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Prices on Transfer of Intangible Property Between Related Taxpayers: Can the Section 482 White Paper's Arm's Length Return Method Work?

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PRICES ON TRANSFER OF INTANGIBLE PROPERTY BETWEEN RELATED TAXPAYERS: CAN THE SECTION 482 WHITE PAPER'S ARM'S LENGTH RETURN METHOD WORK?

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I. INTRODUCTION

Section 482 of the Internal Revenue Code authorizes the Secretary of the Treasury (the "Secretary") to allocate items of income between related taxpayers to reflect their true tax liability.[1] Administration of this statute has long been difficult for lack of precise regulatory standards, especially in cases involving income derived from intercompany transfers of intangible property. As a result, Congress amended section 482 in 1986 to incorporate a new standard for dealing with such transfers.[2] The statute now prescribes that income derived from transfers of intangible property be "commensurate with the income" attributable to the intangible itself.[3]

To implement the new statute's requirements, the Internal Revenue Service has proposed using the Basic Arm's Length Return Method to calculate appropriate transfer prices between related entities.[4] As applied to the transfer of unique intangible assets that have unusually high profit potential, however, the method has produced a much criticized result, a royalty to the transferor of over ninety percent.[5] This result has tainted the credibility of the method as a viable tool for addressing the allocation problem.

This article first analyzes the Basic Arm's Length Return Method (BALRM) and criticisms of its operation.[6] It then suggests modifications in the method's application that correct the current deficiencies.[7] Finally, this article applies the modified method to various factual situations to illustrate the modified method's effectiveness and the consistency of its results.[8]

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1. I.R.C. § 482 (1986).
2. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (1986).
3. I.R.C. § 482 (1986).
4. Internal Revenue Service, *Sec. 482 White Paper: On Intercompany Pricing*, 75 STAND. FED. TAX. REP. (CCH), No. 53, at 87-107 (Oct. 20, 1988) [hereinafter *White Paper*].
5. *See infra* text accompanying notes 76-100.
6. *See infra* text accompanying notes 51-147.
7. *See infra* text accompanying notes 148-63.
8. *See infra* text accompanying notes 165-81.

II. HISTORICAL BACKGROUND

A. *Origin of Section 482*

Congress recognized the potential for problems arising from transactions between related taxpayers as early as 1921.[9] In response, Congress enacted legislation empowering the Commissioner of the Internal Revenue Service (the "Commissioner") to treat controlled entities on a consolidated basis for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital among the entities in determining their correct tax liability.[10] Congress expanded this power in 1928 when it gave the Commissioner authority to adjust the federal income tax returns of related trades or businesses as necessary to prevent tax evasion and ensure a clear reflection of income.[11] The objective of both laws was to tax each entity according to its true liability.[12]

Congress reenacted the 1928 statute in substantially unchanged form as section 482 of the Internal Revenue Code of 1954.[13] The language of the 1928 statute dealt broadly with the authority of the Internal Revenue Service (the "Service") to reallocate items of income between controlled organizations.[14] However, it did not specifically address transfers of intangible property.[15] Congress added new language for that purpose in 1986.[16]

Section 482 applies to all situations in which a reallocation of income items between related taxpayers is necessary to reflect true tax liability. However, because the transfer of intangible property by a domestic corporation to a foreign subsidiary represents the most commonly encountered fact situation, this article concentrates solely on such intercompany transfers. Typically, intangible property includes patents, trademarks, know-how, goodwill, and similar items that have intrinsic commercial value as a result of their potential contribution

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9. *See* S. REP. NO. 275, 67th Cong., 1st Sess. 10-20 (1921).

10. Revenue Act of 1921, ch. 136, § 240(d), 42 State 260.

11. Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (1928).

12. H.R. REP. NO. 2, 70th Cong., 1st Sess. 16-17 (1927).

13. Pub. L. No. 83-591, § 162, 68A Stat. 3 (1954). The legislative history to the Internal Revenue Code of 1954 indicates that § 482 was substantively unchanged from § 45 of the Internal Revenue Code of 1939. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4304.

14. *See* Pub. L. No. 83-591, § 162, 68A Stat. 3 (1954).

15. *See* 1954 U.S CODE CONG. & ADMIN. NEWS 4017, 4949. The legislative history of the 1954 Act does not show any discussion concerning transfers of intangibles.

16. I.R.C. § 482 (1986). For a discussion of the 1986 amendments, see *infra* text accompanying notes 32-40.

to the enterprise's profitability.[17] Although susceptible to a variety of transactional forms, the transfer of intangible rights is usually accomplished through a license agreement[18] that requires the transferee to pay the transferor a royalty for use of the intangible. For example, the owner of a patent covering a certain product may grant a licensee the right to manufacture and sell it in exchange for periodic royalty payments. The parties generally measure this royalty payment as a percentage of the transferee's gross revenues.[19] For simplicity, this article will utilize such a license/royalty scenario in situations requiring illustrative analysis.

To demonstrate how the transfer of intangible property between related taxpayers can result in an artificial shifting of income that requires application of section 482, consider a domestic corporation with a valuable patent developed in the United States. This company could exploit the patent by using it in the company's own operations or by transferring patent rights to a third party under a license agreement, thus earning a royalty determined by free market forces. If such third party is a controlled subsidiary and the royalty paid is less than the true market price, the resulting income to the parent company will be artificially low. Correspondingly, by virtue of having incurred a lower than market royalty expense, the income of the subsidiary will be artificially high, with a net shift of income from the domestic parent to the foreign subsidiary. Because sales by the foreign affiliate

17. For the purposes of § 482, the Internal Revenue Code defines intangible property by reference to I.R.C. § 936(h)(3)(B) (1986), which states:

(B) INTANGIBLE PROPERTY. — The term "intangible property" means any

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

which has substantial value independent of the services of any individual.
I.R.C. § 936(h)(3)(B) (1989).

18. *See White Paper, supra* note 4, app. A, at 12 (showing that documentation produced by taxpayers with respect to the transfer of intangibles has included only licensing agreements and section 351 transfer documents). Other common transactions include the outright purchase of the intangible in exchange for a lump sum payment to the transferor and the contribution of the intangible by the transferor to the transferee in exchange for its stock in a § 351 tax free transaction. *See* AMERICAN INTELLECTUAL PROPERTY LAW ASSOCIATION, HOW TO PROTECT AND BENEFIT FROM YOUR IDEAS 37 (1988).

19. *See supra* note 18, at 37-39 (discussing determination of a fair percent royalty).

originate outside of the United States,[20] the Internal Revenue Code (the "Code") does not subject such revenue to U.S. taxation[21] until repatriation to the U.S. parent occurs.[22] The net result is avoidance or deferral[23] by the domestic company of U.S. income tax attributable to the transfer of rights in its patent. In this situation, the Service would invoke section 482 to redistribute income between parent and subsidiary based on a hypothetical royalty that unrelated parties would have negotiated under the same circumstances.

B.   *Treasury Regulations Under Section 482 and Its Predecessors*

The Service promulgated the first regulations for section 482 and its predecessors in 1935.[24] Those regulations prescribed an "arm's-length" standard to measure the proper allocation of income items between related taxpayers.[25] That is, adjustments to the income of each party should result in liability equivalent to that of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[26] This concept was retained in new regulations issued in 1965 and these regulations are still in effect today.[27]

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20.   STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., *General Explanation of the Tax Reform Act of 1986* 1011 (Comm. Print 1987) [hereinafter *General Explanation*] ("Foreign corporations generally are not subject to U.S. tax unless they receive U.S. source income or have a U.S. business . . . [.]"). The committee print states:

> The problems have been particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may have transferred such intangibles to foreign related corporations or to possessions corporations at an early stage, for a relatively low royalty, and taken the position that it was not possible at the time of the transfers to predict the subsequent success of the product.

Id. at 1114.

21.   I.R.C. § 882(b) (1986). Generally, gross income of a foreign corporation does not include sales outside the United States, unless they are related to a trade or business conducted in the United States. *Id.*

22.   *See id.* §§ 11, 245(b)(2) (1989). Generally, dividends from a wholly owned foreign subsidiary are taxed to the U.S. parent to the extent that they represent earnings and profits not related to trade or business in the United States. *See id.* § 245(b).

23.   H.R. REP. No. 426, 99th Cong., 1st Sess. 423 (1985) [hereinafter H.R. REP. No. 426]. Citing the reasons for the 1986 change in the law, the report states:

> There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption of the earnings, while retaining the value of the earnings in the related group.

Id.

