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In this article, Subramanian and Zollo examine the evolution of the commensurate with income standard, its current and prospective application, and its practical implications for taxpayers.

The views expressed are solely the authors'. The authors are responsible for any errors or omissions.

The Tax Reform Act of 1986 introduced the commensurate with income (CWI) standard into both section 367(d) and section 482 to police the pricing of intangible property transfers between related taxpayers.[1] While the issue motivating Congress to enact the CWI standard was clear, the intended meaning and application of the standard were not. As a result, interpretations of the CWI standard have shifted over time to reflect changes in the global economy and international transfer pricing developments related to the arm's-length standard. Still, almost four decades after the enactment of the CWI standard, ambiguity on its scope and appropriate application persists.

This article discusses the evolution of the CWI standard, its current and prospective application, and its practical implications for taxpayers. We start with a discussion of the transfer pricing environment for IP transfers in the years leading up to the introduction of the CWI standard. The CWI standard was Congress's response to years of disputes between the IRS and taxpayers related to IP transfers, particularly transfers of high-profit-potential IP. However, from the beginning, the CWI standard has been subject to intense debate.

We discuss interpretive issues with the CWI standard, including a fundamental question that arose almost immediately with its enactment: whether the CWI standard is consistent with the arm's-length standard. The challenges with interpreting the CWI standard are further illustrated by the lack of agreement within the judiciary on the meaning and scope of the CWI standard in some notable cases. We review some of those cases and their interpretation of the CWI standard.

On the regulatory front, Treasury issued substantially revised transfer pricing regulations in 1994 following the enactment of the CWI standard. We examine those regulations, which included periodic adjustment rules for the first time, and also discuss similar guidance introduced by the OECD some decades later. Over time, questions about the breadth of the definition of IP, as well as how to attribute value to specific intangibles, led to transfer pricing disputes, with the IRS often on the losing side. That in turn led Congress to bolster the CWI standard by expanding the definition of IP and adding new rules for IP valuations in the Tax Cuts and Jobs Act.[2] We discuss the revisions to IP rules in the TCJA. Further, we explain the interplay between the CWI standard and tax treaties. We conclude with a discussion of some issues related to the practical application of the CWI standard that

[1]P.L. 99-514, section 1231.

[2]*See* P.L. 115-97, section 14221(a).

arise frequently — in particular, regarding the periodic adjustment rules.

I. Evolution of CWI Standard

A. IP Transfers Before CWI

In the years leading up to the introduction of the CWI standard, the IRS was involved in numerous disputes with taxpayers related to their outbound transfers of IP to related parties. These transfers could occur in any of three scenarios: (1) the sale or license of IP to a related foreign transferee, governed by section 482; (2) the transfer of IP to a foreign transferee in a transaction described in section 351 or section 361; or (3) the transfer of IP to a possessions corporation described in former section 936.[3] While the specific tax consequences of these three scenarios differed, the tax avoidance opportunity was the same: A U.S. multinational could reduce its global tax burden by transferring IP to a foreign affiliate (or possessions corporation) at a relatively low valuation if the transferee could then successfully commercialize the IP in a low-tax jurisdiction.

The tax avoidance problem was considered particularly acute in the case of unproven IP with high profit potential (or what the OECD would later call "hard-to-value" intangibles (HTVIs)).[4] Taxpayers would rely on two then-prevailing transfer pricing principles to support the amount of income they reported for the outbound transfer of IP. The first principle was that parties would negotiate the terms of a transaction based on what they knew and reasonably expected at the time of the transaction. In other words, parties valued assets that would produce a future revenue flow based on their ex ante expectations of those revenue flows. The second principle was that comparable uncontrolled transactions (CUTs) generally provided the best measure of an arm's-length price.[5]

The application of these principles is illustrated by *R.T. French Co.*,[6] which ironically involved the inbound license of relatively routine intangibles at a royalty rate the IRS asserted was too high. R.T. French Co. was a U.S. manufacturer and distributor of various food products and other merchandise. In 1946 a U.K. company (MPP) that was 51 percent owned by the same group of U.K. companies that owned R.T. French licensed to R.T. French its patented process and know-how for producing instant mashed potatoes. The license had a term of approximately 21 years. In 1960, after the parties had become wholly owned by the same interests, they amended the license in some minor respects. The amendments were not disadvantageous to R.T. French because the parties left the royalty rate unchanged.

In its examination of R.T. French's 1963 and 1964 tax returns, the IRS disallowed the company's royalty deductions, pointing out that R.T. French received no significant benefits in those years from the licensed IP, that the process licensed under the 1946 agreement was by then widely understood throughout the food industry and therefore of little or no marketable value, and that R.T. French had by then developed an impressive potato research capability of its own.

The Tax Court refused to look solely at the facts that existed in the years in dispute and held that the arm's-length nature of the license must be

[3]Section 936 provided a U.S. tax credit for domestic corporations that operated in a U.S. possession — *e.g.*, Puerto Rico. Because the "possessions corporations" eligible for the credit were domestic corporations, the transfer of IP to those corporations under section 351 was not subject to section 367(d). Moreover, taxpayers asserted that the IRS could not apply section 482 to override the tax-free treatment expressly provided in section 351 — a position accepted by the Seventh Circuit in *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988). Greatly simplified, by amending section 936, Congress effectively foreclosed the opportunity for taxpayers to transfer IP tax free to possessions corporations by requiring that a U.S. transferor recognize income that would have satisfied the CWI standard. The Small Business Job Protection Act of 1996, P.L. 104-188, enacted restrictions on the section 936 credit that effectively phased out the possessions incentive over a 10-year period ending in 2005. However, because sections 367(d) and 482 both cross-referenced section 936(h)(3)(B) for the definition of IP, the section remained relevant to a generation of tax practitioners who never had occasion to work with possessions companies. Finally, in 2018 Congress moved the definition of IP to section 367(d)(4) and repealed section 936 entirely. P.L. 115-141, section 401(d)(1)(C) and (D).

[4]*See* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, ch. 7, section D.4 (2022).

[5]Reg. section 1.482-2A(d)(ii) (1968) ("Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration."). Note that this version of the CUT method was very narrow because it required that the controlled transferor also be the transferor in the uncontrolled transaction. If no such CUT could be identified, the regulations defaulted to a general facts and circumstances test. Reg. section 1.482-2A(d)(iii) (1968). The regulations were amended in 1994 and included a "best method rule," discussed later in this article.

[6]*R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973).

assessed based on the parties' expectations when they negotiated the license in 1946. The court noted that the existence of MPP's 49 percent minority owner in 1946 likely ensured that the royalty rate under the license was arm's length. The court also noted that the royalty rate under the license was corroborated by the rate MPP charged under a 1942 license with an unrelated French company. On that basis, the court found that the 1946 license reflected arm's-length terms. The court also found that the 1960 amendment to the license agreement, which did not affect MPP's right to royalties, was consistent with arm's-length dealings. Although the court conceded that R.T. French might have secured the license on more advantageous terms if the parties had been able to foresee later developments in 1946, "what later transpired in no way detracted from the reasonableness of the agreement when it was made."[7] Applying an ex ante approach, the court held that because the terms of the license were arm's length in 1946 when it was executed, the IRS could not adjust the royalties based on the facts that existed in 1963 and 1964.

The second principle — that CUTs generally provide the most reliable measure of an arm's-length result — was expanded through the liberal application of the CUT standard. For example, in *United States Steel*,[8] the court held that the taxpayer had established arm's-length rates for shipping fees based on the fees that its captive shipping affiliate charged to 12 unrelated customers, even though no one of those customers accounted for more than 2 percent of the affiliate's total cargo shipments and the unrelated customer business in the aggregate made up less than 10 percent of the affiliate's total capacity. The court rejected the IRS's arguments that the unrelated transactions were rendered noncomparable by their substantially lower volume.

Taxpayers also tried to stretch the concept of comparability by determining royalty rates based on the rates charged for IP in the same general IP category, without considering differences in the profit potential of the IP. When a taxpayer licensed IP to an affiliate before commercialization, it would often rationalize this approach based on the argument that the subject IP had unproven potential. On this basis, a taxpayer might, for example, use its experience with intangibles in the same general product category (for example, pharmaceutical products) to support the pricing for the transferred intangible. In other cases, a taxpayer might rely on industry data concerning royalty rates. This loose interpretation of comparability opened the door to cherry-picking particularly promising IP for transfer to low-taxed affiliates.

B. 1986 Legislative Response

As described above, Congress added the CWI standard to sections 367(d) and 482 in 1986 (as part of TRA 1986). The language used was identical in each section, requiring that any income recognized under the section as the result of a transfer of IP "be commensurate with the income attributable to the intangible."[9]

The statutory language raised several interpretative questions. First, by referring to the income "attributable to the intangible," was Congress referring to the income *expected* to be recognized from the intangible (an ex ante approach) or the income *actually* recognized from the intangible (an ex post approach)?

The legislative history of TRA 1986 seems to favor the latter interpretation. In explaining the CWI standard, the House Ways and Means Committee noted in its report that it did not intend that the inquiry into the appropriate compensation for the intangible be limited to "whether it was appropriate considering only the facts in existence at the time of the transfer."[10] Instead, Ways and Means noted its intention that "consideration also be given the actual profit experience realized as a consequence of the transfer."[11] Thus, as the committee noted, it intended to "require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible."[12]

[7] *Id.* at 852.

[8] *United States Steel Corp. v. Commissioner*, 617 F.2d 942 (2d Cir. 1980).

[9] P.L. 99-514, section 1231(e)(1) and (2).

[10] H.R. Rep. No. 99-426, at 425 (1985).

[11] *Id.*

[12] *Id.*

The House report does state that "the bill is not intended to require annual adjustments when there are only minor variations" in the revenue attributable to the intangible.[13] However, it immediately adds: "It will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments *will be required* when there are major variations in the annual amounts of revenue attributable to the intangible" (emphasis added).[14]

Thus, taken as a whole, the House report does seem to endorse an ex post approach to determining whether consideration for the transfer of IP is sufficient, albeit with an unspecified amount of leeway for "minor" valuation discrepancies.[15] This approach represents a significant departure from the ex ante approach the court applied in *R.T. French* to achieve an arm's-length result. In fact, the legislative history of TRA 1986 does not mention the arm's-length standard in the context of the CWI standard, perhaps not surprisingly, given that Congress was more concerned with preserving the U.S tax base than with defining the arm's-length standard. However, as discussed below, the IRS has progressively pulled back on this interpretation to better align the CWI standard with the arm's-length standard.

A second question raised by the statutory phrase is what Congress meant by the word "commensurate." The *Merriam Webster Dictionary* contains two meanings for the term: (1) a proportionate amount or (2) an equal amount. In other words, should the U.S. transferor's income simply increase proportionately with the income earned from the IP, or should the U.S. transferor recognize all the income earned from the IP?

