedded Intangibles

Income Tax Regulations section 1.482-3(f) provides that ordinarily the transfer of tangible property with an "embedded" intangible such as a trademark will be considered a transfer of only tangible property if the purchaser does not receive the right to exploit the embedded intangible other than through reselling the tangible property. For example, where a controlled distributor distributes a product bearing a trademark owned by a related party, the transaction will be treated as a transfer of tangible property rather than as including a separate transfer of intangible property. Therefore, a royalty or other payment for the intangible will not be required. However, the regulation states that the embedded intangible must be accounted for in determining comparability of controlled and uncontrolled transactions.

Exploited Embedded Intangibles

Income Tax Regulations section 1.482-3(f) also provides that where a controlled purchaser receives the right to exploit an embedded intangible, arm's-length consideration must be determined for both the tangible and intangible property. The regulation includes an example of a controlled purchaser of a machine receiving the right to use a process incorporated in the machine to manufacture a product. The regulation concludes that the purchaser is not simply purchasing the machine, but is also exploiting the embedded intangible and thus arm's-length consideration must be determined separately for the embedded intangible. Thus, a royalty or other payment for the intangible may be required, and the controlled purchaser will presumably be treated as owning the embedded intangible for purposes of determining its arm's-length income.

Intangible Property Methods

The final regulations list four methods for determining arm's-length consideration for transfers of intangible property:

- The comparable uncontrolled transaction ("CUT") method,
- The comparable profits methods ("CPM"),
- The profit split method and
- Unspecified methods.

Income Tax Regulations section 1.482-4(a) provides that each of the above methods must be applied in accordance with all of the provisions of Income Tax Regulations section 1.482-1, including the "best method" rule.

Comparable Uncontrolled Transaction ("CUT") Method

The comparable uncontrolled transaction ("CUT") method of Income Tax Regulations section 1.482-4(c) determines whether the amount charged for a controlled transfer of intangible property is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

Reliability of CUT Method

Income Tax Regulations section 1.482-4(c)(2)(ii) provides that if an uncontrolled transaction involves the transfer of the same intangible under the "same," or "substantially the same," circumstances as the controlled transaction, the results derived from applying the CUT method will generally be the most reliable measure of an arm's-length result for the controlled transfer of an intangible. The circumstances of the controlled and uncontrolled transactions will be considered "substantially the same" if there are at most only minor differences that have a definite and reasonable ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of "comparable" intangibles under "comparable" circumstances may be used in applying the CUT method, but the reliability of the analysis will be reduced. This "comparable" standard allows more frequent use of the CUT method, which otherwise would rarely be applicable.

CUT Comparability Requirements

Income Tax Regulations section 1.482-4(c)(2)(iii)(A) provides that the degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of Income Tax Regulations section 1.482-1(d). In addition, the regulation states that because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under the CUT method also depends on similarity with respect to those factors.

Under Income Tax Regulations section 1.482-4(c)(2)(iii)(B)(1), the intangible property involved in the controlled and uncontrolled transactions must be used in connection with similar products within the same general industry or market having similar "profit potential." The regulations provide that the profit potential of an intangible is most reliably measured by calculating the net present value of the benefits to be realized. This calculation is based on prospective profits to be realized or costs to be saved through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may instead be based upon the following "comparable circumstances" factors listed in Income Tax Regulations section 1.482-(c)(2)(iii)(B)(2):

- The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use or any limitation on the geographic area in which the rights may be exploited,
- The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations or licenses) in the market in which the intangible is to be used,
- Rights to receive updates, revisions or modifications of the intangible,
- The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries,
- The duration of the contract or other agreement, and any termination or renegotiation rights,
- Any economic and product liability risks to be assumed by the transferee,
- The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor and
- The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

Although all of the factors described in Income Tax Regulations section 1.482-1(d)(3) must be considered in evaluating the comparability of the circumstances of the

controlled transactions, the foregoing factors may be "particularly relevant" to the CUT method.

Income Tax Regulations section 1.482-4(c)(4) discusses four examples of the application of the intangible property comparability provisions.