24.   Treas. Reg. 86, § 45-1(b) (1935).

25.   *Id.*

26.   *Id.*

27.   *See* Treas. Reg. § 1.482-2(d)(2) (as amended in 1988). The regulations followed a congres-

Regarding the transfer of intangibles, the 1965 regulations direct the taxpayer to determine the amount of arm's-length consideration by searching for appropriate comparable transfer prices among unrelated parties.[28] When sufficiently similar comparables are unavailable, the regulations list twelve factors to consider as guidelines in arriving at the hypothetical amount of arm's-length consideration.[29] Among these factors are any facts and circumstances that unrelated parties would likely consider in determining the amount of an arm's-length consideration for the transfer of the intangible.[30] However, the regulations give no priority of importance and no analytical approach for the practical implementation of these guidelines.[31]

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sional mandate to provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income. H.R. CONF. REP. No. 2508, 87th Cong., 2d Sess. 18-19 (1962), *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 3732. The report shows that the House was particularly concerned about allocations among related groups including foreign organizations. The House proposed an amendment to section 482 listing specific factors to be considered in making allocations between foreign and domestic entities, but the Senate disagreed, believing that the statute already contained broad authority to deal with the problem. *Id.* at 3738-39. Instead, the conferees asked the Treasury to explore the possibility of developing regulations for cases involving foreign income. *Id.* at 3739.

28. Treas. Reg. §§ 1.482-2(d)(2)(i)-(ii) (as amended in 1988).

29. *Id.* § 1.482-2(d)(2)(ii). The regulations state that the following factors may be considered to the extend appropriate (depending on the type of intangible property and the form of the transfer):

     (a) The prevailing rates in the same industry or for similar property,

     (b) The offers of competing transferors or bids of competing transferees,

     (c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,

     (d) The uniqueness of the property and the period for which it is likely to remain unique,

     (e) The degree and duration of protection afforded to the property under the laws of the relevant countries,

     (f) Value of services rendered by the transferor to the transferee in connection with the transfer . . .,

     (g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,

     (h) The capital investment and starting up expenses required of the transferee,

     [(i) the regulation contained no (i) provision]

     (j) The availability of substitutes for the property transferred,

     (k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,

     (l) The costs incurred by the transferor in developing the property, and

     (m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

Id.

30. *See id.* § 1.482-2(d)(2)(iii)(m) (as amended in 1988).

31. *See White Paper, supra* note 4, at 11.

C. *1986 Amendment to Section 482*

Due to the lack of specific regulatory guidance in situations where intangible property is transferred between related entities and arm's-length information is unavailable to estimate appropriate transfer prices, taxpayers often set such prices by relying on industry averages. By their nature, these averages measure general conditions and cannot appropriately reflect the specific circumstances concerning the type of intangible involved, market geography, potential profitability, investment risks, and contractual relationships.[32] This problem is particularly clear when a taxpayer transfers high profit intangibles[33] for which no comparable data are available. The transfer of such intangibles leaves the taxpayer with great flexibility, and corresponding potential for abuse, in applying the factors listed in the regulations to estimate arm's-length transfer prices.[34]

This potential for abuse signaled to Congress that the 1965 regulations failed to assure adequate allocations between related parties.[35] Congress determined that the Service should apply an additional principle, based on the "actual economic activities"[36] undertaken by each entity, in arriving at the proper allocation of income, deductions, and other items. Accordingly, Congress amended section 482 in 1986 to require that income with respect to the transfer of intangible property be "commensurate[37] with the income[38] attributable to the intangible"

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32. *Id.* at 47.

33. *Id.* at 51. The White Paper states:

The term high profit potential intangibles refers to those products which generate profits far beyond the normal returns found in the industry. No specific definition or formula for determining whether an item is a high profit potential product is suggested herein. Nonetheless, hypothetical products such as an AIDS vaccine, a cure for the common cold, or a cheap substitute for gasoline would all fit into this concept because of the enormous consumer demand for such a product, the market protection provided by a patent, and the corresponding potential for enormous profitability. Similarly, a patented product that just happens to work better than others, or produces the same result with fewer side effects, may also qualify.

Id. at n.138.

34. *Id.* at 47.

35. H.R. REP. No. 426, *supra* note 23, at 423 states: "The committee is concerned that the provisions of sections 482 . . . may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations."

36. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-637 (1986) [hereinafter H.R. CONF. REP. No. 841].

37. See WEBSTER'S NEW COLLEGIATE DICTIONARY (1988) (defining "commensurate" as: 1) equal in measure or extent (coextensive); or 2) corresponding in size, extent, amount or degree (proportionate)).

38. Neither the statute nor its legislative history clarify the practical meaning of the word commensurate. The General Explanation states somewhat ambiguously that the "requirement

itself.[39] Concurrently, Congress directed the Commissioner to conduct a comprehensive study of intercompany pricing rules under the new language of the statute to consider whether existing regulations should be modified to reflect a concept of allocation based on actual economic activity.[40]

D. *Treasury's White Paper*

In response to Congress's request, the Internal Revenue Service published an in-depth study of intercompany pricing as a "discussion draft" on October 18, 1988.[41] The study, now known as the section 482 "White Paper," reexamines the theoretical basis of section 482, with particular emphasis on intangible property, and recommends new approaches for allocations under the amended statute.

The White Paper concludes that the "commensurate-with-income" language is equivalent to the arm's-length standard of the regulations and is therefore consistent with prior law.[42] This interpretation allows the Service to retain arm's-length prices as the correct measure of compensation for transfers of intangible property. When free market information is unavailable for comparable transfer prices, the study introduces a new approach which involves analyzing each component activity of the transferee's business and its economic contribution to the overall revenue earned.[43]

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is established to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each." *General Explanation, supra* note 20, at 1015. It gives no explanation, though, on how to achieve a reasonable reflection of economic activity. Several commentators have suggested that the phrase "commensurate with income" comes from Nestle Co. v. Commissioner, 22 T.C.M. (CCH) 46 (1963), where the court approved a royalty paid for the transfer of intangibles on the basis that it was "commensurate with the value of the benefits received" from them. *Id.* at 62; *see White Paper, supra* note 4, at 46 n.126 (quoting the *Nestles* case). For a discussion of how the Service interprets "commensurate," see *infra* notes 51-56 and accompanying text.

    39. The Tax Reform Act of 1986 states:

       (e) Treatment of Certain Royalty Payments —

         (1) In general. — Section 482 (relating to allocation of income and deductions among taxpayers) is amended by adding at the end thereof the following new sentence: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (1986).

    40. H.R. CONF. REP. No. 841, *supra* note 36, at II-638.

    41. *White Paper, supra* note 4.

    42. *Id.* at 52, 55.

    43. *See id.* at 47; *see also infra* text accompanying notes 51-56.

Instead of estimating the arm's-length transfer price by weighing the factors listed in the regulations, the White Paper's approach derives the price by isolating the contribution of the intangible to the overall income it helped produce for the transferee.[44] Thus, the income that the transferred intangible asset generated for the transferee becomes the focus of the section 482 analysis.[45] The BALRM is the analytical tool used to calculate such income and, correspondingly, the transfer price.[46] The White Paper gives several examples to demonstrate the application of the BALRM. Only one, Example 7,[47] illustrates the numerical calculations to obtain a transfer price.[48] This example has generated much controversy among practitioners because it imposes a 92.1% royalty on a foreign manufacturing affiliate as compensation for the transfer of the United States parent's intangible rights,[49] a result that commentators have found inconsistent with arm's-length free market expectations.

E. *Scope of Remaining Discussion*

The remainder of this article examines the BALRM as applied in the White Paper to achieve the objectives of the 1986 amendment to section 482. Then, it analyzes Example 7 and the way the judiciary would likely treat the same set of facts if the Service were to incorporate the BALRM in the regulations. Finally, this article proposes a solution for a more precise application of the method, consistent with the commensurate-with-income standard and the other objectives of the White Paper.

III. THE USE OF THE BALRM TO CALCULATE ARM'S-LENGTH TRANSFER PRICES

A. *General Description of the Method*

As mentioned above,[50] the White Paper concludes that the commensurate-with-income standard is consistent with the arm's-length principle[51] and, thus, is simply a clarification of prior law.[52] Therefore,

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44. *White Paper, supra* note 4, at 84.

45. *Id.* at 47.

46. *See id.* at 94; *see generally infra* text accompanying notes 51-72.

47. *White Paper, supra* note 4, app. E, at 7.

48. While purporting to describe the application of the BALRM, Example 5 does not use it in developing its numerical solution. *See id.* app. E, at 4-6.

49. *Id.* app. E, at 9.

50. *See supra* text accompanying notes 42-43.

51. *White Paper, supra* note 4, at 2, 52, 55.