The House Report seems to lean toward the first meaning. It states:

> In requiring that payments be commensurate with the income stream, the bill does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties' marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.[16]

In other words, the measurement of the appropriate income inclusion should recognize the risks managed and the contributions made by the foreign transferee. When the foreign transferee is a risk-taking licensee, this generally would permit it to retain a share of the nonroutine profits earned from using the IP. While the House report seems to endorse an ex post approach to determining whether consideration for the transfer of IP is sufficient, it also suggests that not all profit realized from the IP ex post (that is, after resolution of all risk) is required to be attributed to the IP transferor under the CWI standard. Nonetheless, the IRS has often taken positions that try to bring all residual profits back to the United States by characterizing the foreign affiliate as a limited-risk entity, thereby denying it an appropriate return on its successful management of the risk it assumed on the IP. As discussed below, the courts have generally rejected the IRS's attempts to ignore a licensee's acceptance and management of the risk of successfully using the transferred IP.

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[13] *Id*. at 426.

[14] *Id.*

[15] The Senate version of the bill did not contain a corresponding provision. The House's conference report to TRA 1986 — H.R. Rep. No. 99-841, Vol. II (1986) — did not directly address this issue. However, the Joint Committee on Taxation's "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 1016 (May 15, 1987), contains language substantively identical to the House report.

[16] H.R. Rep. No. 99-426, at 426.

II. Reconciling CWI and Arm's-Length Standards

The conference committee report[17] directed the IRS to conduct a comprehensive study of the transfer pricing rules, including the CWI standard. Treasury and the IRS published the findings of this study in Notice 88-123, 1988-2 C.B. 458, commonly referred to as the "white paper."

The legislative history of TRA 1986 does not describe whether or how the CWI standard satisfies the international arm's-length norm, perhaps unsurprisingly, given that Congress was primarily concerned with addressing rules that permitted taxpayers to transfer high-value IP to tax havens without an appropriate exit charge. However, U.S. treaty partners did take note, and representatives of several foreign governments "expressed concern that the enactment of the commensurate with income standard was inconsistent with the 'arm's length' standard embodied in tax treaties and adopted by many countries for transfer pricing matters."[18] For that reason, Treasury devoted an entire chapter of the white paper to allaying those fears, describing how it would interpret the CWI standard in a manner consistent with the arm's-length standard.[19]

The white paper concludes:

> The arm's-length standard as accepted by the international community *does not preclude* reference to profits of related parties to allocate income, but in fact encompasses such an approach *as a supplement* to the traditional approach of looking to comparable transactions. *It is therefore reasonable to conclude that such an approach is consistent with international norms* as applied to situations in which comparables do not exist.[20] [Emphasis added.]

The white paper finds that comparable third-party licenses are likely to exist for "normal profit intangibles."[21] Results from comparable third-party transactions could thus continue to provide appropriate arm's-length results consistent with the CWI standard for normal profit intangibles. As an example of a normal profit intangible, the white paper refers to intangibles that are widely available to producers, such as the technology used in pocket calculators, digital watches, or microwave ovens, for which "exact" comparables[22] are likely to exist.

In the case of high-value intangibles, which generate profits far beyond the normal returns found in the industry, the white paper concludes that transactions between unrelated parties involving comparable intangibles "almost never exist."[23] Consequently, industry norms for royalties would generally not provide realistic benchmarks for those intangibles. From an economic perspective, the white paper argues that an unprecedented or "super-royalty"[24] rate may be required to achieve a proper allocation of income given the contributions of the transferor and transferee. The CWI standard, in requiring a super-royalty rate to achieve a proper allocation of income, does not mandate a rate greater than an arm's-length rate, according to the white paper. Instead, the enactment of the CWI standard was a directive from Congress to the IRS to promulgate rules that would give primary weight to the income attributable to a transferred intangible in determining the proper division of that income among related parties when appropriate comparable transactions do not exist. If a true comparable for a high-profit intangible did exist, the royalty rate based on the comparable would remain the best measure of how third parties would allocate intangible income.[25]

A few observations on the white paper are in order. First, the finding that in most cases applying the CWI standard will be unnecessary does not support the argument that the CWI standard is consistent with the arm's-length standard in those cases in which it is being applied. Second, while it is relatively rare for companies to license their fully developed "crown

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[17] H.R. Rep. No. 99-841, Vol. II.

[18] Notice 88-123, at 83.

[19] *See id*. at 83-93.

[20] *Id*. at 92.

[21] *Id*. at 74.

[22] *Id*. at 134, defining exact comparables as "those involving the transfer of the same intangible property."

[23] *Id*. at 75.

[24] *Id*. at 76.

[25] *Id*. at 77.

jewels" to third parties, a significant number of joint ventures and collaboration agreements between unrelated parties do involve the transfer of potentially high-value IP, particularly in the pharmaceutical industry. Moreover, the market provides ample examples of sales of IP-rich businesses for fixed prices or for prices that provide for limited purchase price adjustments. In fact, the IRS's acquisition price method is premised on those transactions providing potentially reliable indicators of IP value. Those transactions may provide a basis for determining an implied royalty rate based on financial projections. Third, the characterization of the CWI standard as a *supplement* to traditional transfer pricing methods may represent the start of a shift toward characterizing the CWI standard as a means of corroborating or discrediting an ex ante valuation rather than dictating an ex post valuation approach.

III. CWI Standard in Section 482 Regulations

Following the introduction of the CWI standard in TRA 1986, Treasury started working on revising the regulations under section 482. After releasing proposed regulations in 1992 and temporary and proposed regulations in 1993, Treasury released final transfer pricing regulations in 1994. The 1994 regulations substantially revised the previous regulations issued in 1968. Although the 1994 regulations directly apply only to controlled sales and licenses of IP subject to section 482, they also apply to income inclusions under section 367(d) by reference. The temporary regulations under section 367(d) provide that the appropriate charge for a transfer of IP subject to section 367(d) "shall be determined in accordance with the provisions of section 482 and the regulations thereunder."[26]

The preamble to the 1994 regulations acknowledges the concern expressed in the legislative history of TRA 1986 that insufficiently stringent standards had been used in determining whether an uncontrolled transaction was comparable enough to a controlled transaction to provide a reliable benchmark. To address this concern, the 1994 regulations introduced the best method rule and added extensive guidance to be applied in determining whether an uncontrolled transaction is sufficiently comparable to serve as a basis for the application of a transfer pricing method. The best method rule requires taxpayers to identify the transfer pricing method that would provide the most reliable measure of an arm's-length result,[27] replacing the hierarchy of methods under the previous regulations that placed the CUT method for IP transfers at the top. The best method rule of the 1994 regulations explicitly removes this hierarchy, stating that "there is no strict priority of methods, and no method will invariably be considered to be more reliable than others."[28]

Further, the 1994 regulations introduced periodic adjustment rules to address Congress's instruction that "consideration also be given the actual profit experience realized as a consequence of" the IP transfer.[29] Under the periodic adjustment rules, if an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each tax year may be adjusted to ensure that it is commensurate with the income attributable to the intangible by reference to the actual profit realized from the transferred IP.[30]

In 1995 Treasury added a section on cost-sharing arrangements (CSAs), reg. section 1.482-7, to the section 482 regulations. The 1995 cost-sharing regulations were meant to produce results consistent with the CWI standard. To further this consistency, they also allowed the IRS to apply the periodic adjustment rules under reg. section 1.482-4 to buy-in payments for preexisting intangibles of a cost-sharing participant.

Despite the introduction of the CWI standard in TRA 1986 and the substantial revision of the section 482 regulations to incorporate it, disputes between the IRS and taxpayers on IP transfers continued unabated. In some of these disputes, the

[26] Reg. section 1.367(d)-1T(c)(1). *See also* reg. section 1.482-1T(f)(2)(ii), Example 8 ("the arm's length compensation for the transfer of IP transferred in a section 351 transaction subject to section 367(d) must correspond to the arm's length compensation that would be determined if the IP were transferred in a transaction subject to section 482").

[27] Reg. section 1.482-1(c)(1).

[28] *Id*.

[29] H.R. Rep. No. 99-426, at 425.

[30] Reg. section 1.482-4(f)(2).

issue was the breadth of the definition of IP, with taxpayers relying on the statutory language of section 936(h)(3)(B) and legislative history to exclude any value attributable to goodwill, going concern value, and workforce in place. To address its concern that the buy-in payment for preexisting IP too narrowly defined the compensation a party should receive for the contributions it made to a CSA, Treasury in 2009 promulgated new, temporary cost-sharing regulations that replaced the buy-in for IP with the concept of the platform contribution.[31] A platform contribution was defined as "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles."[32] This expanded definition was intended to encompass not only IP made available to the CSA but also other rights, resources, and capabilities, such as an established technical workforce in place. Under the 2009 cost-sharing regulations, all controlled participants are required to engage in platform contribution transactions (PCTs) for platform contributions made to a CSA.[33]

We discuss the best method rule, periodic adjustment rules, and the revisions to the 1995 cost-sharing regulations (that is, the 2009 cost-sharing regulations) below.

IV. Best Method Rule in 1994 Regulations

The 1994 regulations specify three methods for determining an arm's-length consideration for the transfer of IP: (1) the CUT method, (2) the comparable profits method,[34] and (3) the profit-split method (PSM).[35] The 1994 regulations also provide that an unspecified method may be used if it provides a more reliable measure of an arm's-length price than the specified methods.[36] According to the best method rule, the arm's-length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result.[37]

The CUT method provides a direct measure of an arm's-length result based on the consideration charged in one or more CUTs.[38] The CPM and "residual" PSM,[39] on the other hand, both derive an arm's-length consideration by applying financial profit-level indicators to the results of comparable companies that may or may not be using similar IP. Because an exact CUT is more likely to provide a reliable measure than a derived result, the regulations recognize 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 by applying the . . . [CUT] method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible" (emphasis added).[40]

However, licenses involving the same intangible are relatively rare, and the application of the CUT method therefore often involves the use of similar, but not identical, IP (that is, inexact CUTs). This raises the question of how one should determine whether the use of an inexact CUT provides a more reliable measure of an arm's-

[31]The temporary regulations were finalized in December 2011, with certain changes not relevant to the concept of platform contributions. T.D. 9568. The final regulations were generally effective as of the January 5, 2009, effective date of the 2009 temporary regulations.

[32]Reg. section 1.482-7(c)(1).

[33]Reg. section 1.482-7(b)(1)(ii).

[34]The CPM evaluates the results of a controlled transaction by benchmarking a return for the less complex party to the transaction (the tested party), allocating a return to the tested party based on the comparable benchmarks, and then allocating the residual to the other party. Reg. section 1.482-5(b)(1). In general, the tested party will be the transferee of the IP and the IP transferor will receive the residual share of the profits. Reg. section 1.482-5(b)(2).

[35]Reg. section 1.482-4(a)(1)-(3).

[36]Reg. section 1.482-4(a)(4).

[37]Reg. section 1.482-1(c)(1).

[38]Reg. section 1.482-4(c)(1).