Example 1 involves a U.S. pharmaceutical company that develops a disease-fighting drug and licenses the drug under identical terms to its foreign subsidiary and to an unrelated company in a neighboring country. The neighboring country is described as similar to the subsidiary's country in terms of population, per capita income and the incidence of the disease. The drug is expected to sell in similar quantities and prices in both countries and the costs of producing and marketing the drug is expected to be approximately the same in both countries. The example concludes that the uncontrolled license is a reliable measure of an arm's-length royalty rate. Thus, this is an example of the theoretical application of the CUT method. See also *Income Tax Regs. § 1.482-8, Example 7,* which is the same example.

Example 2 involves the same facts except the incidence of the disease is "much higher" in the neighboring country. The example concludes that the "profit potential" is much higher in the neighboring country and thus the unrelated license is unlikely to provide a reliable measure of an arm's-length result.

Example 3 illustrates the use of an arm's-length range to determine a royalty for the transfer of intangible property. Example 3 involves a foreign company that for a 3 percent royalty licenses to its U.S. subsidiary the exclusive North American rights to use a patented heat exchanger used to cool industrial equipment. The foreign parent does not license the heat exchanger to unrelated parties. The district director uses an SEC database to identify 40 uncontrolled license agreements, which yield 15 agreements the district director finds to involve similar rights and a "similar level of technical sophistication." From these 15 agreements the district director computes an interquartile range of from 1.25 to 2.5 percent and makes an adjustment reducing the 3 percent royalty to 2 percent, the median of the range. This example is significant as typically the CUT method will not apply, but taxpayers may be able to locate unrelated license agreements of "similar levels of sophistication" from SEC or other databases.

Example 4 involves a U.S. pharmaceutical company licensing a new anti-headache drug to its European subsidiary. The U.S. company previously licensed a different anti-headache drug to unrelated European licensees, but that drug produced some side effects and was similar to other drugs on the market. The example concludes that the new drug has greater profit potential and thus the previous license is not a comparable uncontrolled transaction.

The Comparable Profits Method ("CPM")

Under the Comparable Profits Method ("CPM") of Income Tax Regulations section 1.482-5, an arm's-length result is determined by comparing the operating profit of the "tested" party with the operating profit of an uncontrolled party involved in comparable transactions. Thus, the CPM looks at profits rather than transactions. Generally, the tested party's profit is measured in terms of "profit-level indicators" such as rate of return on capital employed or the ratio of gross profit to operating expenses. The regulations state that the tested party should normally be the "least complex" of the controlled entities. *Income Tax Regs. § 1.482-5(b)(2).*

The final regulations state that the CPM is less dependent on close functional comparability than the cost plus or resale price methods because operating profit is used rather than gross profit. The final regulations also state that the CPM should generally be less sensitive to product comparability differences than the resale price or cost plus methods, but may be more sensitive to differences such as business structure or management effectiveness, which may impact operating profit to a greater extent than gross profit. *Income Tax Regs. § 1.482-5(c)(2)(ii), (iii).* This language may be used to support use of the CPM where the Service is attempting to use a gross margin method such as the resale price method, despite significant functional differences between the controlled and uncontrolled transactions.

The inclusion of the CPM in the regulations reflects the increasing use of that method by the Service and, to a lesser extent, by the courts in resolving transfer pricing disputes. See, *e.g., Westreco, Inc. v. Commissioner,* T.C. Memo. 1992-561, 64 TCM (CCH) 849, 862-64 (1992) where the court relied in part on a CPM-type method in concluding that no adjustment to the taxpayer's transfer prices was required.

The Profit Split Method

The final regulations provide in Income Tax Regulations section 1.482-6 for two profit split

methods, the "comparable" profit split method and the "residual" profit split method.

Under the comparable profit split method, the profit split used in comparable uncontrolled transactions is applied to the controlled transactions. Because of the difficulty in obtaining uncontrolled profit split information, including information needed for consistent accounting treatment, it is likely that the comparable profit split method will seldom be a viable approach. *Income Tax Regs. § 1.482-6(c)(2).*

Under the residual profit split method, a market return is assigned to routine functions, with the residual profit divided based upon the controlled parties' relative contribution of the intangible property generating the residual profit. The final regulations, under certain circumstances, allow the use of the capitalized cost of intangibles to determine the relative value of intangibles. *Income Tax Regs. § 1.482-6(c)(3).*

The final regulations state that if the data and assumptions are significantly more reliable with respect to one of the controlled parties, a method other than the profit split method which focuses on the results of that party, may yield more reliable results. Thus, the regulations prescribe use of the CPM rather than the profit split method where, as may often occur, the data and assumptions are significantly more reliable as to one of the controlled parties. See, *e.g., Income Tax Regs. § 1.482-8, Example 9,* where the CPM is used in lieu of the profit split method.