52. *Id.* at 1, 46.

taxpayers must use, when available, comparable transfer prices from unrelated parties operating at arm's length to determine allocations of income in a related party setting.[53] Although not clearly in harmony with the legislative history of the 1986 amendment,[54] this conclusion[55] has generally been accepted by commentators and renders the new standard consistent with current regulations.[56]

Thus, the White Paper confirms the long standing position in the regulations[57] that actual data on comparable royalties are the best measure of an arm's-length transaction[58] and must be used when available.[59] It also recognizes, however, that the regulations have failed to produce results consistent with the arm's-length standard when comparables are unavailable.[60] For such cases, therefore, the White Paper introduces the BALRM, a new procedure to estimate the theoretical arm's-length transfer prices for a proper allocation of income under section 482's commensurate-with-income standard.[61]

According to the legislative history of section 482, the purpose of applying the commensurate-with-income standard to intercompany transfers of intangibles is to achieve "a division of income between related parties [that] reasonably reflect[s] the relative economic activities undertaken by each."[62] According to the Service, it is important to analyze the functions performed and the economic risks assumed by each party to the transaction, so that the "allocation of income from the use of the intangible will be made in accordance with the relative economic contributions and risks"[63] taken by each party. In the context of a simple license/royalty scenario, however, where the licensor performs no function and assumes no risk contributing to the licensee's income, only the economic activities of the subsidiary and the corresponding income are relevant for the application of the

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53. *Id.* at 2, 52.

54. The legislative history of the amendment does not address the issue. Arguably, one could read the history as criticizing the arm's-length approach for its ineffectiveness in view of the recurrent absence of comparable data. *See* H.R. REP. NO. 426, *supra* note 23, at 423-24.

55. Treas. Reg. §§ 1.482-2(d)(1)(i)-(ii) (as amended in 1988).

56. *See, e.g.,* Bischel, *White Paper Analysis: Ballroom Dancing with an Intangible,* 41 TAX NOTES (TAX ANALYSTS) 1097, 1098 (Dec. 5, 1988); Fuller, *The IRS Section 482 White Paper,* 41 TAX NOTES (TAX ANALYSTS) 655, 657 (Nov. 7, 1988).

57. *See* H.R. REP. NO. 426, *supra* note 23, at 423-24.

58. *White Paper, supra* note 4, at 52.

59. *Id.* at 2.

60. *Id.* at 52.

61. *Id.* at 87-109.

62. H.R. CONF. REP. NO. 841, *supra* note 36, at II-637.

63. *White Paper, supra* note 4, at 47.

BALRM. Therefore, this article focuses only on the subsidiary transferee.

The House Report states that the overall income earned in connection with the exploitation of the intangible property must be given primary weight in finding a commensurate-with-income transfer price.[64] The Service has interpreted this statement to mean that the taxpayer, in planning, or the Service, in auditing, must use such income as the starting point of the analysis.[65] In essence, by using the commensurate-with-income standard, instead of focusing on the transfer price paid to the transferor,[66] the BALRM achieves arm's-length results by estimating the revenue that the intangible produces in the hands of the transferee.[67]

In applying the BALRM to the basic situation considered in this article involving the transfer of patent rights by a parent to a subsidiary under a typical license/royalty arrangement, the subsidiary's business must be broken down into its component activities or functions. This analysis provides for easier identification of the assets and other measurable factors of income production that contribute to the subsidiary's total revenue.[68] Each function is then assigned a rate of return on assets based on comparable arm's-length returns.[69] Because a wide range of unrelated parties likely conduct activities involving measurable factors of income production, the valuing party can generally find and assign a market return consistent with the returns of unrelated parties to each of the functions identified in the business of the subsidiary and can calculate the corresponding income generated by those functions.[70] The residual income is then assigned to the intangible and used as the correct measure of its contribution to the overall income.[71] This portion of income itself is then taken to be the arm's-length value of the intangible transferred and it is used as the appropriate free market transfer price.[72]

For example, if a parent company transfers a patent to a subsidiary for use in the manufacturing of a specialized product, the arm's-length standard first looks for the royalty payment that two unrelated parties

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64. H.R. REP. NO. 426, *supra* note 23, at 426.
65. *White Paper, supra* note 4, at 47 (citing H.R. REP. NO. 426, *supra* note 23, at 426).
66. *See id.* at 84.
67. *Id.* at 47, 56.
68. *Id.* at 96.
69. *Id.* at 95-96.
70. *Id.* at 96.
71. *Id.*
72. *Id.* at 97.

would negotiate under the same circumstances.[73] If that information is unavailable, the BALRM's implementation of the commensurate-with-income standard then focuses on the total income earned by the subsidiary and apportions that income among each identifiable income-producing activity of the business as well as the exploitation of the patent. Since the only identifiable activity in this case is manufacturing, the BALRM allows an arm's-length return on manufacturing assets and provides for calculation of the corresponding income. The balance of the subsidiary's income is then allocated to the patent and taken as the appropriate royalty payment to the parent company for the transfer of the patent itself. The BALRM considers this royalty payment, or transfer price, commensurate with the income attributable to the transferred intangible. Presumably, such a royalty also coincides with the transfer price that an arm's-length negotiation would have produced.

B. *Example of Numerical Application of the BALRM*

Using the same basic example given above, involving the transfer of patented technology to a manufacturing subsidiary, assume that the subsidiary's operation is expected to generate revenues and total expenses (royalty payments excluded) of $10 and $7 million per year, respectively. Because the royalty payments by definition equal the product of revenues and the unknown royalty rate, R, the project's royalty payments are $10xR million. Assume further that the subsidiary's total investment in operating assets is $15 million.

Following the BALRM's procedure, one must identify each function in the subsidiary's operation and select a corresponding rate of return on assets from comparable data. Manufacturing is the only distinct function. Assuming that a survey of comparable manufacturing facilities, where no technology transfer is involved, shows that a 15% rate of return is the norm, that rate will be used to assign a return on the manufacturing assets as well. The ratio of net income to book value of the assets represents the rate of return on assets.[74] This ratio provides a means for calculating the net income that corresponds to the rate of return chosen for the subsidiary's assets. That is:

$$\text{Return on Assets} = \text{Net Income}$$
$$= 0.15 \times \$15 \text{ million}$$
$$= \$2.25 \text{ million.}$$

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73. *See supra* text accompanying notes 57-59.
74. *See* J. WESTON & E. BRIGHAM, ESSENTIALS OF MANAGERIAL FINANCE 85 (1982).

Thus, the operation's net income, based on a return of 15%, is fixed at $2.25 million.

One can also, however, express net income in terms of the difference between revenues and total expenses, as follows:

Net Income = Revenues − Expenses − Royalty Payments.

In this equation, after supplementing information from the example, only one unknown remains, the royalty rate (R):

$2.25 million = $10 million − $7 million − $10xR million.

Solving this equation for R yields a royalty rate 0.075, or 7.5%. In dollar terms, this means that the BALRM would allocate a royalty payment of $750,000 (0.075 x $10 million) to the parent company for the transfer of the patented technology used by the subsidiary. In effect, the method shifts back to the parent all income earned by the subsidiary that exceeds the return on manufacturing assets that comparable operations earn under free market conditions. The Service takes this amount to be the hypothetical arm's-length royalty that unrelated parties would have negotiated under the same circumstances.[75]

IV. THE WHITE PAPER'S APPLICATION OF THE BALRM

A. *Example 7*

The White Paper discusses the application of the arm's-length return method to commonly encountered factual situations.[76] Unfortunately, only two examples deal with actual numerical illustrations and one of them, Example 5, on close scrutiny does not in fact apply the BALRM.[77] Therefore, Example 7 is the only complete numerical illustration of the BALRM's application. In Example 7, a United States corporation transfers intangible rights to a foreign subsidiary established in a low labor cost country to manufacture a unique, highly profitable drug for sale back to the parent.[78] The example seeks the

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75. *See supra* text accompanying notes 68-72.

76. *See White Paper, supra* note 4, app. E.

77. Instead, it uses the Berry Ratio Method, based on the ratio of income to expenses. This method is discussed later in the article. *See infra* text accompanying notes 141-49. The process is termed the "Berry Ratio" because Dr. Charles Berry has used the method in expert testimony in cases concerning § 482 allocations resulting from transfers of intangibles. *See White Paper, supra* note 4, at 97.

78. *White Paper, supra* note 4, app. E, at 7.

appropriate royalty that the subsidiary should pay to the parent for a section 482 allocation of income between the two entities.

The example assumes annual revenues of $2,970 million, operating expenses of $190 million plus an unknown royalty payment, and an initial capital investment of $360 million for plant assets.[79] No comparable transfer prices are available.[80] The example finds that a sample of comparable manufacturers operating at arm's length in locations with low labor costs earn a 12% average rate of return on their manufacturing assets.[81] Consequently, the example applies this rate to the subsidiary's plant assets of $360 million to calculate the return on assets and corresponding net income, as follows:

$$
\begin{aligned}
\text{Return on Assets} &= \text{Net Income} \\
&= 0.12 \times \$360 \text{ million} \\
&= \$43.2 \text{ million.}[82]
\end{aligned}
$$

Then, because the net income from the operation also equals total revenues ($2,970 million)[83] minus total operating expenses ($190 million) and minus royalty payments ($2,970xR million, the product of revenues and the royalty rate R), the following equation results:

$$
\$43.2 \text{ million} = \$2,970 \text{ million} - \$190 \text{ million} - \$2,970\text{xR}
$$
million.