[39]Reg. section 1.482-6 describes two different PSMs: the residual PSM and the comparable PSM. Both versions of the PSM are relevant when both parties to a transfer of IP make nonroutine contributions to the relevant business activity. The residual PSM, which is the PSM more commonly applied in practice, involves a two-step process. First, each controlled party in the transaction is allocated a profit for its routine contributions to the relevant business activity. Essentially, this step involves applying the CPM to each party. Second, residual profits are divided between the controlled parties based on the "relative value" of their nonroutine contributions. The comparable PSM, on the other hand, determines the controlled participants' relative profit shares based on CUTs involving parties using intangibles and performing activities comparable to those of the parties in the controlled transaction.

[40]Reg. section 1.482-4(c)(2)(ii).

length result than the CPM or the PSM (or some unspecified method). One might expect that the use of alternative methods would yield similar results if they could be reasonably applied.

In practice, when exact CUTs are unavailable, the IRS often defaults to an application of the CPM. This approach raises two issues: (1) When the license is structured such that the licensee and licensor share in the ex post outcome of risk, the CPM modifies the sharing of risk between the parties by giving the licensee a routine return and treating the licensor as if it assumes most of the risk by earning the residual; and (2) the commonly used CPM benchmarks are also "inexact," since no two companies are perfectly comparable, raising the question whether the CPM more reliably captures the return to the licensee than the CUT method.

On the first point, if the risk the IP transferee assumes is material, the residual PSM, like the CUT method, more closely captures the nature of the risk-sharing between the controlled parties to the IP transfer by treating the IP transferee's assumption of risk as a nonroutine contribution for which it would be allocated a profit share under the second step of the residual PSM. Instead of defaulting to the CPM, therefore, in those cases, the best method rule may point to an application of the residual PSM or even the CUT method with the inexact CUTs instead of the CPM.

On the second point above, the return to the risk-bearing licensee under the CPM is often understated based on commonly used CPM benchmarks. These uncontrolled CPM benchmarks generally do not involve IP licensees and fail to sufficiently reward the controlled IP transferee for the risk that it is assuming under the terms of the intercompany IP transfer agreement. As the vast literature on the risk-return tradeoff shows, the magnitude of the return expected to be earned from an investment goes up as the level of risk goes up.[41] In the context of an IP license, therefore, a licensee will require a higher *expected* return to accept the risk than a company that performs similar functions but does not own or license rights to the IP. Setting aside the difference in ex post sharing of the outcome of IP risk under the CUT method and CPM, the underestimation of profit entitlement of an IP transferee (and the resulting overestimation of the profit entitlement of the IP transferor) under the common application of the CPM could be rectified by determining an appropriate profit premium that the IP transferee should receive above the CPM returns for its assumption of risk. However, that adjustment is difficult in practice and leads back to the question whether the inexact CUT method, the CPM, or an unspecified method is the best method.

Absent exact CUTs, the IRS has often taken the position that the CPM is the best method and that the assignment of all residual profits to the licensor under the CPM is an appropriate application of the CWI standard. The determination of the best method for pricing an IP transfer has been a continual source of dispute between taxpayers and the IRS. As discussed later, the courts have generally rejected IRS proposals to treat the CPM as the best method in IP transfer disputes.

V. Periodic Adjustment Rules in 1994 Regs

The 1994 regulations also introduced periodic adjustment rules for IP transfers in reg. section 1.482-4 in line with congressional intent, as explained in the white paper. According to the white paper, aside from the empirical evidence of what unrelated parties seem to do, actual profit experience is generally the best indication available, absent comparables, of anticipated profit experience that unrelated parties would have considered at the outset of the arrangement.[42] Thus, according to the white paper, it is perfectly consistent with the arm's-length standard to treat related-party license agreements generally as renegotiable arrangements and to require periodic adjustments to the transfer price to reflect substantial changes in the income stream attributable to the intangible.[43]

[41] *See, e.g.*, Eric Ghysels, Pedro Santa-Clara, and Rossen Valkanov, "There Is a Risk-Return Trade-Off After All," 76 *J. Fin. Econ.* 509 (June 2005).

[42] *See generally* Notice 88-123, at 93-97.

[43] *Id*. at 95.

More recently, a 2007 IRS generic legal memorandum explained the agency's position that the periodic adjustment rules allow the IRS (but not the taxpayer) to, "in its discretion, provisionally . . . treat the income actually resulting from the transferred intangible as evidence of what should have been projected at the time of the transfer and to make periodic adjustments to reflect the pricing had such results been projected at such time."[44] The 2007 memo rationalizes the one-sided application of CWI adjustments on the basis that the IRS is at an evidentiary disadvantage to the taxpayer. In other words, while a taxpayer has the best understanding of the IP it is transferring at the time of the transfer, the IRS examination necessarily occurs only after the fact. According to the memo, looking at actual profits therefore gives the IRS evidence to assess whether the taxpayer's valuation is supported by a "reasonable and conscientious" up-front evaluation of the projected operating profits attributable to the transferred IP.[45] As discussed below, the 1994 regulations allow taxpayers to rebut the presumption — for example, by showing that the actually realized results were beyond the control of the taxpayer and could not have reasonably been foreseen at the time of the transaction.

Consistent with the reasoning in the white paper, the section 482 regulations provide that if IP is transferred under an arrangement that covers more than one year, the consideration charged in each tax year may be adjusted to ensure that it is commensurate with the income attributable to the intangible, but any such adjustments must be consistent with the arm's-length standard.[46]

The section 482 regulations contain a series of rules that permit taxpayers to avoid periodic adjustments. Whether these exceptions are broad enough to protect a taxpayer that has based its IP valuation using a reasonable and conscientious up-front evaluation of the projected operating profits is arguable.

The only blanket exception from the application of the periodic adjustment rules applies when a taxpayer has determined the value of IP using a CUT involving the transfer of the *same* intangible under substantially the same circumstances as those of the controlled transaction — that is, an exact CUT.[47] Exact CUTs are rare, and this exception never exists for an HTVI.

The section 482 regulations also provide limited exceptions from the application of periodic adjustments under certain circumstances when the controlled transaction is priced using (1) a CUT involving a comparable, but not identical, intangible (an inexact CUT) or (2) an entirely different method (generally the CPM or PSM).[48] However, these two exceptions only preclude the IRS from making periodic adjustments if (1) the taxpayer maintains a written agreement meeting certain criteria, including that the amount payable is an arm's-length amount in the first year that "substantial" consideration is payable; (2) there are no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and (3) the total profits actually earned or the total cost savings realized by the controlled transferee are not less than 80 percent or more than 120 percent of the profits or cost savings foreseeable at the time the controlled agreement was entered into (the 80/120 condition).[49] If a taxpayer can satisfy the conditions for these exceptions for each year in the five-year period beginning in the first year in which substantial periodic consideration was required to be paid, the IRS will not make periodic adjustments for the IP in any later year.[50]

Finally, the section 482 regulations provide that if the 80/120 condition is not met because of "extraordinary events" that were beyond the control of the controlled taxpayers and that

[44] AM 2007-007.

[45] *Id*.

[46] Reg. section 1.482-4(f)(2)(i).

[47] Reg. section 1.482-4(f)(2)(ii)(A).

[48] Reg. section 1.482-4(f)(2)(ii)(B) and (C).

[49] Reg. section 1.482-4(f)(2)(ii)(C)(4).

[50] Reg. section 1.482-4(f)(2)(ii)(E). When a taxpayer has paid for IP using a lump sum or fixed installments, this five-year rule should be applied by reference to the equivalent royalty amount determined under reg. section 1.482-4(f)(6).

"could not reasonably have been anticipated" at the time the controlled agreement was entered into, the IRS would not be permitted to make periodic adjustments.[51]

For several reasons, these exceptions are too narrow to protect all taxpayers that have made a reasonable and conscientious up-front evaluation of the projected operating profits attributable to transferred IP. First, the 80/120 condition establishes a tight limit on acceptable fluctuations in projected income or cost savings, particularly if the transferred IP has an unproven track record or is in an early stage of development. The 80/120 condition seems to imply that the taxpayer has a single forecast (or at least a baseline forecast) against which the actual profits or cost savings may be compared. However, in many cases the value of IP may most reasonably be determined by considering several probability-weighted alternative forecasts. In those cases, the question is which of these forecasts should be used to apply the 80/120 condition. If the most likely or baseline forecast is used, the 80/120 condition may not be satisfied even though the taxpayer considered a forecast corresponding to the results achieved and appropriately weighted that outcome's probability.

Second, while the exception for extraordinary events theoretically provides some relief for taxpayers that fail the 80/120 condition, the IRS may be prone to hindsight bias, which causes it to believe that anything that has happened must have been foreseeable.[52] Moreover, as discussed in the preceding paragraph, even if an outcome outside the 80/120 range were foreseeable, the taxpayer may have considered that outcome in pricing the transaction but properly assigned it a low probability of occurring.

Third, the requirement that there be no substantial changes in the functions performed by the controlled transferee after the controlled agreement is executed, except changes required by events that were not foreseeable, may be hard to satisfy given the dynamic business environment in which the IP is used.

[51]Reg. section 1.482-4(f)(2)(ii)(D).

[52]Hopefully, the IRS will consider the COVID-19 pandemic to have been an unforeseeable event.

VI. Cost-Sharing Rules in Reg. Section 1.482-7

The 1995 cost-sharing regulations were meant to be consistent with the instruction in the House report that for a CSA to produce results consistent with the CWI standard, (1) a cost sharer should be expected to bear its portion of all research and development costs, on both unsuccessful and successful products, within an appropriate product area, and the costs of R&D at all relevant development stages should be shared; (2) the allocation of costs generally should be proportionate to profit as determined before deduction for R&D; and (3) if one party contributes funds toward R&D significantly earlier than another (or is otherwise putting its funds at risk to a greater extent than the other), that party should receive an appropriate return on its investment.[53]

As described above, Treasury substantially revised the 1995 cost-sharing regulations in the 2009 cost-sharing regulations, maintaining that the revised regulations were consistent with the principles noted above for a CSA to produce results consistent with the CWI standard.[54] In Treasury's view, under the 1995 cost-sharing regulations, taxpayers had reduced buy-in payments by maintaining that a foreign participant's results were attributable in part to foreign goodwill or similar factors that were not IP and therefore not subject to the buy-in requirement. As a result, taxpayers applied methods to determine the value of the IP in isolation, rather than determining the buy-in payment amount using enterprise valuation methods that included other hard-to-value factors contributing to the foreign participant's operating profits, such as goodwill, going concern value, and workforce in place.

The 2009 cost-sharing regulations were designed to increase a participant's cost of entering into a CSA by expanding the buy-in requirement beyond IP and providing specified valuation methods based on a participant's enterprise value.

As mentioned above, the 2009 cost-sharing regulations introduced the concept of a platform

[53]T.D. 8632.

