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Tax-Advantaged Transfer Pricing For Intellectual Property

Handling the transfer pricing of intellectual property is similar to election year coverage – the intellectual property attorney, the tax attorney, the accountant, and the economist all have opinions. However, unlike a democracy, the only opinion that matters is that of the IRS, which has written transfer pricing regulations encompassing 160 pages. Those regulations can appear intimidating, but also can offer a powerful tool to lower a multi-national's taxes.

What is Intellectual Property?

Although the IRS regulations provide a lengthy list of intellectual property ("IP") for tax purposes, IP can be divided among trade intangibles (*i.e.*, patents, trademarks, designs, models, etc.), marketing intangibles (*i.e.*, brands), and know how (*i.e.*, trade secrets). Transfer pricing professionals consider IP as anything not tangible that provides a return in excess of a routine return.

Example – SailCo, a Chicago based sail manufacturer, creates a new design for a sail from which both SailCo and its subsidiary in the British Virgin Islands ("BVISub") will manufacture and profit. Even though not patented, the design constitutes IP.

The Transfer Price is the Arm's Length Price

The principles of Internal Revenue Code section 482 require pricing intercompany transactions at arm's length. Intercompany transactions include, among many others, the transfer of rights to use IP (*i.e.*, a license for a royalty). The remainder of this article will focus on the tax impact of differentiating between the appropriate transfer pricing methodology for a royalty from licensing the IP and, in the alternative, the related parties entering a cost sharing arrangement that shares the ownership of the IP.

Example – SailCo has extensive research and development ("R&D") facilities in Chicago to create new products. SailCo desires to create a new super-sail for sailing both the Great Lakes and the Caribbean. SailCo can either incur all the R&D expenses at its Chicago facility and license the design to BVISub for a royalty or enter a cost sharing arrangement with BVISub.

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If SailCo decides to incur all the R&D expenses itself, SailCo will own the resulting IP and BVISub must pay SailCo a royalty, the amount of which will impact taxes in the United States, a high-tax jurisdiction. The IRS regulations specify the following methods for determining the royalty for IP:

- the comparable uncontrolled transaction method,
- the profit split methods, and
- the comparable profits method.

Under the comparable uncontrolled transaction ("CUT") method, the arm's length royalty is the royalty charged for comparable IP in transactions between unrelated parties. To be comparable, the IP must be used in connection with similar products or processes in the same general industry or market and must have similar profit potential. As a result, if SailCo could find a similar type of sail design that unrelated parties license under comparable circumstances and obtain the actual royalty rates, SailCo could use the CUT method. However, because SailCo would unlikely find similar IP that satisfies the high standard of comparability, the CUT method rarely works.

The two profit split methods have theoretical appeal, but can be difficult to apply. Under the comparable profit split method, the allocation of the combined profit between related parties is based on how unrelated parties engaging in similar activities allocate their combined profit. Under the residual profit split method, each related party earns a return for its routine contributions before splitting any residual profit based on the relative value of the IP that each party contributes. Although the comparable profit split method is impractical and rarely used, the residual profit split method is an emerging method.

SailCo will likely use the comparable profits method ("CPM") to determine the arm's length royalty. The CPM determines the royalty as the amount of the licensee's return in excess of the routine return (expressed as a range). More specifically, the CPM requires (1) finding companies comparable to the licensee, (2) constructing a range for the routine return, the middle 50% of the returns of the comparable companies, and (3) determining the royalty by the amount of the licensee's return in excess of the routine return.

Example – With the use of the super-sail design, the financial results of BVISub, the licensee, are as follows:

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Sales	$20 million
Cost of goods sold	($12 million)
Operating expenses	($ 2 million)
Operating profit	$ 4 million 20% return on sales

A search results in eight sporting goods companies in the Caribbean for which the routine return on sales is a range of 7% to 15%. BVISub's higher return on sales of 20% is attributable to BVISub's use of SailCo's IP. As a result, to report a return on sales that is within the range of 7% to 15%, BVISub should pay a royalty of its excess return in an amount that provides the opportunity to place the income in the most tax-advantaged jurisdiction to SailCo. This royalty could be a percent of sales anywhere SailCo chooses between 13% and 5% (BVISub's 20% the 7% low end of the range = a 13% royalty and BVISub's 20% the 15% high end of the range = a 5% royalty). If BVISub's return is not above the range, then a royalty to SailCo is inappropriate.

In lieu of later receiving a royalty for the resulting design from its R&D expenses, SailCo can enter a cost sharing arrangement with BVISub. A cost sharing arrangement is a written agreement between related parties that provides for the sharing of the costs of developing IP that may result. More specifically, the costs are shared in proportion to the reasonably anticipated benefits based on measures such as units sold, sales, or profit. If a party's share of costs is inconsistent with its share of the reasonably anticipated benefits, a balancing payment may be required between the parties to adjust their respective costs.

Example – SailCo anticipates spending $1 million this year on R&D for a super-sail design. SailCo reasonably anticipates that 40% of the market for the super-sail will be in the Caribbean. If SailCo enters a cost sharing arrangement with BVISub, SailCo should charge BVISub $400,000 (the 40% anticipated share of the market x the $1 million of R&D expenses). Accordingly, BVISub would own the Caribbean rights to the super-sail design and not have to pay a royalty for its future use.

SailCo will want to balance the tax impact of currently reducing its deductible expenses under a cost sharing arrangement verses incurring all the deductible expenses and later receiving a royalty.

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If one party to the cost sharing arrangement brings pre-existing IP to the cost sharing arrangement, the other party will have to make a buy in payment (a.k.a. a platform contribution). The amount of a buy in payment is currently a hotly contested IRS audit issue.

Defending Transfer Pricing Practices

When the IRS makes a transfer pricing adjustment of $5 million or more or determines that an intercompany price is either less than half of or more than twice the actual arm's length price, the IRS will impose a penalty equal to 20% of the additional tax. The only way to avoid the penalty is to contemporaneously document the transfer pricing practices by the due date of the tax return. The documentation must provide a business description, a thorough analysis of the intercompany transactions, a detailed functional analysis of the related parties, a review of the transfer pricing methods resulting in the method chosen, and an economic analysis showing the arm's length nature of the transfer pricing. This documentation not only protects the taxpayer from a penalty, but should justify the planning and often persuades the IRS that a transfer pricing adjustment is unnecessary.

To obtain certainty that there will not be a transfer pricing adjustment from an IRS audit, a taxpayer may seek an advance pricing agreement ("APA") with the IRS. In an APA, SailCo and the IRS would agree to an arm's length royalty for the next five years. Although SailCo may be leery about providing information about its operations to the IRS without an audit, the APA's pre filing procedure permits a taxpayer's attorney to engage in a pre filing conference on a no name basis with the IRS to gauge the reaction of the IRS toward entering an APA.

Although multi-nationals may view the maze of IRS regulations with respect to the transfer pricing of IP as complex, they should consider taking advantage of them to save taxes. First, the multi-national must identify the IP. Second, the multi-national has to determine whether one party will incur all the development costs and license the IP to the other party or whether the parties will enter a cost sharing arrangement. Third, and finally, the multi-national will have to plan the proper defense for its planning through the use of either contemporaneous documentation or an APA.

Robert J. Misey, Jr. may be reached by phone at either (312) 875-9447 or (414) 298-8135 or via email at rmisey@reinhartlaw.com.

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