Solving for R, the procedure yields a royalty rate of 92.1%.[84] Thus, Example 7 indicates that the subsidiary should pay a royalty of $2,735 million (0.921 x $2,970 million) out of total revenues of $2,970 million.

A 92.1% royalty seems facially inconsistent with arm's-length results because such a royalty would allow only 7.9% (100 - 92.1) of revenues to cover all other expenses and a profit margin. In reality, no business could afford the risk of operating under such inflexible terms, with no room for contingencies such as strikes or unusual cost increases. For these reasons, the example's result has been criticized.[85]

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79. *See id.*

80. *See id* at 8.

81. *Id.*

82. *See id.*

83. *See id.* The example includes $1 million in interest revenue that is neglected here for simplicity of calculation. This revenue has no significant effect on the analysis and is therefore omitted.

84. *See id.* at 9.

85. *See, e.g.,* Sheppard, *The Allocation of Location Savings Under Section 482*, 42 Tax Notes (Tax Analysts) 19 (Jan. 2, 1989). The White Paper is "infamous" among practitioners because of the 92% royalty example.

The White Paper itself recognizes that such a "super royalty" appears to be unsupported by free market conditions,[86] but it goes on to say that this royalty may nevertheless be necessary to achieve a proper allocation of income, from "an economic perspective," under the commensurate-with-income standard.[87]

However, because objective information derived from the market place fails to support Example 7's result, the imposition of such a super royalty seems to run contrary to the stated policy that tax rules should not distort business decisions made in an arm's-length environment.[88] Therefore, an alternative method of calculation is needed.

B. *Observers' Criticisms of Example 7*

As stated above, the result from the application of the BALRM to the facts of Example 7 has drawn extensive criticism from commentators.[89] At least one scholar has seen it as a regulatory attempt to impose the "contract manufacturer" method of income allocation to all foreign manufacturing subsidiaries.[90] The contract manufacturer method allows the foreign affiliate only a local market rate of return for its production activities, resulting in a shift of the entire balance of the affiliate's income back to the U.S. parent.[91]

Courts have uniformly rejected the contract manufacturer method,[92] and both the legislative history of section 482[93] and the White Paper itself[94] state that the commensurate-with-income standard is not intended to mandate contract manufacturer treatment. Therefore, to the extent that the BALRM will unavoidably reach such a result (because it allocates all residual income to the parent in payment for the transfer of the intangibles), the criticism is justified.

Another common comment on the BALRM, as applied in Example 7, is that the method denies a U.S. parent location savings that result from choosing to manufacture its product in a less expensive environment.[95] That is, by shifting all residual income back to the parent, the BALRM automatically reallocates any such savings from the sub-

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86. *White Paper, supra* note 4, at 51.
87. *Id.*
88. *Id.* at 82.
89. *See, e.g.*, Sheppard, *supra* note 85.
90. Fuller, *supra* note 56, at 659.
91. Sheppard, *supra* note 85, at 20.
92. *See* Fuller, *supra* note 56, at 660.
93. H.R. REP. No. 426, *supra* note 23, at 426.
94. *White Paper, supra* note 4, at 48, 54.
95. Sheppard, *supra* note 85, at 19.

sidiary back to the parent company. This result is contrary to explicit judicial approval of the apportionment of location savings between affiliates[96] and to the Service's stated position that location savings should be split as if between unrelated parties[97] and on the same bases that would result from an arm's-length transaction.[98] Again, this is a problem with the BALRM that the Service will have to address if the method is to be incorporated in the regulations and used by the courts.

Another commentator has criticized the BALRM because it denies a foreign subsidiary recognition of the risks involved in setting up a separate manufacturing operation.[99] Both the Service and the courts have accepted risk as a proper reason for apportionment of income under section 482.[100] One might argue that allowing a return on the assets invested would properly compensate for this kind of risk. However, the risks faced by a subsidiary in a foreign, often volatile, environment are not the same as the risks of local investors in the same line of business. Therefore, local-market comparables do not represent the true business risks involved and should not be used when valuing intangibles transferred to a foreign subsidiary.

V.   RECENT JUDICIAL APPROACH TO MANUFACTURING SUBSIDIARY CASE: THE BEST JUDGMENT PROFIT SPLIT APPROACH

When information on comparable transfer prices is unavailable, the Service has advocated using the rate-of-return-on-assets concept as the basis of a method for dividing income between parent and its manufacturing subsidiary in section 482 court allocations.[101] But the courts have refused to accept the procedure as an appropriate method by itself. Rather, they have used it in conjunction with other criteria as one of the factors prescribed in the regulations.[102] In effect, instead

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96.   Eli Lilly & Co. v. Commissioner, 856 F.2d 855, 871 (7th Cir. 1988). For a discussion of *Lilly*, see *infra* text accompanying notes 103-11.

97.   *See* Sheppard, *supra* note 85, at 20 (quoting IRS associate chief counsel: "Our basic position is that location savings ought to be allocated as if they were being split between unrelated parties, who would be expected to send some of them back to the U.S.").

98.   *White Paper*, *supra* note 4, at 102.

99.   Bischel, *supra* note 56, at 1098, 1102.

100.   *See, e.g.*, Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973), *acq.*, 1974-2 C.B. 2; *see also* Sheppard, *supra* note 85, at 21 (discussing *Ross Glove* and the White Paper's recognition of risk as a factor in setting transfer prices).

101.   Fuller, *supra* note 56, at 656.

102.   *See infra* notes 103-23 and accompanying text.

of using a fixed procedure, the courts have repeatedly allocated the revenues attributable to intangibles by an ad hoc profit split between the related entities based on the facts and circumstances of each case.

In *Eli Lilly & Co. v. Commissioner*,[103] one of the leading cases dealing with transfer prices of intangibles, the U.S. parent corporation transferred patent rights and know-how for the manufacture of highly profitable drugs to its Puerto Rico subsidiary in exchange for the subsidiary's stock.[104] The Seventh Circuit agreed with the Tax Court that the subsidiary should allocate some of its income to the parent as a royalty payment under section 482.[105] The court, however, was unable to find comparable arm's-length information for similar transfers to apply to the case.[106] The court also rejected application of the regulations' parallel guidelines for the transfer of tangible property.[107]

Instead, the court estimated the revenues that the patent and know-how generated by assigning returns to the tangible assets of the subsidiary and subtracting them from total revenues.[108] The court attributed the remaining balance to the intangibles.[109] Then the court weighed the factors listed in the regulations for treatment of intangibles to arrive at a forty-five/fifty-five split of the estimated intangible revenues between parent and affiliate.[110] Thus, the court artificially created a royalty by allocating a portion of the subsidiary's revenue back to the parent. The Seventh Circuit noticed that the Tax Court did not reach this result on the basis of any articulated methodology, but from a general evaluation of all data received from the Tax Court's "extensive exposure to the testimony at trial and the voluminous documentary record in the case."[111]

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103. 856 F.2d 855 (7th Cir. 1988).

104. *Id.* at 857-58.

105. *See id.* at 859-60.

106. *See id.* at 869-70.

107. *Id.* at 870; Treas. Reg. § 1.482-2(e) (as amended in 1988).

108. *Id.* at 871 (the court labeled this method a profit split).

109. *Id.*

110. *Id.*

111. *Id.* at 872. In supporting the Tax Court's rationale in arriving at the 45-55 profit split, the court said:

> Allocations of combined revenues under the profit split method are inherently imprecise. No unassailably precise methodology exists for determining normal profit rates on marketing expenses or the relative contributions of manufacturing and marketing intangibles. These judgments must rely largely on *intuitions* informed by an understanding of the business in which the affiliated companies are engaged.

Id. (emphasis supplied).

The Tax Court followed the same approach in *G.D. Searle & Co. v. Commissioner*,[112] a case also involving the transfer of highly profitable manufacturing patents and know-how to a Puerto Rico subsidiary in exchange for stock.[113] The court rejected the comparable data used by the company in valuing the transfer of the intangibles[114] and, likewise, refused to apply the contract manufacturer approach promoted by the Commissioner.[115] Instead, the court recognized the subsidiary as a separate business entity, entitled to a return on its intangible assets during the years in issue.[116] The court allowed a return on the tangible assets of the subsidiary and identified the balance as income attributable to the intangibles.[117] In allocating a portion of this income to the parent under section 482, the court again used its "best judgment based on a consideration of the entire record . . . and mindful of the factors . . ." set forth in the regulations.[118]

The most recent case applying this judicial approach is *Bausch & Lomb Inc. & Consolidate Subsidiaries v. Commissioner*.[119] This case dealt with the transfer of manufacturing technology to an Irish subsidiary of Bausch & Lomb, a world leader in the production of optical lenses. The parties set a royalty of 5% as consideration for the transfer.[120] After an extensive review of the economics of the transaction and of the expert testimony presented by both sides, the court arrived at a royalty of 20% based on what it considered an appropriate split of the subsidiary's profits.[121] In the final analysis, the court again based the decision on its "best judgment" as to what an arm's-length transaction would have produced.[122]