[54]T.D. 9441 (temporary regulations).

contribution as "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles,"[55] and they require all controlled participants to engage in PCTs for platform contributions made to a CSA.[56] While these resources, capabilities, and rights include IP, they also could include other contributors to the intangible development activity, such as technical workforce in place.

To support the broader concept of platform contributions, Treasury introduced three new methods for pricing PCTs, in addition to the CUT method and the residual PSM: the income method, the acquisition price method, and the market capitalization method. Broadly speaking, the income method prices the PCT by determining the present value of profits above "licensee" returns. In the most commonly used application of the income method, the licensee's returns are set equal to routine returns determined using the CPM. The PCT payment in this application of the income method thus captures the discounted value of all residual profits above a routine return. The acquisition price method evaluates whether the amount charged in a PCT is arm's length by reference to the amount charged for the stock or asset purchase of a business or organization in an uncontrolled transaction, whereas the market capitalization method determines the PCT payment by reference to the average market capitalization of a controlled participant whose stock is regularly traded on an established securities market. These new pricing methods take a more holistic approach to IP valuation by anchoring the IP value to the larger business value.

VII. Periodic Adjustment Rules in Reg. Section 1.482-7

The 1995 cost-sharing regulations allowed the IRS to apply the periodic adjustment rules under reg. section 1.482-4 to ensure that payments made under a CSA related to preexisting IP was commensurate with the income attributable to the IP. The 2009 cost-sharing regulations removed the cross-reference to the periodic adjustment rules in reg. section 1.482-4 and adopted specific periodic adjustment rules related to PCT payments, as well as rules for adjusting reasonably anticipated benefit (RAB) shares.[57] The periodic adjustment rules for RAB shares permit the IRS to adjust the RAB shares if actual benefit shares diverge significantly from projected benefit shares, because that divergence may indicate that the projections used to establish the RAB shares were unreliable.[58] As with the periodic adjustment rules discussed above, projections will not be considered unreliable if in a given tax year divergence between projected and actual benefits is less than 20 percent for each participant, or if the difference is attributable to extraordinary events beyond the control of the participants. The periodic adjustment rules for PCT payments follow a similar logic to that of the periodic adjustment rules for IP transfers described in the previous section. However, the mechanics of these rules are more complex and will not be described in any detail here.

In summary, under the periodic adjustment rules for PCT payments, the IRS may make periodic adjustments for an open tax year and for all subsequent CSA years if a controlled participant required to make a PCT payment has an actually experienced return ratio that is outside the periodic return ratio range (PRRR). The PRRR is a range between 0.667 and 1.5, unless the controlled participants failed to substantially comply with the documentation requirements in the 2009 cost-sharing regulations, in which case the PRRR will be the range 0.8 to 1.25. The actually experienced return ratio is the present value of total profits divided by the present value of the investment, each as defined in the 2009 cost-sharing regulations. As with the periodic adjustment rules for IP transfers, the 2009 cost-

[55]Reg. section 1.482-7(c)(1).

[56]Reg. section 1.482-7(b)(1).

[57]*Id*. Controlled participants in a CSA are required to share intangible development costs in proportion to their RAB shares. A controlled participant's share of RABs is equal to its RABs divided by the sum of the RABs of all the controlled participants.

[58]Reg. section 1.482-7(i)(6).

sharing regulations provide certain exceptions to the application of periodic adjustments to PCT payments. If it is determined that periodic adjustments are appropriate for the PCT payment, the section 482 regulations provide a specific approach for making the adjustments.[59]

VIII. Further Legislation: The TCJA

Congress introduced the CWI standard in TRA 1986 to stem the flow of high-value IP from the United States to low-tax jurisdictions at prices that were thought to be below the value of the transferred IP. By requiring that the income for a controlled IP transfer be commensurate with the income attributable to the IP, the expectation was that the IRS would be able to enforce more appropriate pricing for IP transfers. However, as noted, the introduction of the CWI standard in TRA 1986 and the substantial revision of the section 482 regulations to incorporate the CWI standard did not lead to the desired reduction in disputes between the IRS and taxpayers on IP transfers. These disputes did not abate even after the introduction of the 2009 cost-sharing regulations.

In response to the continuing IP transfer disputes, Congress made two further changes to IP rules in the TCJA. First, it expanded the definition of IP[60] to include "any goodwill, going concern value, or workforce in place" and any "other item the value or potential value of which is not attributable to tangible property or the services of any individual."[61]

Second, it added the following sentence to the end of section 482:

> For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.[62]

In the "Description of the Chairman's Mark" of the TCJA,[63] Congress explained that the above changes address "recurring definitional and methodological issues that have arisen in controversies in transfers of intangible property" but do not modify the basic approach of the existing transfer pricing rules regarding income from IP.[64] The conference report notes cases in which taxpayers had successfully argued that goodwill, going concern value, and workforce in place fell outside the prior definition of IP as a reason for explicitly including those in the definition.[65]

The amendment to section 482 grants the IRS authority to use aggregate basis valuation or to apply the realistic alternative principle when those provide a more reliable result. Regarding aggregate basis valuation, Congress explains that when multiple intangible properties are transferred such that their value in aggregate is more reliable as a result of their interrelatedness than on an asset-by-asset basis, the IRS may value that IP in aggregate. The realistic alternative principle is predicated on the notion that a taxpayer will enter a particular transaction only if none of its realistic alternatives is economically preferable to the transaction under consideration. Thus, the IP price must be such that the transferor (or transferee) derives at least as much value from the transfer as it would from its best realistic alternative.

In amending section 482 and the definition of IP in the TCJA, Congress was continuing its work of addressing the potential for tax avoidance in the transfers of IP, particularly high-profit IP, which it started with the inclusion of the CWI standard in TRA 1986.

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[59] The periodic adjustment rules in reg. section 1.482-7(i)(6) apparently purport to allow the IRS to make a cumulative adjustment in a year after the "periodic trigger" is satisfied, even though one or more earlier years in which the IRS may have made an adjustment are closed. Any attempted circumvention of the statute of limitations rules likely would be challenged.

[60] In the TCJA, Congress amended the definition of IP in section 936(h)(3)(B). *See* P.L. 115-97, section 14221(a). In 2018 Congress moved the definition to section 367(d)(4) and made conforming changes to the cross-references in sections 367(d)(1) and 482. P.L. 115-141, section 401(d)(1)(D)(viii)(I)-(III).

[61] P.L. 115-97, section 14221(a)(2).

[62] *Id.* at section 14421(b)(2).

[63] *See* JCT, "Description of the Chairman's Mark of the 'Tax Cuts and Jobs Act,'" JCX-51-17 (Nov. 9, 2017).

[64] *Id.* at 236 ("limitations on income shifting through intangible property transfers").

[65] *Id.*

IX. The CWI Standard in Case Law

Since the introduction of the CWI standard in 1986, several transfer pricing cases implicating the standard have been litigated and decided. Most of these cases involved the fundamental issue of how profits realized after the transfer of IP should be split between the transferor and transferee. These cases are *Veritas*,[66] *Amazon*,[67] *Coca-Cola*,[68] and *Medtronic*.[69] *Veritas* and *Amazon* involved the transfer of preexisting IP under CSAs, while *Coca-Cola* and *Medtronic* involved ongoing licenses of IP.

In the only case in which the IRS prevailed, *Coca-Cola*, the IRS convinced the court that the profits earned by uncontrolled bottlers provided a reliable benchmark for the profits that Coca-Cola's affiliates (the "supply points") should earn from the production of concentrate used to produce finished beverages. In that case, the IRS introduced specific information from comparable transactions that permitted the court to make a detailed comparison of the functions performed, assets used, and risks assumed by the unrelated bottlers and the affiliated supply points.

In *Veritas* and *Amazon*, the Tax Court found that the IRS abused its discretion by including goodwill, going concern value, and growth opportunities in the IP value and assigning the present value of all IP profits in perpetuity to the transferor. While none of the parties cited the CWI standard as the driver for their conclusions, the court's rejection of the IRS's approach implies that it did not consider the agency's valuation — capturing residual profit in perpetuity — to be required by the CWI standard, at least under the definition of IP for the years at issue.[70]

In *Medtronic*, the Tax Court found that the IRS abused its discretion in trying to limit a foreign transferee's share of profits from exploitation of the IP based on unspecific external comparables that the court believed did not appropriately reward the IP transferee for its functional contributions, assets used, and risks assumed. The *Medtronic* decision implies that the Tax Court favors inexact CUTs, PSMs, and unspecified methods over the CPM in cases in which the IRS cannot demonstrate that it can appropriately identify and adjust for the differences between the tested transaction and the comparable sets that it is using. We discuss *Medtronic* below in more detail to illustrate this point.

Two other recent cases, *Altera*[71] and *3M*,[72] do not directly address the split of profits from the exploitation of IP, but the courts nevertheless relied on Congress's addition of the CWI standard to uphold post-1986 regulations issued by Treasury. The courts have used the addition of the CWI standard as an amendment that justifies their upholding regulations that might otherwise be deemed inconsistent with the arm's-length standard or pre-2016 case law.

Altera highlights the tension between the CWI standard and the arm's-length standard. In that case, the taxpayers argued that the mandatory inclusion of stock-based compensation (SBC) in the costs to be shared under a CSA was invalid because unrelated parties did not share those expenses. The Ninth Circuit upheld the regulation, despite the behavior of unrelated parties, because Congress authorized the mandatory inclusion of SBC when it enacted the CWI standard in 1986.

The application of the CWI standard to uphold the regulation at issue in *3M* seems more strained. That case involves the validity of the "blocked income" regulation,[73] which specifies when a U.S. taxpayer can avoid recognizing income currently if there is a foreign legal restriction that prevents a foreign related party from making the payment that would give rise to the income. Because the blocked income regulation is not relevant to determining an arm's-length charge — indeed, it becomes relevant only if an arm's-length charge cannot be paid — the relevance of the CWI standard to the issue is not immediately apparent. Moreover, the regulation

[66] *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009).

[67] *Amazon.com Inc. v. Commissioner*, 934 F.3d 976 (9th Cir. 2019).

[68] *Coca-Cola Co. v. Commissioner*, 155 T.C. 145 (2020) (on appeal).

[69] *Medtronic Inc. v. Commissioner*, T.C. Memo. 2016-112, *vacated and remanded*, 900 F.3d 610 (8th Cir. 2018), T.C. Memo. 2022-84 (remand decision, which is on appeal).

[70] Congress cited the losses in *Veritas* and *Amazon* as reasons for changing the definition of IP in section 482.

[71] *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), *rev'd*, 926 F.3d 1061 (9th Cir. 2019).

[72] *3M Co. v. Commissioner*, 160 T.C. 50 (2023).

[73] Reg. section 1.482-1(h)(2).

is relevant to any type of payment restricted under foreign law, not just payments for IP. *Altera* and *3M* are also discussed in more detail below.