Courts generally have used the profit split method to test the reasonableness of transfer pricing, rather than as an allocation methodology. See, *e.g., National Semiconductor v. Commissioner,* T.C. Memo. 1994-195, 67 TCM (CCH) 2849, 2865-66 (1994) and *PPG Industries v. Commissioner,* 55 T.C. 928, 997 (1970). Compare *Eli Lilly & Co. v. Commissioner,* 84 T.C. 996 (1985), *aff'd in part, rev'd in part, and rem'd,* 856 F.2d 855 (7th Cir. 1988) (taxpayer used a profit split method which was adjusted by the court).

Unspecified Methods

Income Tax Regulations section 1.482-4(d)(1) states that consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. The regulation further states that, to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced.

Income Tax Regulations section 1.482-4(d)(2) contains an example of a U.S. company that licenses an industrial adhesive process to its foreign subsidiary for a royalty of $100 per ton of adhesive produced. The example concludes that the royalty is not arm's length because "reasonably reliable estimates" indicate that the U.S. company could have manufactured the adhesive and earned a $250 per ton profit. Apart from problems relating to projecting profits, this "make or buy" analysis is inconsistent with the case law. Compare *Bausch & Lomb, Inc. v. Commissioner,* 92 T.C. 525, 593 (1989), *aff'd,* 933 F.2d 1084 (2d Cir. 1991) (U.S. parent corporation's ability to manufacture contact lens at $1.50 per lens held not to impair reliability of CUP transactions supporting a $7.50 per lens controlled sales price to Irish subsidiary).

"Unspecified methods" for intangible transfers could include profit split methods other than the two methods prescribed in Income Tax Regulations section 1.482-6, *e.g.,* a split computed using a rate of return on asset analysis.

Periodic Adjustments

Adopting the "commensurate with income" language added to section 482 by the Tax Reform Act of 1986, the final regulations state that where an intangible is transferred under an arrangement covering more than one year, each year will be examined separately "to ensure that it is commensurate with the income attributable to the intangible." *Income Tax Regs. § 1.482-4(f)(2)(i).* The regulations state that an adjustment may be made for a later year, even though the initial year's consideration is arm's length. The regulations further state that periodic adjustments "shall be consistent with the arm's-length standard." *Id.* Query, whether taxpayers may still contend, relying on the "arm's-length standard" language, that if uncontrolled parties would have bargained based upon projected profits, then later-year actual profits should not be taken into account in determining an arm's-length royalty. Cf. *R.T. French Co. v. Commissioner,* 60 T.C. 836, 852 (1973).

There is little experience to date where the Service has applied the periodic adjustment provision. Compare *Bausch & Lomb v. Commissioner,* 92 T.C. 523 (1989) where the Court's determinations may have been different under the final regulations. In determining the arm's-length

royalty, the Court presumably would have considered later-year actual, rather than projected profits. Because actual profits exceeded projected profits, the Court would have calculated a greater royalty, assuming the same methodology was employed. *Id.* at 608-11.

Exceptions to Periodic Adjustment Requirement

The final regulations include five exceptions to the periodic adjustment rule which differ depending upon whether the CUT method is used. Several of the exceptions apply only if a number of preconditions exist. The regulation provisions prescribing the exceptions, which are summarized below, should be carefully reviewed to determine their application to particular fact situations.

The first exception applies where the CUT method is used to determine the arm's-length price and (i) the CUT involves the "same" intangible transferred under "substantially the same circumstances" and (ii) the first-year compensation for the controlled transaction is arm's length as measured by the uncontrolled transaction. *Income Tax Regs. § 1.482-(4)(f)(2)(ii)(A).*

The second exception applies where the CUT method is used to determine the arm's-length price, the CUT involves a "comparable" intangible transferred under "comparable circumstances" and:

- The controlled taxpayers enter into a written agreement providing for arm's-length consideration for the first taxable year for which substantial periodic consideration is required;
- There is a written agreement setting forth the terms of the comparable uncontrolled transaction that does not contain any provisions that would permit a change in the amount of periodic consideration under circumstances comparable to those of the controlled transaction;
- The controlled agreement is substantially similar to the uncontrolled agreement with respect to the time period for which it is effective;
- The controlled agreement limits use of the intangible to a specified field or purpose in a manner consistent with industry practice;
- There are no substantial changes in functions performed by the controlled transferee after the controlled agreement is executed, except changes required by unforeseeable events; and
- The controlled taxpayer's total actual cost savings or profits earned for the year under examination and all past years are no less than 80 percent or no more than 120 percent of the cost savings or profits foreseeable when the comparability of the uncontrolled agreement was established. *Income Tax Regs. § 1.482-(4)(f)(2)(ii)(B).*

The third exception applies where there is no CUT, *i.e.*, no uncontrolled transaction involving the same or a comparable intangible. The third exception requires that:

- The controlled taxpayers enter into a written agreement providing for consideration each year subject to the agreement,
- The consideration be arm's length for the first year,
- "Relevant supporting documentation" be prepared contemporaneously with the execution of the controlled agreement,
- No substantial changes in the functions performed by the controlled transferee occur except changes that were not foreseeable and
- The aggregate actual cost savings or profits earned for the year under examination and all past years are not less than 80 percent or more than 120 percent of the foreseeable cost savings or profits. *Income Tax Regs. § 1.482-4(f)(2)(ii)(C).*

The fourth exception precludes periodic adjustments where the cost savings or profits fall outside of the 80 percent to 120 percent range, if caused by "extraordinary events" which could not reasonably have been anticipated and all of the requirements of the second or third exception have otherwise been met. *Income Tax Regs. § 1.482-4(f)(2)(ii)(D).* The final regulations include an example, Income Tax Regulations section 1.482-4(f)(iii), Example 3, where the "extraordinary event" is an earthquake. The preamble to the final regulations states that the failure of a market to develop as anticipated is not an "extraordinary event."

The fifth exception applies to licenses of more than five years and precludes any periodic adjustment after five years if no adjustments were required because the second or third exception applied during the first five years. *Income Tax Regs. § 1.482-4(f)(2)(iii)(E).*

Ownership of Intangible Property

As with the 1968 regulations, the final regulations in Income Tax Regulations section 1.482-4(f)(3)(ii) require that arm's-length consideration be paid when intangible property is transferred from one member of a controlled group to another. However, the final regulations differ from the 1968 regulations in that the final regulations contain separate rules for "legally protected" intangible property and intangible property which is not "legally protected."

Intangible Property that is "Legally Protected"

Income Tax Regulations section 1.482-4(f)(3)(ii)(A) provides as follows concerning "legally protected" intangible properly:

> "The legal owner of a **right to exploit** an intangible ordinarily will be considered the owner for purposes of this section. Legal ownership may be acquired **by operation of law or by contract** under which the legal owner transfers all or part of its rights to another." [Emphasis added.]

Significantly, the final regulations provide that intangible property such as trademarks may have multiple owners, with separate controlled members owning exploitation rights in different geographic areas. In this regard, Income Tax Regulations section 1.482-4(f)(3)(i) provides:

> "Because the right to exploit an intangible can be subdivided in various ways, a single intangible may have multiple owners for purposes of this paragraph (3)(i). Thus, for example, the owner of a trademark may license to another person the exclusive right to use the trademark in a specified geographic area, for a specified period of time (while otherwise retaining the right to use the intangible). In such a case, both the licensee and the licensor will be considered owners for purposes of this paragraph (f)(3)(i), with respect to their respective exploitation rights."

Intangible Property that is Not "Legally Protected"

Income Tax Regulations section 1.482-4(f)(3)(ii)(B) provides the ownership rules for intangible property that is not "legally protected." Under this section, the "developer" of non-legally protected intangible property is treated as the owner. The developer is "ordinarily" the controlled taxpayer bearing the largest portion of the direct and indirect costs of development. This is essentially the ownership rule under the 1968 regulations.

The Final Regulation "Cheese" Examples

The final regulations include three examples in Income Tax Regulations section 1.4824(f)(3)(iv) involving a foreign producer of cheese. The foreign producer markets the cheese in the U.S. through a U.S. distribution subsidiary using the trade name "Fromage Frere." These three examples have been the subject of much discussion in the tax press because of their implications concerning ownership of intangible property.