In all cases addressing this issue, the courts have attempted to approximate the result of an arm's-length negotiation between unrelated parties.[123] Courts continue to utilize this method under the com-

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112. *Id.* The Seventh Circuit affirmed the Tax Court's decision except for its allocation of research and development from the Puerto Rican subsidiary to the U.S. parent corporation. *Id.* at 873.
113. *See id.* at 372.
114. *See id.* at 374-75.
115. *See id.* at 367.
116. *See id.* at 366-67.
117. *See id.* at 376.
118. *Id.* at 376.
119. 92 T.C. No. 33 (CCH) Dec. 45,547 (Mar. 23, 1989).
120. *Id.* at 2864.
121. *Id.* at 2887-90.
122. *Id.* at 302, 306.
123. *See* Ciba-Geigy Corp. v. Commissioner, 85 T.C. 172, 221 (1985), *acq.*, 1987-2 C.B. 1 (critical inquiry in determining royalty for transfer of intangibles to a subsidiary is "whether the transaction in question would have been similarly effected by unrelated parties dealing at arm's length"); *Searle*, 88 T.C. at 369; *Bausch & Lomb*, 92 T.C. No. 8, at 306.

mensurate-with-income standard. To the extent that the BALRM pro-
duces results that arguably contradict arm's-length expectations, such
as in Example 7, one might question whether the courts will apply it.
This inconsistency may lead a court to hold that the BALRM method
does not comport with section 482's commensurate-with-income re-
quirement. These courts would continue to use a profit split method
based on their best judgment and ignore the BALRM as presently
applied.

<h2 style="text-align:center">VI. COMMENTATORS' ANALYSIS OF THE BALRM AND
PROPOSED SOLUTIONS</h2>

A. Analysis of the Method as Applied in the White Paper

From a theoretical point of view, commentators have criticized the
BALRM because it relies on "normal" rates of return found in compar-
able industries for the economic functions performed by the affiliate.
When the method is applied to the transfer of high profit intangibles,
an uncommon situation, such normal rates are almost by definition
inapplicable and necessarily produce meaningless results.[124] In *Bausch
& Lomb*, for example, the court allocated income to the parent on the
basis of a 20% royalty,[125] the hypothetical arm's-length result. This
royalty translated into a return on the subsidiary's assets of 27%,[126]
which the court found to be appropriate even though normal rates of
return for the industry averaged approximately 15%.[127] Obviously, a
BALRM royalty based on 15%, a normal rate of return, would differ
from the result in *Bausch & Lomb*. The royalty would be substantially
higher because the BALRM would allow less return to the subsidiary
and shift more income to the parent. In this situation, the BALRM
produces a meaningless result in that the royalty does not reflect any
of the subsidiary's entitlement to the high profitability of the intangi-
ble.

Similarly, one scholar has criticized the BALRM's use of industry
"averages" in deriving rates of return as being inconsistent with the
concept of an arm's-length environment.[128] Such an environment should
produce higher or lower returns depending on the efficiency of the

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124. *See* Stoffregen, Higinbotham, Asper & Wexler, *The BALRM Approach to Transfer
Pricing: One Step Forward, Two Steps Back*, 42 TAX NOTES (TAX ANALYSTS) 1257, 1259
(Mar. 6, 1989) [hereinafter Stoffregen, *One Step Forward*].
125. *Bausch & Lomb*, 92 T.C. No. 8, at 298.
126. *Id.*
127. *See* A. HIRT & S. BLOCK, FUNDAMENTALS OF INVESTMENT MANAGEMENT (1986).
128. Bischel, *supra* note 56, at 1102-03.

particular operation.[129] Example 7, which applies a 12% average rate of return on assets to a highly sophisticated and efficient manufacturer, produces an unreasonably high royalty in order to balance the net income equation. The result achieved in Example 7 confirms the validity of this scholar's comment.[130] Note, however, that this criticism is practically indistinguishable from the one above, concerning "normal" rates of return. In both cases, normal or average rates are inappropriate for use in estimating hypothetical transfer prices for extraordinary, high profit intangibles.[131]

The same commentator has also criticized the BALRM for using a return on assets which accounts only for the year in which the allocation is made, instead of the return realized over the life of the project,[132] as Congress suggested in the legislative history of the 1986 amendment.[133] As applied, the method is likely to distort the economics of the venture and, therefore, produce unrepresentative arm's-length results. For example, a project could be highly profitable for a short period of time and then quickly dwindle to a break-even condition. Such is often the case with high technology products that rapidly are supplanted by new developments. Under these circumstances, a fixed return on assets that might be appropriate during the early years of the operation would not reflect true economic conditions over the life of the venture and, therefore, would fail to produce the desired hypothetical arm's-length result.

B. *Commentators' Proposed Solutions*

Commentators have suggested several approaches for remedying these problems. Instead of the rate-of-return-on-assets method, one proposed procedure[134] would use the "resale price" or the "cost plus" methods that the regulations currently prescribe for the transfer of tangible property in the absence of independent comparable data.[135]

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129. *Id.*

130. This result is also contrary to the legislative history of the 1986 amendment to section 482. *See* H.R. REP. No. 426, *supra* note 23, at 425 ("Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms.").

131. Notice that the two criticisms are indeed separate and distinct from an analytical point of view, but cannot be separated in practice searching for one rate of return that accounts quantitatively for both factors.

132. Bischell, *supra* note 56, at 1102-03.

133. H.R. REP. No. 426, *supra* note 23, at 425.

134. *See* Stoffregen, *One Step Forward, supra* note 124, at 1259.

135. Treas. Reg. § 1.482-2(e) (as amended in 1988).

Under these methods, the valuing party calculates the appropriate net income allowable to the subsidiary by equating it to a certain percentage of sales or costs, as applicable. The balance of the subsidiary's actual net income is then allocated to the parent as the intangible's arm's-length transfer price according to the same procedure followed by the BALRM.

Applying the cost-plus method, for example, instead of a free market return on assets, we would search for a free market net income to total costs ratio (gross profit percentage) from comparable manufacturing businesses. Using again the same basic facts from the example above for illustration,[136] assume the comparable gross profit percentage to be 10% of total costs. We would then apply that percentage to the subsidiary's costs[137] ($7 million expenses plus $10xR million royalty) to calculate net income, as follows:

$$\text{Net Income} = \text{Gross Profit Percentage x Total Costs}$$
$$= 0.10 \text{ x (\$7 million} + \text{\$10xR million}).$$

From this point, the procedure mirrors the BALRM. By equating net income to the difference between revenues ($10 million) and all expenses ($7 million plus $10xR million), a new equation results allowing determination of the royalty rate, R:

$$0.10 \text{ x (\$7 million} + \text{\$10xR million)} =$$
$$= \text{\$10 million} - \text{\$7 million} - \text{\$10xR million}.$$

By solving this equation, R = 0.209, or 20.9%.[138] Thus, the appropriate section 482 allocation under this method would be a royalty payment of $2.09 million (0.209 x $10 million) to the parent company.

This approach supposedly provides the advantage of relying on operating information directly available from the manufacturing subsidiary.[139] But one could make the same claim about the BALRM. The only information not directly available for the cost plus method is the gross profit percentage. The rate of return on assets is the only information one must derive from other sources for the BALRM. Otherwise, both procedures use data obtained directly from operations.

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136. *See supra* text accompanying notes 73-75.

137. *Id.*

138. Note that to obtain the same royalty of 7.5% that the BALRM produced, a gross profit margin of 29.03% would have to be used in the cost plus method. Thus, in theory a 29.03% gross profit and a 15% return on assets would correspond to the same free market economic environment and produce the same arm's-length royalty of 7.5%.

139. Stoffregen, *One Step Forward, supra* note 124, at 1259.

Proponents view this method as a good yardstick of its own validity. They say the unavailability of independent comparables for gross profit percentages should be taken as an indication of economic imbalances that would make the method's use inappropriate and lead to distorted results.[140] That would seem likely to occur in extraordinary cases, such as ones involving high profit intangibles, presumably leaving the profit-split method as the alternative left for section 482 allocations.[141]

In other words, this approach seems to have all the advantages (simplicity and use of comparables when available) and all the disadvantages (use of normal, average data and no recognition of location savings and special risks) of the standard BALRM. Therefore, it is difficult to see how this method would improve on the BALRM.

Another proposed approach is the Berry Ratio method.[142] This method uses comparable ratios of income to expenses to allocate net income to the manufacturing subsidiary. For illustrative purposes, assume that a survey of comparable businesses showed an average income to expenses ratio of 1.08. Applying this ratio to the factual situation set forth above, yields the following equation:

$$1.08 = \text{Income/Expenses}$$
$$= \frac{\$10\,\text{million}}{\$7\,\text{million} + \$10\text{xR million}}.$$

One could now solve this equation for R to calculate the royalty rate that corresponds to a Berry Ratio of 1.08. This royalty rate turns out to be 0.226, or 22.6%, resulting in a royalty payment of $2.26 million (0.226 x $10 million).