A. *Medtronic*

One of the key issues in *Medtronic* was the arm's-length royalty rate for a license of IP related to the manufacture of implantable cardiac and neurological devices by Medtronic Inc. (the licensor) to a subsidiary in Puerto Rico (the licensee). The taxpayer used the CUT method to price the license transaction. The IRS used the CPM to price the license, benchmarking the licensee's income against a set of third-party manufacturers that did not create nonroutine assets or bear nonroutine risks. In its initial opinion, the Tax Court ruled that the CUT method was the best method and that the IRS's application of the CPM was unreasonable. The IRS appealed to the Eighth Circuit, which remanded the case because it found the Tax Court's factual findings insufficient to enable the appellate panel to evaluate the determination. On remand, both the IRS and the taxpayer proposed revised approaches. The IRS proposed a slightly modified CPM analysis, and the taxpayer proposed allocations under the CUT method and an unspecified method. The Tax Court again dismissed the IRS's (modified) CPM results as an abuse of discretion. It also rejected the taxpayer's proposed methods as not providing an allocation of income consistent with the arm's-length standard. Instead, in a revised opinion, the Tax Court modified the unspecified method proposed by the taxpayer to determine its own allocation of income and arm's-length royalty rate. The government has again appealed the Tax Court's decision to the Eighth Circuit.

Medtronic illustrates the common IRS view that a CPM approach that allocates a routine profit to the licensee and all residual profit to the licensor is generally the best method in the absence of closely comparable transactions and is consistent with the CWI standard, which has often been rejected by the courts.

The IRS argued in *Medtronic* that the CUT method applied by the taxpayer did not use a sufficiently comparable transaction to establish an arm's-length royalty consistent with the CWI standard. The IRS contended that the facts in the case reflected the very concerns expressed by Congress in crafting the CWI standard — that is, that there are extreme difficulties in determining whether the arm's-length transfers between unrelated parties are comparable. In *Medtronic*, the IRS contended that the licensor had transferred its crown jewel IP to the licensee. As the white paper had recognized, in cases in which there is a transfer of high-profit intangibles such as the IP at issue, the arm's-length rate may be a super-royalty that cannot be benchmarked by reference to uncontrolled transactions. The IRS's approach tested the non-U.S. party's profits using the CPM, and this resulted in a super-royalty, which it argued was an appropriate arm's-length rate for the high-profit intangibles at issue in *Medtronic* and consistent with the CWI standard. The IRS's expert performed a value chain analysis and concluded that a small percentage of the system profits should be allocated to the licensee for the transactions to be arm's length, consistent with the results under the IRS's CPM approach.

In its initial opinion, the Tax Court noted that the section 482 regulations do not prescribe a particular test or standard to determine whether a transaction is CWI and that the CWI standard does not replace the arm's-length standard. The Tax Court therefore concluded that the IRS's use of the CPM is not required under the CWI standard, and the IRS's arguments regarding the CWI standard did not change the court's view that the IRS's allocations were unreasonable.

The Tax Court expressed the same view in the revised opinion regarding the IRS's modified CPM. It also addressed the IRS's contention that the CUT method and the taxpayer's proposed unspecified method did not satisfy the CWI standard. A key argument made by the IRS was that the CUT used by the taxpayer under both the CUT method and the unspecified method failed the similar profit potential requirement for a CUT, resulting in Medtronic US's royalty income from the licensed intangible not being CWI.

In the revised opinion, the Tax Court agreed with the IRS that under the taxpayer's proposed unspecified method the licensor's royalty rate was not CWI. The Tax Court relied on the expert testimony at trial to conclude that the taxpayer's proposed unspecified method did not allocate a sufficient share of profit to the licensor. Even though the Tax Court rejected the taxpayer's unspecified method as proposed, it relied on that method for determining the royalty rate by adjusting some of the parameters to allocate a greater portion of the profits to the licensor. The resulting profit split, according to the Tax Court, reflected the importance of the patents as well as the role played by the licensee and was more reasonable than the profit split resulting from the taxpayer's unspecified method. Thus, while the Tax Court allocated greater profits to the licensor in the revised opinion, it still rejected the IRS's contention that *all* residual profits realized should be allocated to the licensor under the CPM.

B. *Altera*

Altera brought to the fore the tension between the CWI standard and the arm's-length standard that arose immediately after the enactment of the CWI standard in 1986 and has simmered in the background ever since. Treasury and the IRS argued in the white paper that the CWI standard is consistent with the arm's-length standard — the norm that most countries around the world follow for transfer pricing — and have maintained that position ever since. However, *Altera* made it apparent that the government's interpretation of the arm's-length standard was at odds with that of many taxpayers.

The key issue in *Altera* was whether a 2003 amendment to the section 482 regulations (the 2003 rule)[74] that required controlled participants in a CSA to share SBC costs was valid. The meaning of the arm's-length standard was a threshold issue in the case that colored how the Tax Court viewed the degree to which the IRS and Treasury fulfilled their obligations in issuing the 2003 rule.

The taxpayer argued in *Altera* that the 2003 rule was inconsistent with the arm's-length standard. In the taxpayer's view, the arm's-length standard required Treasury to consider the behavior of taxpayers in uncontrolled transactions. Because it failed to consider and respond clearly to the comments it received related to the behavior of uncontrolled parties, Treasury failed to satisfy the notice and comment requirements in the Administrative Procedure Act.

The IRS's response was that the 2003 rule was supportable because it was unnecessary for the agency to undertake an empirical analysis of how uncontrolled parties behave in crafting transfer pricing regulations. It asserted that there was scant evidence of whether unrelated parties would share SBC costs under facts comparable to related-party transactions and that Treasury reasonably determined that unrelated parties would share those costs. The IRS further argued that even if unrelated taxpayers would not share SBC costs in all circumstances, Treasury's determination was supported by considerations of administrability. Essentially, the IRS argued that it was within its authority to issue regulations based on economic principles rather than the behavior of uncontrolled parties.

The Tax Court ruled unanimously for the taxpayer. It found that the comments Treasury received provided material evidence concerning the behavior of third parties. Because Treasury failed to explain its determinations in light of "all the evidence before it,"[75] the Tax Court concluded that Treasury (1) did not reasonably support its assertion that the 2003 rule was consistent with the arm's-length standard; (2) failed to support its belief that unrelated parties would share SBC costs with any evidence in the administrative record; (3) failed to articulate why all CSAs should be treated identically; and (4) failed to respond to significant comments. Accordingly, the Tax Court held that the 2003 rule failed to satisfy the reasoned decision-making standard of *State Farm*[76] and was therefore invalid.

The IRS appealed to the Ninth Circuit, which reversed the Tax Court in a 2-1 decision.[77] The Ninth Circuit majority held that the 2003 rule was necessary for Treasury to fulfill its obligation

[74] Reg. section 1.482-7A(d)(2).

[75] *Altera*, 145 T.C. at 133.

[76] *Motor Vehicle Manufacturers Association of the United States Inc. v. State Farm Mutual Auto Insurance Co.*, 463 U.S. 29 (1983).

[77] *Altera*, 926 F.3d 1061. This was the second 2-1 opinion for the government in the case. The first opinion, filed in July 2018, was withdrawn because one of the judges in the majority, Judge Stephen Reinhart, died before the decision was released. The panel was reconstituted for the rehearing, with Judge Susan Grabel replacing Reinhart.

under section 482, as amended by TRA 1986.[78] The court noted that Treasury's determination was entirely consistent with Congress's rationale for amending section 482 to add the CWI standard — that is, that taxpayers often would try to justify prices for the transfer of intangibles based on external benchmarks that did not meet the comparability standards for determining arm's-length prices. In the majority's view, Treasury had adequately addressed the comments it received because the "comparables" submitted by commenters were not truly comparable.[79] The Ninth Circuit stated:

> The 2003 regulations are not arbitrary and capricious under the standard of review imposed by the APA. Treasury's regulatory path may be reasonably discerned. Treasury understood section 482 to authorize it to employ a purely internal, commensurate with income approach in dealing with related companies. It provided adequate notice of its intent and adequately considered the objections. Its conclusion that stock based compensation should be treated as a cost was adequately supported in the record, and its position did not represent a policy change.[80]

In her dissent, Judge Kathleen O'Malley disagreed with the majority's opinion that Treasury could dispense with a comparability analysis.[81] She further disagreed that cost sharing involves the transfer of IP — a necessary condition for the application of the CWI standard.[82] Moreover, she stated that Treasury did not, in any event, clearly invoke the CWI standard as the basis for its rule. As a result, O'Malley concluded, as the Tax Court did, that Treasury's explanation of its rule failed to satisfy the *State Farm* standard, that Treasury did not provide adequate notice of its intent to change its long-standing practice of using the arm's-length standard and a comparability analysis to get there, and that its new rule is invalid because it is arbitrary and capricious.

The Tax Court and Ninth Circuit opinions bring into focus two issues relevant to understanding the CWI standard. The first issue is whether the CWI standard applies only to the transfer of IP (by sale, license, or contribution) or whether it instead applies more broadly to other issues related to IP ownership within a controlled group. The Ninth Circuit majority opinion is predicated on the interpretation that because Congress authorized bona fide cost sharing in the context of its adoption of the CWI standard, all the concerns it expressed regarding previous applications of the arm's-length standard to controlled transactions involving IP should also be considered in the cost-sharing context. Those concerns, in the majority's view, justified Treasury's dismissal of comments on taxpayers' treatment of SBC in third-party transactions. In short, those transactions simply were not comparable.

O'Malley's dissent most clearly articulates the response to the majority's approach. In her view, qualified CSAs are not subject to the CWI standard. Rather, as the statute states, the CWI standard applies only to transfers of IP.

The second, and more significant, issue is how the CWI standard harmonizes with the arm's-length standard. Under the Tax Court's opinion and O'Malley's dissent from the Ninth Circuit's opinion, the CWI standard is subordinated to the traditional search for CUTs. The Tax Court found Treasury's stated rationale for the 2003 rule insufficient because it focused on situations involving high-profit intangibles and in which SBC constituted a material portion of total development costs but then extended its conclusions to all CSAs, whether they involved those circumstances or not.[83] Moreover, Treasury responded only dismissively to the comments identifying potentially comparable agreements and explanations why unrelated parties would not share SBC.[84] Under this view, also embraced by O'Malley, the CWI standard permits the IRS to

[78] *Id.* at 1079.

[79] *Id.* at 1087.

[80] *Id.* at 1086.

[81] *Id.* at 1092.

[82] *Id.* at 1096.

[83] *Altera*, 145 T.C. at 125-127.

[84] *Id.*

resort to internal or *post hoc* analyses only when third-party comparables are unavailable. This view may find support in the exception to CWI adjustments in reg. section 1.482-4(f)(2)(i) (for exact comparables) and (ii) (for inexact comparables satisfying a *post hoc* floor and cap rule).[85]

The Ninth Circuit majority, on the other hand, views the CWI standard as consistent with the arm's-length standard when it comes to IP. Under this view, Congress believed that third-party "comparable" transactions were inherently suspect, and that Treasury was therefore within its authority to develop transfer pricing methods that may be applied without the need to refer to third-party market data. In this regard, the 1994 regulations adopted the best method rule, which jettisoned the previous approach under which CUTs, if available, were presumed to provide the best measure of the arm's-length result. However, in contrast to the 2003 rule, the 1994 regulations did not disregard evidence of third-party dealings. Thus, while the 1994 regulations may have reduced the primacy of CUTs, they did not disregard them entirely.