In the first "cheese" example, Income Tax Regulations section 1.482-4(f)(3)(iv), Example 2, the U.S. subsidiary incurs expenses for developing the U.S. market for Fromage Frere cheese. The expenses, which include marketing and advertising expenses, are not reimbursed by the foreign parent and are described as comparable to the levels of expense incurred by independent distributors. The example concludes that because the U.S. subsidiary would have been expected to have incurred similar expenses even if unrelated to the foreign parent, no allocation is necessary from the foreign parent to the U.S. subsidiary. That is, the U.S. subsidiary is not treated as having performed marketing services on behalf of the foreign parent, requiring a services allocation.

In the second "cheese" example, Income Tax Regulations section 1.482-4(f)(3)(iv), Example 3, the facts are the same except that the expenses incurred by the U.S. subsidiary are "significantly larger" than the expenses incurred by independent distributors under similar circumstances. Further, the foreign parent does not reimburse the U.S. subsidiary for these "significantly larger" marketing expenses. The example states that an independent distributor would not have incurred such levels of marketing expense to develop an unrelated party's trademark. Therefore, the example concludes, the marketing expenditures in excess of the amount that would have been incurred by an independent distributor under similar circumstances reflect services performed by

the subsidiary for the benefit of the foreign parent. The example states that such services add to the value of the foreign parents' trademark. The example concludes with the district director making an allocation from the foreign parent to the U.S. subsidiary of an amount equaling the fair market value of the services deemed performed by the U.S. subsidiary.

In the third "cheese" example, Income Tax Regulations section 1.482-4(f)(3)(iv), Example 4, the facts are the same except that the U.S. subsidiary concludes a "long term agreement" and thereby receives the "exclusive right" to distribute cheese in the United States under the foreign parent's trademark. The example states that the U.S. subsidiary purchases the cheese from the foreign parent at an arm's-length price, a fact apparently added to indicate that the U.S. subsidiary did not receive reimbursement for its "significant" advertising expenses through a reduced purchase price. From these premises, the example somewhat cryptically concludes that the U.S. subsidiary is the "owner" of the trademark pursuant to paragraph (f)(3)(ii)(A) because its "conduct is consistent with that status." The example concludes that because the U.S. subsidiary is considered the "owner" of the trademark, no services allocation need be made. The implication is that the U.S. subsidiary's advertising efforts were made to develop its U.S. ownership rights to the trademark.

The cross reference in Example 4 (the third "cheese" example) to Income Tax Regulations section 1.482-3(f)(3)(ii)(A) is to the above-quoted language stating that a single intangible may have multiple owners; both Income Tax Regulations section 1.482-3 (f)(3)(ii)(A) and Example 4 involve the transfer of an "exclusive right" to a trademark to a related party for either a "specified period" or a "long term" period. Thus, Example 4 could be cited by the Service in arguing that an intangible such as a trademark may have multiple owners–including a U.S. distribution subsidiary. Taxpayers may similarly argue that a foreign subsidiary that promotes a trademark outside the U.S. should be treated as the owner of the foreign rights. However, the lack of definitions of terms such as "significantly larger" marketing expenses creates considerable uncertainty as to the application of these ownership rules. Also, the "cheese" examples assume that the price paid to the parent for the cheese is arm's length. This is often not the case, which may complicate the analysis of the question of whether the extraordinary promotional activity is reimbursed through the transfer price of the trademarked product.

Another example in the final regulations is relevant as to the ownership issue. Income Tax Regulations section 1.482-1(d)(3)(ii)(c) is an example where a U.S. subsidiary for six years incurs marketing expenses promoting its foreign parent's trade name. The marketing expenses are described as in excess of the level of such expenses that would be incurred by a comparable distributor. In effect, the example concludes that the U.S. subsidiary would not have incurred such expenses over such a period at arm's length unless an agreement existed allowing the U.S. subsidiary to benefit from such expenditures, which under the example result in the foreign parent's trade name commanding a "price premium" in the U.S. The example concludes that the district director may impute an agreement whereby the foreign parent allows the U.S. subsidiary to earn "an appropriate portion" of the "price premium" attributable to the trademark, implying a price allowance to compensate the U.S. subsidiary for the extraordinary marketing expenses. This is similar to the result of the third "cheese" example where the U.S. subsidiary is treated as not performing services, but instead as owning a U.S. marketing intangible, and presumably earning the income attributable thereto.