The White Paper endorses this method in cases when assets are difficult to measure consistently or when the relationship between income and costs is more stable or easier to measure than that between income and assets.[143] Again, however, this method simply substitutes an average arm's-length ratio of income to expenses for an average arm's-length rate of return on assets. It does not address the fundamental problem of the BALRM. The Berry Ratio method still allocates to the parent company all income earned by the subsidiary that is not directly traceable to identifiable operating functions.

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140. *See id.*

141. *Id.* The authors do no explicitly suggest what in their opinion would be an acceptable solution in cases where independent comparables are unavailable.

142. *See supra* text accompanying notes 76-88. This method was applied in E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 455 U.S. 962 (1980). *See also supra* note 77 (discussing the derivation of the term "Berry Ratio").

143. *See White Paper, supra* note 4, at 97.

Finally, one author suggests that an appropriate measure of the arm's-length consideration for the transfer of intangibles could be the cost of producing the intangible itself; that cost would include all relevant actual expenses incurred to develop and maintain the intangible asset.[144] Assume, for instance, that the total development costs of the technology transferred to the subsidiary in the example laid out above were $3 million. This method would set the lump sum transfer price paid to the parent company at $3 million, so that a section 482 allocation of income would occur only once as a purchase price ($3 million), instead of annually through royalty payments. Because this method would base the allocation on a hypothetical arm's-length transfer price under the circumstances, the character of the actual transaction between the parties (license, purchase, or transfer for stock) would be irrelevant and disregarded for section 482 purposes.

In this simple form, the method would skew the actual economics of a venture by front loading the section 482 income allocation to the beginning of the project, a time when income may be insufficient to pay for the transfer of the intangible. Thus, an allocation may not be possible at that time. Spreading the transfer price payment, and therefore the section 482 allocation, over a period of years could alleviate this problem, but only at the expense of adding complexity to the method. Most importantly, however, the allocations reached by this method are senseless in cases involving high profit intangibles. Because of the extraordinarily high revenues generated in relation to development costs, the method by definition would result in an inadequately low transfer price, certainly not "commensurate" with income. As a result, this method would allocate an excessive portion of the income to the subsidiary. Therefore, it does not provide a useful procedure for section 482 allocations.

VII. INTANGIBLE ASSETS: DON'T THEY DESERVE A RETURN?

A. *Intended Purpose of the BALRM*

Summarizing the most significant points of this article, it is clear that Congress expressly mandated a study of intercompany transfer prices to develop regulations with specific objective standards for taxpayers to follow in estimating arm's-length transfer prices.[145] Similarly, commentators have called for guidelines that extend beyond the twelve

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144. Stoffregen, *One Step Forward, supra* note 124, at 1261.
145. *See* H.R. CONF. REP. No. 841, *supra* note 36, at II-638.

factors now listed in the regulations.[146] The BALRM is part of the Internal Revenue Service's response to correct regulatory deficiencies that have long caused significant problems for courts, the Service, and taxpayers alike.[147]

The Service, in auditing, would find the BALRM very useful if it could apply it so as to obtain realistic arm's-length results through accepted objective standards. The courts would probably welcome the method as well, inasmuch as it would free them from the "best judgment" profit split exercise that to which they ultimately have resorted in deciding cases for lack of more specific guidance. However, as it currently exists, the BALRM does not achieve realistic results. Thus, if the method is to serve as a useful evaluative tool, it must be modified.

B. *Proposed Modifications to the BALRM*

1. Use of Internal Rate of Return

As explained above within the context of the illustrative example, the BALRM uses rates of return on the subsidiary's assets.[148] That is, one assigns each asset a certain income for the year in question based on a percentage rate of return obtained from arm's-length comparable operations. While relatively simple, this approach only looks at one year at a time and neglects information concerning other project years. Information concerning future revenue is very relevant for a more precise and valid rate of return analysis. This deficiency is particularly noteworthy in view of the legislative history of the 1986 amendment of section 482, which requires an inquiry that looks beyond the facts and circumstances at the time of the transfer.[149]

As an alternative, the use of the "internal" rate of return,[150] which measures the earnings from the investment over the life of the project,

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146. *See, e.g.*, Bischel, *supra* note 99, at 1102.

147. *White Paper, supra* note 4, at 87-108.

148. For a discussion of BALRM, see *supra* text accompanying notes 51-56.

149. H.R. REP. No. 426, *supra* note 23, at 425-26. The report states:

> The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer. Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible.

150. E. BRIGHAM & L. GAPENSKI, FINANCIAL MANAGEMENT THEORY AND PRACTICE 272 (1988). The internal rate of return is defined as the discount rate that equates the present value of the expected future cash flows, or receipts, to the initial cost of the project. Mathematically, this translates into the following formula:

would be more appropriate and precise. The internal rate of return is the discount factor that equates the present value of expected cash flows from the project to the initial investment. For instance, assume in the basic example set forth above that cash flows of $2 million per year are forecast for a period of ten years. The internal rate of return is the factor that, when applied to calculate the present value of each annual $2 million cash flow, will result in an aggregate value of $15 million, the initial investment in the project. Given the illustrative numbers, the factor equals 0.0561. Thus, discounting each cash flow by the project's internal rate of return of 5.61% results in the following cash flow stream reduced to present value:

Project Year	Cash Flow (million $)	Present Value of Cash Flow (million $)
1	2	1.89
2	2	1.79
3	2	1.70
4	2	1.61
5	2	1.52
6	2	1.44
7	2	1.36
8	2	1.29
9	2	1.23
10	2	1.17

Total = $15.00 million

Because one calculates the internal rate of return by looking at data from each year of operation (cash flows), it more accurately represents a true "return" over the life of the investment.[151]

Moreover, the internal rate of return has become the prevalent method that businesses use for investment decisions because it mea-

$$\frac{CF_1}{(1+IRR)^1} + \frac{CF_2}{(1+IRR)^2} + ... + \frac{CF_n}{(1+IRR)^n} - C = 0$$

where IRR is the internal rate of return; C is the initial cost of the project; and CF_1, CF_2, . . ., and CF_n are the expected cash flows from the project.

151. In Bausch & Lomb, Inc. v. Commissioner, 92 T.C. No. 33 (CCH) Dec. 45,547 (Mar. 23, 1989), the court recognized the relevance of the internal rate of return of the project for a proper section 482 allocation of income. After using a best-judgment approach to find a hypothetical arm's length royalty, the court tested its appropriateness by calculating the corresponding internal rate of return of the project to confirm its commercial viability and, therefore, the reasonableness of the royalty itself. *Id.* at 2877-90.

sures the point at which the expected return from a project exceeds the cost of capital invested.[152] To understand this, assume that the same subsidiary in the example above[153] had borrowed the $15 million initial investment from a bank at an interest rate of 5.61%, the same as the internal rate of return. The subsidiary could then use the $2 million cash flows that the investment generated to pay off the principal and interest from the loan, and the company would come out exactly even. Therefore, any amount by which the internal rate of return exceeds the cost of capital will represent an increase in the value of the company.

2. Return on the Intangible

In addition to the above, the most significant problem with the BALRM is that it denies the transferee affiliate a return on its investment in the intangible received from the parent (whether measured by a profit margin on the royalty paid or a return on its cost of acquisition). This in effect shifts all income derived from the intangible back to the parent under all circumstances. The law states that payments with respect to intangibles must be commensurate with the income attributable to the intangible itself. Nowhere in the text of the statute or in its legislative history, however, is "commensurate" with income equated to "all" income.[154]

The subsidiary should be entitled to the same return on the productive use of the intangible that an unrelated party investing in the intangible would expect to receive under the same circumstances. That is, the entity should earn a return on each of its functional activities, including the acquisition and exploitation of intangible rights. Therefore, the regulations should treat intangibles transferred to a subsidiary as another asset in the BALRM procedure, entitled to a return like all other tangible assets in the operation.

3. Summary

Successful implementation of this proposal would require the following modifications to the BALRM:

1. Selection of an internal rate of return, instead of a return on assets, from comparable free market data;

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152. *See* E. BRIGHAM & L. GAPENSKI, *supra* note 150, at 264.

153. *See* I.R.C. § 482 (1986).

154. However, one could interpret the word "commensurate" to mean "all" according to its dictionary definition. *See supra* note 37.

2.   Identification of the transferred intangible as an asset entitled to a return; and

3.   Solution of the BALRM to find the corresponding royalty according to the general procedure modified to reflect the points made above.

C. *Modified Application of the BALRM*

The method proposed in this article requires some procedural modifications to the standard BALRM illustrated in the White Paper.[155] Once the valuing party (either the Service or the taxpayer) chooses an appropriate internal rate of return from comparable arm's-length data, a determination of the hypothetical cost of the transferred intangible asset is necessary to apply the rate of return to that asset as well. Thus, an acceptable estimate must be found for the transfer price that the transferee would pay at arm's length for acquisition of the intangible. The cumulative royalty payments by a subsidiary to the parent required by a section 482 allocation over the useful life of the intangible asset appear to reasonably measure this cost.