The last chapter of this saga likely has not been written. A Seventh Circuit taxpayer, Abbott Laboratories,[86] is challenging the validity of the 2003 rule, so another circuit may eventually make its views known. Further muddying the waters, in adjudicating Abbott's case, the courts will assess the validity of the rule under the standards of *Loper Bright*,[87] which overruled *Chevron*, on which the Ninth Circuit relied.

C. *3M*

In *3M*, the taxpayer (3M US) allowed a Brazilian subsidiary (3M Brazil) to use its IP to manufacture and sell products on the Brazilian market.[88] The parties stipulated that under Brazilian rules, 3M Brazil was not permitted to make royalty payments above a certain threshold to 3M US. 3M US therefore reported less than the full arm's-length royalty that it would have received in the absence of the Brazilian restrictions. The IRS took the position that the Brazilian rules did not meet the conditions in reg. section 1.482-1(h)(2) (the blocked income regulations) that allow a U.S. taxpayer to exclude or defer taxable income that a foreign affiliate would have paid but for foreign legal restrictions on the payment (blocked income). Accordingly, the IRS disregarded the Brazilian restrictions and adjusted 3M US's income to the full arm's-length royalty. 3M US contended that the blocked income regulations were invalid and that the prior case law on blocked income was determinative. Thus, the primary question in *3M* was whether the blocked income regulations were valid.

The Tax Court upheld the blocked income regulations by a 9-8 vote, but two of the judges joining the majority concurred in the result only, while the eight dissenting judges wrote three dissenting opinions, none of which was endorsed by more than six of the dissenters. The fragmented Tax Court thus failed to deliver clear consensus but provided the Eighth Circuit a variety of theories it could apply in deciding whether the regulations are valid. To further complicate matters, the Tax Court judges were applying the *Chevron* standard for assessing the validity of the regulation, and *Chevron* was later reversed by *Loper Bright*.

The plurality opinion, written by Judge Richard Morrison, held that the blocked income regulations satisfied *Chevron*'s two-step test for regulatory validity. The taxpayer argued that the blocked income regulations failed step 1 of the *Chevron* test because they were inconsistent with the unambiguous language of section 482. The taxpayer cited four prior opinions as supporting its contention that the blocked income need not be included by 3M US as taxable income. These were

[85] The 2009 cost-sharing regulations may in fact leave room for this approach. A taxpayer could deliberately fail to satisfy the requirements of reg. section 1.482-7 (*e.g.*, by failing the administrative requirements or failing to include SBC) and then have its arrangement analyzed under general transfer pricing principles. *See* reg. section 1.482-7(a)(3)(iv). However, Treasury did not explain the rules under reg. section 1.482-7 as being a safe harbor rather than a strict application of the arm's-length standard, and the IRS has not viewed them as such. Thus, the 2009 cost-sharing regulations should not be validated under the argument that they are not mandatory.

[86] *See* Petition, *Abbott Laboratories v. Commissioner*, No. 20227-23 (T.C. Dec. 22, 2023) (2019 tax year); and Petition, *Abbott*, No. 20227-23 (T.C. Sept. 19, 2024) (2017 and 2018 tax years).

[87] *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024).

[88] 3M Innovative Properties Co. (3M IPC), a wholly owned U.S. subsidiary of 3M US, held the IP. 3M Brazil was a wholly owned subsidiary of 3M IPC.

First Security Bank[89] (the only transfer pricing litigation to be decided by the Supreme Court), *L.E. Shunk Latex*,[90] *Procter & Gamble*,[91] and *Texaco*[92] (collectively, the "prior opinions").

The Tax Court plurality concluded that the earlier decisions were not controlling because they relied not on the language of the statute but rather on a regulation in effect during the periods at issue. That regulation provided that a taxpayer could be subject to an income adjustment under section 482 (or its predecessor) only if the taxpayer had "complete power" to shift income within its controlled group. The 1994 regulations at issue in *3M* did not contain the "complete power" provision. The plurality opinion interpreted the first sentence of section 482 in effect both before and after TRA 1986 and concluded that the language did not unambiguously express Congress's intent on how to account for legal restrictions that prevent the receipt of income. The plurality then noted that TRA 1986 added the second sentence to section 482 providing that in the case of a transfer of IP, the income the transferor recognizes "shall be commensurate with the income attributable to the intangible." The plurality rejected the taxpayer's argument that Congress's addition of the second sentence was not relevant to the validity of the blocked income regulations, noting that the conference committee said the second sentence "was added to ensure that 'the division of income between related parties reasonably reflect[s] the relative economic activity undertaken by each'" (citations omitted).[93] The opinion goes on to observe that the conference committee report urged Treasury to consider comprehensive revisions to the 1968 regulations.[94] In furtherance of that congressional directive, Treasury did substantially revise the 1968 regulations when producing the 1994 regulations, including omitting the former "complete control" provision and adding the blocked income regulations at issue.

The plurality opinion then addressed whether the blocked income regulations satisfy *Chevron*'s step 2 test — that is, whether the regulations were a reasonable interpretation of the statute. In that discussion, the plurality opinion considered each of the requirements of the blocked income regulations, but its analysis of the requirement that the foreign legal restriction apply to both controlled and uncontrolled transactions provided the fundamental rationale for its decision upholding the blocked income regulations. If the purpose of section 482 is to place controlled taxpayers on parity with uncontrolled taxpayers, any restriction, such as the Brazilian rules at issue in *3M*, that does not affect uncontrolled taxpayers should be disregarded. More relevant to this article, the plurality bolstered its conclusion by referring to the addition of the CWI standard in 1986, noting that "the second sentence of section 482 provides that in the case of transfer or license of intangible property, the income with respect to the transfer or license *must* be commensurate with the income attributable to the intangible" (emphasis added).[95] If a foreign legal restriction could prevent the transferor from fully recognizing income commensurate with the income generated by transferred IP, the CWI standard would be thwarted.

The concurring and dissenting opinions further highlight the differences in interpretations of concepts fundamental to the scope and application of the CWI standard that persist almost 40 years after the standard was introduced.

In the concurring opinions, Chief Judge Kathleen Kerrigan and Judge Elizabeth A. Copeland further elaborated on their views on the CWI amendment supporting the validity of the blocked income regulations.

Kerrigan noted that the courts in the prior cases did not have the opportunity to consider whether the CWI standard added to section 482 would affect their interpretation of section 482. In her view, the challenged regulation perfectly

[89] *Commissioner v. First Security Bank*, 405 U.S. 394 (1972).

[90] *L.E. Shunk Latex Products Inc. v. Commissioner*, 18 T.C. 940 (1952).

[91] *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990).

[92] *Texaco Inc. v. Commissioner*, 98 F.3d 825 (1996).

[93] *3M Co.*, 160 T.C. at 202.

[94] *Id.*

[95] *Id.* at 285.

accomplishes Congress's purpose in enacting TRA 1986 — that is, that the income from transfer or license of an intangible shall be commensurate with the income attributable to the intangible. Further, because Congress added the CWI standard to section 482, Treasury promulgated new regulations in 1994, with one of the changes being to eliminate the "complete power" regulation that was a basis for the Supreme Court's opinion in *First Security Bank*.

Copeland argued that the IRS's allocation to 3M US was not just consistent with TRA 1986 but was required by the amended statute, with or without the clarifications of the blocked income regulations. TRA 1986 specified a new standard for determining income in the context of intangible transfers among related parties. In effect, the new sentence added to section 482 more clearly defines the income that must be reflected under the first sentence of section 482. Copeland also argued that the legislative history of TRA 1986 supports an inference that the new CWI standard cannot be implemented consistently with a strict adherence to the *First Security Bank* holding. The language in the conference committee report suggests that relevant facts and circumstances *internal* to generating income from the intangible should be considered. Moreover, accommodating foreign legal restrictions in cases like *3M* would give primary weight to the restriction rather than to the "income stream generated by" the IP, contrary to congressional intent in drafting the CWI standard.[96]

Judges Ronald L. Buch and Cary Douglas Pugh wrote dissenting opinions disagreeing with the Tax Court's conclusion that the CWI amendment to section 482 reasonably supported the blocked income regulations. According to Buch, nothing in the amendment, which addresses the transfer or license of IP, addresses blocked income. Conversely, blocked income may be wholly unrelated to the transfer or license of IP. Buch further argued that Congress did not amend section 482 in any way that would materially alter the Supreme Court's holding in *First Security Bank* that section 482 cannot be used to allocate blocked income to someone that did not receive it and could not receive it. He argued that because the blocked income regulations are inconsistent with limits on section 482 as described by the Supreme Court in *First Security Bank*, they are invalid.

Dissenting from the Tax Court's ruling, Pugh noted that nothing in the CWI amendment to section 482 expressly mentions blocked income. For example, the sentence does not specify whether legal restrictions should be considered in deciding whether income is "commensurate." Moreover, the sentence seems perfectly consistent with what may be viewed as a central lesson of the blocked income cases: that "income" for purposes of section 482 does not include amounts that a taxpayer is legally prohibited from receiving. And the sentence addresses income from transfers of intangibles only, whereas blocked income can be present in many types of transactions. He argued that connecting the dots between the second sentence of section 482 and the blocked income regulations requires explanation because their relationship is neither obvious nor reasonably discernable, but Treasury did not provide that explanation.

The narrow majority ruling in favor of the taxpayer in *3M* highlights the significant differences in opinion among the Tax Court judges on the scope of the CWI standard. The taxpayer has appealed the ruling to the Eighth Circuit, so it remains to be seen how the CWI standard will affect the final decision in *3M*, particularly in light of the Supreme Court's decision in *Loper Bright*, which reversed *Chevron* and therefore the standard of review the Tax Court applied.

X. The Timing of CWI Payments

As discussed above, the measurement of compensation for the use of IP under the CWI standard should be the same whether a transfer of IP is subject to section 482 or section 367(d). However, the rules under section 482 regarding the timing of the transferor's required income inclusion are considerably more liberal than those under section 367(d).