The 1968 Regulation Ownership Rules

The 1968 regulations provide that when one member of a controlled group transfers intangible property to another member of the group, the district director may make appropriate allocations to reflect arm's-length consideration for the transferred intangible property. *Income Tax Regs. § 1.482-2(d)(1)(i) (1968).* But the district director may not make such an allocation until the "developer" of the intangible property transfers it to another member of the controlled group.

> "[W]here one member of a group of related entities undertakes the development of intangible property as a developer . . . , no allocation with respect to such development activity shall be made . . . until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned or otherwise made available in any manner in a transfer subject to the rules of this paragraph." *Income Tax Regs. § 1.482-2(d)(1)(ii)(a) (1968).*

Income Tax Regulations section 1.482-2(d)(1)(ii)(c) (1968) contains the rules for determining which member of a controlled group is the "developer" of intangible property.

> "The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all of the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, **greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group** . . . . Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members." [Emphasis added.]

Thus, the 1968 regulations, in determining which controlled entity is the "developer," provide that the "greatest weight" should be given to the relative development costs and corresponding risks borne by the members of the controlled group. Lesser weight may be given to the other factors listed in the regulations, such as the location of the development activity or control over the project.

Notably, the 1968 regulations do **not** list legal ownership of the intangible, or contractual relationships within the controlled group, among the factors to be considered in determining ownership of intangible property. When the Service issued the final regulations, it acknowledged in the preamble that the prior regulations had "disregarded legal ownership."

> "The 1993 [proposed] regulations also provide rules for identifying the owner of an intangible for purposes of section 482 (the developer-assister rule). These rules generally track rules provided in prior regulations, under which the owner normally is considered to be the controlled taxpayer that bears the greatest share of the risk of developing the intangible. The party that bears the greatest risk of development generally is determined by identifying costs of development. Under this rule the owner for purposes of income allocation under section 482 would not necessarily be the legal owner.
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> "The 1993 regulations provided that, for purposes of section 482, intangible property generally would be treated as owned by the controlled taxpayer that bore the greatest share of the costs of development [*i.e.,* the 1968 regulation rule]. This rule was criticized by many commentators, **principally because it disregarded legal ownership.**" *T.D. 8552,* 1994-2 C.B. 93, 96, 108 (emphasis added).

Allocations with Respect to Assistance Provided to the Owner of Intangible Property

Under Income Tax Regulations section 1.482-4(f)(3)(iii) allocations may be made to reflect arm's-length consideration for assistance provided to the owner of an intangible in connection with the development or enhancement of the intangible. Such assistance may include loans, services or the use of tangible or intangible property. Assistance does not, however, include expenditures of a routine nature that an unrelated party dealing at arm's length would be expected to incur under similar circumstances. See the discussion below of Income Tax Regulations section 1.482-2(b)(8) concerning such "ancillary" services.

Lump Sum Payments

Income Tax Regulations section 1.482-4(f)(5) provides that if an intangible is transferred for a lump sum, the lump sum must be "commensurate" with the income attributable to the intangible. The regulation states that a lump sum will be commensurate with the income if the "equivalent royalty amount" is equal to an arm's-length royalty. The "equivalent royalty amount" is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible, taking into account the projected sales of the licensee as of the date of the transfer.

To determine the "equivalent royalty amount," the taxpayer must:

- Determine the projected sales of the licensee of the intangible over the projected life of the intangible (or for the period covered by the license agreement, if shorter);
- Determine the present value of the projected sales by applying an appropriate discount rate, taking into account the risk involved;

- Divide the lump sum payment by the present value of the projected sales to determine the "equivalent royalty rate;" and
- Apply the "equivalent royalty rate" to the projected sales to determine the "equivalent royalty amount" for each year over the life of the intangible. *Income Tax Regs. § 1.482-4(f)(5)(i).*

The "equivalent royalty amount" for each year is subject to "periodic adjustments" to the same extent as actual royalty payments. *Id.* Thus, although the Service's initial focus may be on the year the lump sum amount is paid, the regulations permit the Service to re-examine the issue each year to determine if the "equivalent royalty amount" is "commensurate" with the income attributable to the intangible.

It can be anticipated that the Service will not hesitate in challenging lump sum payments, particularly where valuable intangibles are involved.