For example, if a foreign affiliate using technology transferred by the U.S. parent under a license agreement were paying an arm's-length royalty during the useful life of the intangible, one could fairly view the sum of all payments made over the period as the subsidiary's investment in that asset.[156] Supposedly, the subsidiary could have purchased the technology with a lump sum payment financed with borrowed funds and then have repaid the loan on a schedule equal to the actual royalty payments. Viewed that way, the intangible asset could be valued reasonably and with a high degree of certainty by the tax planner or Service auditor as the sum of all such payments.

Returning to the basic example mentioned earlier in this article, assume that a section 482 allocation determines that a royalty of 7.5% of revenue is an arm's-length result under the circumstances. Because the venture would generate revenues of $10 million per year, the corresponding annual royalty payments are $750,000 (0.075 x $10 million). If the project has a ten-year life, the subsidiary's cumulative payments for the transferred technology will be $7.5 million (10 x $750,000). The party valuing the asset can thus accept this amount as a reasonable estimate of the intangible asset's cost to the subsidiary

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155. *See White Paper, supra* note 4, at 87.

156. I disregard the time value of money throughout this article for simplicity. By also disregarding inflation on revenues and expenditures, the effects of neglecting the time value of money is balanced out to a net negligible error.

and assign a return to that asset under the BALRM, as modified by this article.

In the course of applying the BALRM, we do not actually know the amount of these royalty payments because the hypothetical arm's-length royalty rate is unknown. In fact, such royalty rate is the variable that the BALRM seeks to determine. But one can nonetheless express these royalty payments as the product of project revenues ($10 million) times royalty rate (R) for the projected life of the venture (ten years). Thus, the cost of the intangible asset can be set at $100xR million (10 x $10xR million).

This approach requires an estimate of the expected useful life of the intangible asset to calculate the cumulative royalty payments over the life of the project. By setting the useful life equal to the recovery period for depreciation purposes of the tangible assets[157] acquired for its exploitation, a clear and rational number is readily available.[158] Though arbitrary, this choice is reasonable because the intangible's contribution to the production of income necessarily is tied to the underlying tangible assets used by the operation; without them, the business would cease to function and would generate no income. With no tangible assets, the intangible would no longer be useful. Therefore, the subsidiary would not pay a royalty beyond the useful life of the tangible assets used for the intangible's exploitation.

Additionally, the recovery period of tangible assets set by the Service is a completely objective input to the procedure, thus reducing the potential for manipulation and abuse. Therefore, by setting the cost of the intangible asset equal to the cumulative projected royalty payments (the hypothetical free market transfer price), one can express the cost in terms of the royalty itself. The BALRM is then applied in all other respects as illustrated in the White Paper.[159]

D. *Illustration of Application of the Modified BALRM*

The following example illustrates the mechanics of the application of the BALRM, as modified in the discussion above. Assume that a

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157. The recovery period of the intangible itself, while attractive from the point of view of consistency of analysis, is economically meaningless and practically unworkable because of the arbitrary useful lives set by law for some intangibles (for example, 17 years for patents and 50 years beyond the life of the author for copyrights), and the indefinite lives of other intangibles (goodwill). The recovery periods for tangible assets, on the other hand, better represent their actual useful lives.

158. Rev. Proc. 87-56, 1987-2 C.B. 674. This revenue procedure sets forth the class life and the corresponding recovery period of assets in general, as necessary to calculate the depreciation allowance available under I.R.C. § 168.

159. *White Paper, supra* note 4, at 94-99.

well-known foreign corporation is setting up an affiliate in the United States to import and market a new line of video games. These video games are expected to be highly profitable because of a new concept, not yet available in this country, that has proven remarkably successful in a comparable foreign test market. The parent company enjoys an excellent reputation in the United States and the subsidiary plans to exploit the trademark of the parent in marketing the product. The parties execute a license agreement. For purposes of section 482, the question is what an appropriate royalty payment by the subsidiary to the foreign parent would be for use of the parent's trademark.

Given the rapid evolution of the American public's taste in video games, the subsidiary expects that revenues from the new product line will peak during the second year of the project and become insignificant after year five. The following revenues and expenses (excluding depreciation[160]), and corresponding royalty payments and cash flows from operation are forecast (where R is the royalty rate sought), as follows:

(all numbers expressed in million $)

Project Year	1	2	3	4	5
a. Revenues from Sales	10	50	30	5	1
b. Operating and Other Expenses	8	30	20	2	1
c. Royalty	10xR	50xR	30xR	5xR	1xR
Cash Flow (a-b-c)	$\overline{2-10xR}$	$\overline{20-50xR}$	$\overline{10-30xR}$	$\overline{3-5xR}$	$\overline{-1xR}$

Assume further that the subsidiary, in setting up its operation, invests $5 million for its import function (warehousing equipment and central office) and $3 million for marketing (graphic arts equipment and branch offices). According to the Service's guidelines, the recovery period for these assets is seven years.[161] Thus, the cumulative royalty payments over the useful life of the trademark (set at seven years, which equals the recovery period of the corresponding tangible assets) are set to equal the hypothetical cost of the intangible asset used by the subsidiary, as follows:

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160. Because the modified BALRM uses cash flow information (*see supra* text accompanying note 151), depreciation expenses must be added to net income to obtain cash flows. Alternatively, one can obtain cash flows by subtracting expenses (excluding depreciation) from revenues.

161. *See* Rev. Proc. 87-56, 1987-2 C.B. 674, at 676, 679.

Cost of Intangible　= $(10xR + 50xR + 30xR + 5xR + 1xR) million

　　　　　　　　　　= $96xR million

Note that no royalty payments are assigned to years six and seven. This is because forecasted revenues are negligible for those periods.

Now all information necessary to estimate the project's total initial investment is available, including a cost for the intangible as well as for the tangible assets. The total investment, the sum of the import, marketing, and intangible assets, can thus be expressed in terms of the royalty rate R, as follows:

Total Investment = $5 million + $3 million + $96xR million
　　　　　　　　= $8 million + $96xR million.

Finally, because no comparable arm's-length royalty information is available (if it were, there would be no need to apply the BALRM), we must look for a comparable internal rate of return. Assume that a market search shows that unrelated parties performing similar importing and marketing functions normally earn an internal rate of return of 10%. Based on this information, 10% is an acceptable comparable internal rate of return on which the parent and subsidiary would structure an arm's-length royalty payment.

The market rate of return provides the final information necessary to apply the internal rate of return equation.[162] The result is an equation with only one unknown, the royalty rate R (all terms in million dollars):

$$\frac{2\text{-}10xR}{1.1} + \frac{20\text{-}50xR}{(1.1)^2} + \frac{10\text{-}30xR}{(1.1)^3} + \frac{3\text{-}5xR}{(1.1)^4} - \frac{R}{(1.1)^5} - (8 + 96xR) = 0$$

By solving for R,[163] one obtains a royalty rate of 11.51%. Thus, a royalty would be calculated based on 11.51% of revenues each year, resulting in payments of $1.151 million (0.1151 x $10 million), $5.755

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162. The necessary variables are cash flows, initial investment, and internal rate of return. *See* E. BRIGHAM & L. GAPENSKI, *supra* note 150.

163. The equation is solved by a straightforward application of algebraic principles, as follows:

$$\frac{2\text{-}10R}{1.1} + \frac{20\text{-}50R}{(1.1)^2} + \frac{10\text{-}30R}{(1.1)^3} + \frac{3\text{-}5R}{(1.1)^4} - \frac{R}{(1.1)^5} - (8 + 96R)$$

= 1.82-9.09R + 16.53-41.32R + 7.51-22.54R + 2.05-3.41R-0.62R-8-96R = 0.

Combining and solving for R yields:

19.91 − 172.98R = 0,

and

R = 19.91/172.98 = 0.1151, or 11.51%.

million (0.1151 x $50 million), $3.453 million (0.1151 x $30 million), $0.575 million (0.1151 x $5 million) and $0.115 million (0.1151 x $1 million) for years one through five, respectively. Given the economics of the project (reflected in the financial data) and the free market comparable internal rate of return of 10%, this result represents the corresponding arm's-length royalty rate that the subsidiary would pay for a proper section 482 allocation of income.

E. *Solution of Example 7 Under Proposed Procedure*

The facts of Example 7[164] aptly illustrate and test the reasonableness of the results of the proposed methodology. To review the basic facts,[165] the example deals with the transfer of intangibles under a royalty arrangement to a manufacturing subsidiary in a low cost country.[166] The subsidiary manufactures a highly profitable drug and sells it back to the parent company.[167] The example assumes annual revenues to the subsidiary of $2,970 million, operating expenses of $190 million plus the unknown royalty payment, and an initial capital investment of $360 million for plant assets.[168] To apply the method, the valuing party needs data concerning cash flows, total investment including an estimate for the cost of the intangible, and an arm's-length internal rate of return.