For a sale or license of IP, the consideration may be paid in the form of a lump sum, fixed installments, or a series of payments contingent

[96] *Id*. at 309.

on the productivity, use, or disposition of the IP.[97] When the payment is a lump sum, the arm's-length consideration is determined by computing the present value of the expected stream of royalties over the life of the IP (or the term of the transfer, if shorter).[98] When payments are made in installments, the installments must reflect an appropriate return for the deferral, applying the principles applicable to loans.[99] In assessing whether accelerated payments satisfy the CWI standard, the IRS is not limited to adjusting the transferor's income in the year it receives the payments; the IRS may raise an adjustment in any open year during the entire period over which the IP was transferred. To do so for any year, the IRS must compare the CWI payment that would have been appropriate for that year with the estimated royalty for that year used to compute the accelerated payment or payments.[100] If the appropriate royalty so determined exceeds the estimated royalty, the IRS may make an adjustment equal to the difference.[101]

Under section 367(d), a transferor of IP is required to recognize income "*annually* in the form of such payments *over* the useful life of such property" (emphasis added).[102] Read literally, the statutory language seems to preclude any acceleration of the transferor's income recognition for IP transferred in a section 351 or 361 transaction. However, if a taxpayer transfers IP in a section 351 or 361 transaction and receives boot,[103] its recognition of gain under section 351(b) or section 361(b), coupled with the full annual section 367(d) inclusion, would result in its recognizing the same economic gain twice, at least to the extent of the boot recognized as gain. The IRS addressed this issue regarding a section 351 contribution in a 2006 IRS legal memorandum.[104]

[97] *See* reg. sections 1.482-4(f)(6)(i) and 1.482-7(h)(2)(i).

[98] Reg. section 1.482-4(f)(6)(i).

[99] *See* reg. section 1.482-7(h)(2)(i)(A).

[100] Reg. section 1.482-4(f)(6)(i).

[101] Reg. section 1.482-4(f)(6)(iv).

[102] Section 367(d)(2)(A)(ii)(I). If the transferee disposes of the IP after the transfer, the transferor recognizes a final CWI payment on the disposition. Section 367(d)(2)(A)(ii)(II).

[103] Boot is cash or other property received in a corporate organization, reorganization, or separation other than stock and securities permitted to be received without the recognition of gain or loss.

[104] ILM 200610019.

The memo concludes that section 351(b) and section 367(d) conflict because they provide different treatment for a single transaction, resulting in a double recognition of the same economic gain. And because section 367(d) was the more specific provision, the memo concludes that it should take precedence over section 351(b). Under this approach, the boot is treated first as the payment of the current-year section 367(d) inclusion to the extent thereof, and then as a prepayment of later years' section 367(d) amounts.

In Notice 2012-39, 2012-31 IRB 95, Treasury and the IRS provided guidance for the application of section 367(d) in the context of a section 361 transaction with boot. Notice 2012-39 was concerned with a different issue raised by the interaction of section 367(d) with the rest of subchapter C. It describes a transaction in which a U.S. parent company (USP) owns a U.S. subsidiary (USS) with a basis and fair market value of $100, and USS owns IP with a basis of zero and an FMV of $100. USS transfers the IP to a controlled foreign corporation in an all-cash D reorganization. If the $100 of boot were subject to the normal subchapter C rules, USS, as a party to the reorganization, would not recognize gain on the transfer of the IP.[105] Also, under the boot within gain rule,[106] USP would not recognize any gain. Going forward, USP would (ignoring present valuing) expect to include $100 of income under section 367(d), which CFC could repatriate to USP without further tax. As a result, USP could receive $200 in cash while recognizing only $100 of income.[107]

As in the 2006 general counsel memorandum, Notice 2012-39 concludes that the boot received in the section 361 transaction will, to the extent allocable to the IP transferred in the exchange, be treated as a prepayment of the section 367(d) amounts, applied on a first-in, first-out basis. Notice 2012-39 further provides that Treasury will issue regulations applying the rules contained in the notice, with an effective date of July 13, 2012.

[105] Section 361(b)(1)(A).

[106] Section 356(a)(1).

[107] The enactment of section 245A has reduced the tax avoidance potential of the transaction described in Notice 2012-39; nonetheless, the coordination approach described in the notice remains appropriate.

Notice 2012-39 and the 2006 general counsel memorandum reach a sensible resolution to the statutory overlap. Bifurcating the boot received in an outbound transaction between the portion allocable to IP and the portion allocable to other transferred property ensures that the transferor recognizes the income attributable to the IP only once and furthers the congressional goal of harmonizing the treatment of outbound transfers of IP under section 367(d) and section 482.

Unfortunately, the authorities fall short of fully explaining how the prepayment mechanism applies. When a taxpayer sells IP for a lump sum, the sales price is determined by discounting the annual CWI payments the transferee would otherwise be expected to make to the date of the sale. To reach results consistent with section 482, the section 367(d) prepayment should be applied by taking into account the value of the acceleration. To achieve this, the prepayment should be treated as a prepayment of all the expected prospective section 367(d) amounts that, if present-valued to the date of the section 351 or section 361 transaction, would have a present value equal to the boot. If the boot prepayment were applied without taking into account the timing of the payments, a taxpayer would recognize more income, on a present value basis, on an outbound transfer of IP under section 351 or 361 with boot than on a taxable transfer of the same IP in a section 351 or 361 transaction without boot or in a transaction subject to section 482.

The regulations under section 367 contain two other exceptions from the annual inclusion rule. First, a taxpayer may elect to recognize gain immediately on the transfer of operating intangibles.[108] An operating intangible is an intangible of a type not normally licensed between unrelated parties for contingent consideration.[109] Operating intangibles include, for example, long-term purchase or supply contracts, surveys, studies, customer lists, and, presumably, goodwill, going concern value, and workforce in place.[110]

Under the second regulatory exception, if the useful life of the transferred IP is reasonably anticipated to exceed 20 years, the taxpayer may elect to limit its section 367(d) inclusions to 20 years and increase its annual inclusions during those years to reflect the amounts it would have been required to include after the 20-year period.[111] This election must be made with the taxpayer's timely filed original return for the year of the transfer and is irrevocable.[112] The preamble to the regulation states that Treasury and the IRS "have determined that this optional limitation should not affect the present value of all amounts included by the taxpayer under section 367(d)."[113] Thus, this exception assumes that the taxpayer will be able to establish the appropriateness of its additional inclusions during the 20-year period based on projections and discount rates, just as would be necessary to establish the appropriateness of prepaid royalties under section 482. Given that this last exception requires taxpayers to develop and defend the same sort of economic analysis that would be required under reg. section 1.482-4 for prepaid royalties or sales for a lump sum, one may ask why Treasury doesn't simply import the section 482 principles for prepayments wholesale into section 367(d). After all, each of the exceptions indicates that Treasury and the IRS believe that they can deviate from the "annual" inclusion language in the statute. Moreover, the latter two exceptions assume that section 367(d) can reasonably be applied through an explicit election and compliance with the ex ante valuation methods applicable under section 482. However, the IRS is not (yet) willing to go quite that far. In 2022 generic legal advice, the IRS considered whether section 367(d) permits a taxpayer to make advance payments of annual inclusions.[114] It concluded that other than the specific exceptions discussed above, section 367(d) requires annual inclusions, and that taxpayers have no other ability to accelerate income inclusions through advance payments.

[108]Reg. sections 1.367(d)-1(g)(2)(i) and 1.367(d)-1T(g)(2)(i).

[109]Reg. section 1.367(a)-1(d)(6).

[110]*Id*. The regulation does not list goodwill, going concern value, or workforce in place, but those items were added to the definition of IP subject to section 367(d) after the regulation was promulgated.

[111]Reg. section 1.367(d)-1(c)(3)(ii).

[112]*Id.*

[113]T.D. 9803.

[114]AM 2002-003.

XI. HTVI Approach in OECD Guidelines

The OECD guidelines[115] added rules similar to the periodic adjustment rules of the section 482 regulations following the base erosion and profit-shifting project. Action 8 of the OECD's action plan on BEPS[116] mandated the development of transfer pricing rules or special measures for transfers of HTVIs aimed at preventing BEPS by moving intangibles among group members.

The outcome of that work is the HTVI approach. HTVIs are intangibles for which no reliable comparables exist at the time of their transfer between associated enterprises, and the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible, are highly uncertain, making it difficult to predict the ultimate level of success of the intangible at the time of the transfer.[117] The HTVI approach purportedly protects tax administrations from the negative effects of information asymmetry by ensuring that tax administrations can consider ex post outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements. However, the consideration of ex post evidence should be based on a determination that the evidence is necessary to assess the reliability of the information on which ex ante pricing has been based. When the tax administration can confirm the reliability of the information on which ex ante pricing has been based, adjustments based on ex post information should not be made. In evaluating ex ante pricing arrangements, the tax administration is entitled to use the ex post evidence about financial outcomes to inform the determination of the arm's-length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction.[118]

At the same time, the taxpayer may rebut ex post presumptive evidence by demonstrating the reliability of the information supporting the pricing method adopted at the time the controlled transaction took place. The HTVI approach will not apply to transactions involving the transfer or use of an HTVI when at least one of several exemptions — which are similar, but not identical, to those provided in the periodic adjustment rules of reg. section 1.482-4 — applies.

XII. The CWI Standard in Practice

As the history of the CWI standard and case law discussed above show, there are some fundamental disagreements among the government, the courts, and practitioners on the scope and application of the CWI standard. Nevertheless, given that the CWI standard is contained in the statute and the section 482 regulations, it is an important element of transfer pricing law in the United States, and taxpayers often have questions on its practical import for them. The following discussion addresses some typical issues related to the practical application of the CWI standard — in particular, the periodic adjustment rules included in the section 482 regulations under the CWI standard. We also discuss the interplay between the CWI standard and tax treaties.

A. Taxpayer Use of Periodic Adjustments

A frequent question is whether a taxpayer must make adjustments under the periodic adjustment rules of the section 482 regulations. The short answer is no. The taxpayer is not required to make adjustments under the periodic adjustment rules and, in fact, does not have authority to make adjustments based solely on those rules. The periodic adjustment rules in the section 482 regulations are a tool for the IRS to use actual results to adjust the transfer prices for IP transfers that were determined at the time of the transfer using forecasts.

While a company cannot make periodic adjustments relying solely on the periodic adjustment rules, controlled parties have flexibility in agreeing to contingent payment terms, which may include price adjustment clauses. However, those pricing terms must be determined up front and must be consistent with the arm's-length standard. Taxpayers may make periodic adjustments consistent with those arm's-length pricing terms in their agreements.

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[115] OECD, *supra* note 4.

[116] OECD, "Action Plan on Base Erosion and Profit Shifting" (2013).

[117] OECD, *supra* note 4, at para. 6.189.

[118] *Id*. at para. 6.192.

B. Documentation

Another question that often comes up is whether a company needs to document that periodic adjustments should not apply to its IP transfer given the exceptions listed in the periodic adjustment rules. Under U.S. documentation rules,[119] if a taxpayer prepares documentation meeting certain criteria contemporaneously with its tax return filing, it will not be subject to penalties in the event of an adjustment by the IRS. Those criteria relate to documenting that the taxpayer reasonably selected and applied the best method for pricing the controlled transaction. As noted, the periodic adjustment rules are a tool for the IRS to adjust transfer prices for intangibles that it determines were inconsistent with the arm's-length standard given the gap between actual results and forecasts made at the time of the transfer. The periodic adjustment rules do not provide an approach for the taxpayer to affirmatively determine arm's-length prices. The U.S. transfer pricing documentation requirements do not include documentation related to the periodic adjustment rules.