Ancillary Services

Income Tax Regulations section 1.482-2(b)(8) states that ancillary services provided in connection with the transfer of intangible property do not require separate arm's-length compensation for the services rendered, but instead are treated as being included in the price of the property transferred. Thus, technical assistance provided to a foreign affiliate to install a manufacturing process does not require separate compensation for the services. However, such services are listed in Income Tax Regulations section 1.482-4(C)(2)(iii)(B)(2)(viii) as one of a number of "particularly relevant" factors to be considered in determining comparability under the CUT method.

Computer Software Regulations

On September 30, 1998, the Service issued final regulations, Income Tax Regulations section 1.861-18, concerning the characterization of income derived from transfers of computer software. The regulations generally treat computer software programs as falling within one of the following four categories:

- A transfer of a copyright right in the computer program,
- A transfer of a copy of the computer program (a copyrighted article),
- The provision of services for the development or modification of the computer program or
- The provision of know-how related to computer programming techniques. *Income Tax Regs. § 1.861-18(b)(1).*

The regulations distinguish between the transfer of a "copyright right" and the transfer a "copyrighted article." *Income Tax Regs. § 1.861-18(a)(2).* The regulations provide rules for determining whether the transfer of a "copyright right" should be treated as a sale or exchange or as a license generating royalty income. *Id.* As to the transfer of a "copyrighted article," the regulations provide rules for determining whether the transaction should be classified as a sale or exchange or as a lease generating rental income. *Id.*

The transfer of a computer program is treated as a transfer of a "copyright right" if the transferee acquires one or more of the following rights:

- The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership or by rental, lease or lending,
- The right to prepare derivative computer programs based on the copyrighted computer programs,
- The right to make a public performance of the computer program or
- The right to publicly display the computer program. *Income Tax Regs. § 1.861-18(c)(2).*

The regulations state that the term "copyrighted article" includes a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk or in the main memory or hard drive of a computer. *Income Tax Regs. § 1.861-18(c)(3).*

The determination of whether a transaction involves the provision of services as opposed to the transfer of a copyright or a copyrighted article is based on the facts and circumstances, including the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties. *Income Tax Regs. § 1.861-18(d).*

The regulations provide that the provision of information with respect to a computer program will **not** be treated as the provision of "know-how" unless the information is (i) information relating to computer programming techniques, (ii) furnished under conditions preventing unauthorized disclosure, specifically contracted for by the parties and (iii) subject to trade secret protection. *Income Tax Regs. § 1.861-18(e).* For purposes of the section 482 regulations "know-how" may constitute an intangible irrespective of whether it is subject to trade secret protection.

The regulations provide that the determination of whether the transfer of a "copyright right" is a sale or an exchange is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all "substantial rights" in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred, will be classified as a license generating royalty income. *Income Tax Regs. § 1.861-18(f)(1).*

Finally, the regulations provide that the determination of whether a transfer of a "copyrighted article" is a sale or exchange is made on the basis of whether, taking account all facts and circumstances, the "benefits and burdens of ownership" have been transferred. A transaction that does not constitute a sale or exchange because insufficient burdens and benefits have been transferred–such that a person other than the transferee is properly treated as the owner–will be classified as a lease generating rental income. *Income Tax Regs. § 1.861-18(f)(2).*

Effective Dates

Income Tax Regulations section 1.482-1(j) provides that the final regulations are generally effective for taxable years beginning after October 6, 1994. Taxpayers may elect to apply the final regulations to any open year, but if such an election is made, the final regulations will apply to the initial year and all later years.

Income Tax Regulations section 1.482-1(j)(3) states that the final sentence of Internal Revenue Code section 482 containing the "commensurate with income" language is generally effective for taxable years beginning after December 31, 1986. For periods after December 31, 1986, but before the October 6, 1994 effective date of the final regulations, the final sentence of section 482 must be applied "using any reasonable method not inconsistent with the statute." Income Tax Regulations section 1.482-1(j)(3) states that the IRS considers a method that applies the final regulations "or their general principles" to be a "reasonable method."

Income Tax Regulations section 1.482-1(j)(4) states that the final regulations do not apply for transfers or licenses to foreign persons before November 17, 1985 or before August 17, 1986, for transfers or license to other persons. However, the final regulations do apply for transfers or licenses before such dates as to property transferred pursuant to an earlier and continuing agreement if the transferred property was not in existence or owned by the taxpayer on or before such dates.