Given the nature of the tangible assets (pharmaceutical plant), the corresponding recovery period set by the Service is five years.[169] Assume a straight line depreciation for the project of $72 million, resulting from the $360 million initial investment (1/5 x $360 million = $72 million).[170] Again, the royalty is expressed as the product of revenues and the unknown royalty rate, R. In this example, the annual royalty payment is set at $2,970xR million. Now subtract the operating expenses ($190 million) and the royalty payments ($2,970xR million) from the revenues ($2,970 million) to obtain net income, as follows:

Net Income = $2,970 million − $190 million − $2,970xR million

= $2,780 million − $2,970xR million.

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164. *See White Paper, supra* note 4, app. E, at 7.

165. *See supra* text accompanying note 4.

166. *White Paper, supra* note 4, app. E, at 7.

167. *Id.*

168. *Id.* at 7-9.

169. Rev. Proc. 87-56, 1987-2 C.B. 674, 679-80.

170. The White Paper does not provide depreciation information in Example 7, but it would be available in real situations.

By adding depreciation ($72 million) to net income, one can obtain the annual cash flow:[171]

$$\text{Cash Flow} = \$2{,}780 \text{ million} - \$2{,}970 \text{xR million} + \$72 \text{ million}$$
$$= \$2{,}852 \text{ million} - \$2{,}970 \text{xR million}.$$

Now estimate the cost of the intangible by aggregating all of the royalty payments over the recovery period. That is, annual payments of $2,970xR million for five years:

$$\text{Cost of Intangible} = 5 \text{ x } \$2{,}970 \text{xR million}$$
$$= \$14{,}850 \text{xR million}.$$

By adding this cost to the company's tangible assets of $360 million, the hypothetical total initial investment:

$$\text{Total Investment} = \$360 \text{ million} + \$14{,}850 \text{xR million}.$$

Finally, the facts of Example 7 allow a return of 12% on manufacturing assets.[172] Assuming for purposes of illustration that the same percentage is also the appropriate arm's-length internal rate of return of the project,[173] we have all information necessary to apply the internal rate of return formula[174] as follows (all terms in million dollars):

$$\frac{2{,}852\text{-}2{,}970R}{1.12} + \frac{2{,}852\text{-}2{,}970R}{1.12^2} + \ldots + \frac{2{,}852\text{-}2{,}970R}{1.12^5}$$
$$- (360 + 14{,}850R) = 0.$$

Solving for R,[175] this equation yields a royalty rate of 38.82%.

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171. Cash flow is generally defined as net income plus depreciation. *See* E. BRIGHAM & L. GAPENSKI, *supra* note 150, at 48.

172. *See White Paper, supra* note 4, app. E, at 8.

173. This assumption is reasonable in view of the current value of the prime rate of major banks of 11%. *See* Wall St. J., Jun. 8, 1989, at C21, col. 1. If the intangible asset were purchased outright with funds entirely financed at 11% interest, an internal rate of return of at least that amount would be needed to service the loan. Therefore, such a return establishes a floor within the range of reasonable choices available for analysis. *See supra* text accompanying notes 150-52.

174. *See generally* E. BRIGHAM & L. GAPENSKI, *supra* note 150.

175. The equation is solved as follows:
$$\frac{2{,}852\text{-}2{,}970R}{1.12} + \frac{2{,}852\text{-}2{,}970R}{1.12^2} + \ldots + \frac{2{,}852\text{-}2{,}970R}{1.12^5} - (360 + 14{,}850R)$$
$= 2{,}546\text{-}2{,}651R + 2{,}274\text{-}2{,}367R + 2{,}030\text{-}2{,}114R + 1{,}813\text{-}1{,}887R + 1{,}618\text{-}1{,}685R\text{-}360\text{-}14{,}850R = 0.$
Combining and solving for R:
$9{,}921 - 25{,}554R = 0,$ and
$R = 0.3882,$ or 38.82 percent.

This rate is well within the range of typical arm's-length data from industry. For example, comparable royalties submitted into evidence in *Bausch & Lomb* ranged from a low of 3% (for trademarks and other marketing intangibles) to a high of 39% (for design, manufacturing and marketing intangibles together).[176]

Compare this rate of 38.82% to the 92.10% royalty obtained by the standard BALRM. Note also that 38.82%, which is relatively high within the typical range, reflects the high profit nature of the intangible, which in turn requires a higher than normal transfer price. That is exactly what we would expect from free market conditions.

F. *General Considerations*

As explained above in the context of the definition of internal rate of return,[177] a project will be economically viable only if its internal rate of return at least equals the cost of the capital invested. Any excess, which is normally called risk premium, will increase the value of the enterprise and make the venture more attractive.[178] For example, for a subsidiary operation that the business community perceives to be low risk and high profit, such as in Example 7,[179] an internal rate of return even marginally greater than the current cost of capital would be acceptable to an investor in an arm's-length transaction. For a riskier venture, however, such as one involving new technology or a product with questionable market potential, investors would require a higher premium before providing the capital necessary for the investment.

Thus, it is clear that cost of capital, project risks, and internal rate of return are closely interrelated quantities. This relationship is useful in further determining precise guidelines for section 482 allocations under this procedure. Assuming, for example, that the 12% internal rate of return used in Example 7 were the current cost of capital,[180] the valuing party would know that the corresponding royalty of 38.82% represented the economic breakeven transfer price for the project. If market information indicated that businesses would engage in similar ventures only if they could expect an average return at

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176. *See* Bausch & Lomb, Inc. v. Commissioner, 92 T.C. No. 33, at 299 (Mar. 23, 1989).

177. *See* E. BRIGHAM & L. GAPENSKI, *supra* note 150, at 194.

178. *Id.*

179. *See White Paper, supra* note 4, at 7. This type of venture is considered low risk because of the proven manufacturing technology transferred by the parent company. It is high profit because of the low labor costs and the potentially extraordinary market share of the product.

180. *See supra* note 173.

least eight percentage points above the cost of capital, we could then also say that a project rate of return of 20% (12+8=20) represented the minimum risk premium at which a business operating at arm's length would invest under the circumstances of Example 7. Thus, the correct internal rate of return for use in the modified BALRM procedure would be 20%. Solving the problem under the modified BALRM yields a royalty of 34.42%.

Because market information about the cost of money and financial performance of comparable businesses is readily available, one can reasonably target the appropriate internal rate of return within a narrow range of realistic choices. In fact, from a practical point of view, management bases all real world projects on internal rates of return that exceed the cost of capital by relatively small premiums.[181] At the limit, the regulations could even prescribe certain allowable risk premiums above the cost of capital based on fixed determinable standards, such as product novelty and country of operation. This additional complication would probably not be cost effective, but it would provide total objectivity in the application of the BALRM.

VIII. CONCLUSION

This discussion has shown that a modified form of the BALRM can be an effective method of calculating allocations under section 482 resulting from intercompany transfers of intangible assets. The proposed changes require the use of the internal rate of return, instead of the return on assets, and the treatment of the intangible as an additional asset invested in the venture. As shown above, the procedure is founded on sound economic principles and produces a transfer price that corresponds to a rate of return compatible with the same project economics information on which management bases actual business decisions. The procedure also is based on available and objective information, such as the recovery period of assets (found in the regulations) and actual project data (revenues, costs, and investment). The only piece of data left to the discretion of the taxpayer is the selection of an appropriate internal rate of return from comparable arm's-length operations, just as the standard BALRM requires the selection of a return on assets.

The procedure produces a royalty that is based on a hypothetical arm's-length internal rate of return. Therefore, according to the Service's interpretation of the term, the result also meets the commensu-

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181. *See* A. HIRT, *supra* note 127, at 14. Over the years, businesses have operated on risk premiums in the 2-to-10% range. *Id.*

rate-with-income standard of section 482. The method uses information from the period of the project's useful life, in conformity with congressional desire and in contrast with the standard BALRM, which only looks at the year in which the allocation occurs. Furthermore, because the proposed method allows a return to the intangible itself, only a portion of the "residual" income that an affiliate earns is allocated back to the related company (as opposed to the BALRM, which shifts all residual income back to the related company). This method avoids the contract manufacturer result that courts, commentators, and the Service all have criticized. It also allows the subsidiary a return for location savings and special business risks, all reflected in the selection of the appropriate rate of return. Finally, and perhaps most importantly, the procedure produces predictable and realistic transfer prices based on objective information; it also provides a clear methodology that eliminates the need for best judgment allocations.

In conclusion, this modified BALRM can be a very useful tool in administering the regulations under section 482. The procedure adds certainty to what has been a very arbitrary process, both administratively and judicially, and it greatly reduces the opportunity for taxpayer abuse. The method is consistent with the economic theory that the White Paper follows to meet the commensurate-with-income requirement of section 482. Therefore, it can be applied without conceptual changes in the Service's current approach to the problem. Finally, this procedure resolves the BALRM deficiencies revealed by commentators without unnecessarily complicating the calculations required in valuing intangible assets.