Having said that, it may be useful for a company to evaluate the controlled transaction under the relevant periodic adjustment rules to assess its exposure related to the transaction. It is advisable to keep this evaluation separate from the transfer pricing documentation because, as noted, it is not required to be included in that documentation.

XIII. Periodic Adjustments in Practice

A question of interest to many is how frequently the IRS makes CWI adjustments. In our experience, the IRS has historically exercised restraint in making periodic adjustments and has rarely proposed adjustments based on a formal application of the periodic adjustment rules. As the IRS noted in 2007 generic legal advice to the field:

> Although the IRS necessarily must examine the taxpayer's transaction after-the-fact, it should exercise its periodic adjustment authority consistent with what would have been a conscientious upfront valuation — had the taxpayer in fact made one. Thus, the IRS should decline to make a periodic adjustment to a royalty on the basis of outcomes that could not be reasonably anticipated at the time the intangible transfer was entered into. The [1994] regulations clearly reflect the intent that the IRS exercise restraint in making periodic adjustments based only on the upfront reasonable expectations and not based on subsequent events which could not be reasonably anticipated.[120]

After the IRS makes a periodic adjustment, the taxpayer still has an opportunity to challenge it by demonstrating that one or more of the exceptions to the application of the adjustment are met.

In general, based on our experience, the IRS is much more likely to propose adjustments by questioning various aspects of the transfer pricing approach that was used to set prices at the time of the transfer rather than by formally applying the periodic adjustment rules based on ex post information. Nevertheless, the IRS is still likely to evaluate whether actual results differ significantly from the projections to inform its proposed adjustments to the transfer prices set at the time of the transfer, even if the IRS does not formally cite those rules frequently in proposing adjustments.

A. Difficulties Applying Periodic Adjustment Rules

The periodic adjustment rules require a comparison of actual results with forecasts from the time of the IP transfer or PCT. However, in some cases, it may be difficult to determine actual results to compare with forecasts. For example, if the IP that was transferred is later integrated with existing IP of the transferee in a new product offering, or if the transferor and transferee are later acquired by another company and post-acquisition sales of the product incorporating the subject IP reflect acquisition synergies, it may be difficult to determine how to compare actual and projected results and apply the 80/120 exception in the periodic adjustment rules.

[119] Reg. section 1.6662-6(e).

[120] AM 2007-007.

Importantly, the periodic adjustment rules are meant to be consistent with the arm's-length standard. According to IRS guidance, "the word 'income' in the phrase 'commensurate with the income attributable to the intangible' in section 482 should generally be construed as operating profits attributable to the intangible the taxpayer would reasonably and conscientiously have projected at the time it entered into the controlled transaction."[121] Because the IRS considers itself to be at a disadvantage in assessing whether the pricing was supported by reasonable and conscientious projections at the time of the transfer, it can, "in its discretion, provisionally" treat ex post results as presumptive evidence of ex ante results. However, the taxpayer can rebut that presumption, for example, by showing that the ex post results could not have reasonably been anticipated. In the face of a taxpayer rebuttal, the IRS faces practical challenges in sustaining periodic adjustments because that would require further arguments from the IRS on the counterfactual of what projections should have been ex ante — running into the very problem of information asymmetry between the taxpayer and the IRS that the periodic adjustment rules are meant to address.

Finally, from a practical perspective, the periodic adjustment rules in reg. section 1.482-7 are complex and difficult to apply — which may also serve as a deterrent to applying them.

B. Financial Statement Exposure

The periodic adjustment rules give the IRS authority to make periodic adjustments in some cases in which there is an IP transfer and actual results deviate significantly from projected results. However, as noted, there is some uncertainty in the application of the periodic adjustment rules given the exceptions to the application of periodic adjustments and IRS administrative practice. In practice, we see companies evaluating the application of periodic adjustment rules to assess potential tax exposure to determine whether a financial statement reserve might be appropriate.

[121] *Id.*

XIV. CWI Standard and Tax Treaties

Treasury and the IRS consider the CWI standard to be consistent with the arm's-length standard and international transfer pricing norms. The white paper noted that the approach taken by Congress in enacting the CWI standard and the approaches suggested by the white paper for implementing that standard — including the provision for periodic adjustments — are consistent with internationally recognized arm's-length principles. Treasury and the IRS made similar arguments more recently in *Altera*. While the taxpayer in *Altera* argued that a purely internal standard (referring to the CWI standard) is inconsistent with the United States' treaty obligations, the Ninth Circuit concluded that there is no evidence that U.S. treaty obligations bind the United States to an analysis of comparable transactions. Moreover, the most recent U.S. treaties incorporate not only the arm's-length standard but also the CWI standard. Also, more recent tax treaty explanations have cited the CWI standard, as noted in *Altera*. These explanations generally emphasize the primacy of the arm's-length standard, and they assure the reader that the CWI standard "operates consistently with the arm's-length standard."[122]

Historically, before the OECD's BEPS project largely flushed IP out of tax havens, IP transfers from the United States often involved related participants based in low- or zero-tax jurisdictions. Since many of these jurisdictions did not have tax treaties with the United States, the IRS's application of the CWI standard was all that mattered in a tax dispute. As noted, the IRS has often interpreted the CWI standard as requiring that all residual profit realized be attributed to the IP licensor under the CWI standard. Since 2015, when the OECD substantially revised its transfer pricing guidance in accordance with the BEPS initiative, there has been a shift in the location of IP transferees to countries in Europe and Asia with tax treaties with the United States. These countries scrutinize IP transfer pricing under the

[122] *See Altera*, 926 F.3d at 1077, *citing* Treasury, "Department of the Treasury Technical Explanation of the Convention Between the United States of America and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income" (Feb. 13, 2013).

revised OECD guidance. Many of these tax authorities are interpreting the OECD guidance to mean that functions performed in their jurisdictions should earn some portion of the residual profits. Given this evolution in OECD standards and the change in the composition of the counterparty jurisdiction away from tax havens to treaty countries, the application of the CWI standard by the IRS has been evolving in practice — moving away from allocation of all residual profit to the IP owner to greater recognition that the licensee could be entitled to some of the residual profits.

XV. Mitigating Risk of Periodic Adjustments

As we have discussed in this article, the periodic adjustment rules apply the CWI standard to transfers of IP and give the IRS permission to use actual results realized after the transaction to adjust the pricing of the IP transfer. But the periodic adjustment rules include provisions that prevent the IRS from making periodic adjustments if certain conditions are met, among which is an exception for unforeseeable actual results. In interpreting Congress's directive to make periodic adjustments, the IRS has noted its inherent disadvantage in assessing the reasonableness of the taxpayer's information as of the time of the transfer.[123] Therefore, the reliability of projections in existence at the time of the IP transfer lies at the heart of the problem the CWI standard is trying to solve and is a key factor in the periodic adjustment rules. Companies can mitigate the risk of periodic adjustments by maintaining strong support for their projections contemporaneously with the IP transaction. The use of projections created for nontax business purposes could bolster a company's arguments that its projections are a true representation of information available at the time of the transfer. Further, documenting at the time of the transfer how possible eventualities were considered in deriving the projections could provide support for a company's contention that it considered results that could have reasonably been anticipated at the time of the transfer and that any significant deviations between actual and projected results are the result of unforeseeable events.

Contingent payment arrangements could be another way to mitigate risk of periodic adjustments by linking payments for the IP transfer to actual results. The contingent payment terms could take various forms — for example, royalties on sales, milestone payments, and tiered payment structures. Contingent payment terms that are defined up front at the time of the transfer, and that clearly and unambiguously specify the basis for the contingent payment, may reduce the difference in the IP transfer price based on actual results versus projections by linking the payment at least in part to actual results. Linking the contingent payment terms to terms in third-party arrangements could further reduce the risk of periodic adjustments.

XVI. Conclusion

Congress added the CWI standard in section 482 and section 367(d) for IP transfers to address the perceived problem of tax avoidance with those transfers, particularly for IP with high profit potential. Although the issue motivating Congress to enact the CWI standard was clear, the intended meaning and application of the standard were not. As a result, interpretations of the CWI standard have differed between the tax authorities, taxpayers, and courts, and they have shifted over time to reflect changes in the global economy and international developments related to the arm's-length standard.

Right from the beginning, the CWI standard has been dogged with interpretive issues, starting with the question whether the CWI standard is consistent with the arm's-length standard. The IRS and Treasury took the view that the two standards are consistent. Yet, more than three decades later, while the Ninth Circuit ultimately ruled for the IRS in *Altera*, there was still disagreement between the judges on the Tax Court and the Ninth Circuit on this point.

There have been disagreements around the exact meaning of the term "commensurate with income." Some key questions that have arisen concern the meaning of the words "commensurate" and "income," how much income is attributable to IP, and whether the IP price needs to be commensurate with the income

[123] AM 2007-007.

expected to be attributable to the IP on an ex ante basis or the actual income as determined ex post. The IRS and Treasury have provided guidance on these points, and these issues have been litigated in some transfer pricing court cases. In general, the conclusion has been that the IP price needs to be commensurate with the income attributable to the IP ex ante. Even so, it is striking that disagreements on these issues persist among the various interested parties.

In addition to the legal interpretations of the CWI standard by the IRS, Treasury, and U.S. courts, the practical application of the CWI standard by the IRS is important to transfer pricing practice in the United States and around the world. Here, given the evolution in OECD standards following the BEPS project and the resulting change in the composition of the counterparty jurisdictions to the U.S. IP transferor away from tax havens to other treaty countries, we see a shift in the application of the CWI standard by the IRS in practice. There has been a gradual move away from the allocation of all residual profit by the IRS to the U.S. IP owner to greater recognition that the foreign licensee could be entitled to some of the residual profits.

Starting with the 1994 regulations and continuing with the 2009 cost-sharing regulations, Treasury introduced the periodic adjustment rules for IP transfers and PCT payments as a tool for the IRS to use ex post results to question ex ante IP pricing to make the pricing commensurate with the income attributable to the IP. The OECD introduced a similar concept in its HTVI approach in 2015.

Although the IRS has historically exercised restraint in making periodic adjustments and has rarely proposed adjustments based on a formal application of the periodic adjustment rules, it is still likely to evaluate whether actual results differ significantly from the projections to inform its proposed adjustments to the transfer prices set at the time of the transfer, even if it does not formally cite those rules frequently in proposing adjustments. Nevertheless, IRS practice regarding periodic adjustments could change in the future. Therefore, taxpayers would be well advised to consider the implications of the periodic adjustment rules for their transfer pricing. Companies can mitigate the risk of periodic adjustments by maintaining strong support for their projections contemporaneously with the IP transaction. Contingent payment arrangements could be another way to mitigate the risk of periodic adjustments by linking payments for the IP transfer to actual results. ■