CAN THE ARM'S LENGTH STANDARD BEAT THE R.A.P.? TRANSFER PRICING AFTER THE T.C.J.A.

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By certain measures, December 21 and December 23 were comparable days for the arm's length standard. The law was not changed on either day, but December 22, when the Tax Cuts and Jobs Act ("T.C.J.A.") became law, was an outlier. On that day, the T.C.J.A. introduced a number of measures that reverse the decisions in *Veritas*[1] and *Amazon*.[2]

In those cases, the arm's length standard and the Code §936(h)(3)(B) definition of intangible assets prevailed against enterprise valuation or aggregate approaches to pricing cost sharing buy-in payments. Now, mechanical rules seem to have been adopted for pricing often-controversial controlled transactions involving intangible assets and loans. The arm's length standard has been challenged, like its O.E.C.D. cousin the arm's length principle at the hand of the G-20 B.E.P.S. Project.

Where *Amazon* and *Veritas* held that the definition of an intangible asset was specific, the T.C.J.A. broadens the Code §936(h)(3)(B) definition to include goodwill (both foreign and domestic), going concern value, workforce in place, and "any other item the value or potential value of which is not attributable to tangible property or the services of any individual." Where the former definition was sufficiently specific so as to lead to separate applications of the comparable uncontrolled transaction ("C.U.T.") method by intangible asset type and an overall lower buy-in transaction value, the T.C.J.A. codifies the realistic alternatives principle ("R.A.P.") and aggregate basis of valuation ("A.B.O.V.") argued by the I.R.S. in *Veritas* and *Amazon*.

The purpose of these amendments is to increase the value of intangible asset transfers to controlled taxpayers, whether the assets are sold outright or co-developed through a cost sharing agreement. The provisions should be looked at as a "pay for," *i.e.*, a measure that offsets the lost tax revenue arising from other T.C.J.A. provisions that reduced tax.

This article examines the R.A.P. in view of current transfer pricing regulations and considers whether the A.B.O.V. can serve as an unspecified transfer pricing method under Treas. Reg. §§1.482-4 or 1.482-7.

CODE §482 AMENDMENT

The amended Code §482 reads as follows:

> For purposes of this section, the [I.R.S.] shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an *aggregate basis* ***or*** *the*

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1 *Veritas v. Commr*., 133 T.C. No. 14 (2009).

2 *Amazon v. Commr*., 148 T.C. No. 8 (2017).

valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the [I.R.S.] determines that such basis is the most reliable means of valuation of such transfers. [Emphasis added.]

The most reliable means of valuation is either the A.B.O.V. or the R.A.P., and not necessarily both. A.B.O.V. suggests in general terms how a grouping of intangible assets should be valued, but R.A.P. defines the data that should be used as opposed to the valuation technique or equation. This is important as realistic alternatives must be considered as part of the comparability analysis under Treas. Reg. §1.482-1(d) when applying a specified or unspecified method. Comparability is in turn a determinant of the best method under Treas. Reg. §1.482-1(c).

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I.R.S. POSITIONS IN *VERITAS* AND *AMAZON*

In *Veritas*, a U.S. parent ("P") and its foreign subsidiary ("S") entered into a cost sharing arrangement pursuant to which P granted S the right to use certain intangibles in exchange for a $166 million buy-in. The C.U.T. method was used to calculate the buy-in amount. The I.R.S. issued a notice of deficiency claiming that the buy-in amount should have been $2.5 billion as measured using the income method.

The income method determines the value of a buy-in payment as the present value of the best realistic alternative to cost sharing. The I.R.S. theory of the case was that this best realistic alternative was a sale of a business. This approach, known as the "akin to sale" theory, relied on the notion that the ex-post increase in the value of the intangible asset was so great that the transaction best resembled a sale in its characteristics.

The I.R.S. ultimately relied on a second report asserting a $1.675 billion buy-in valuation. The allocation took into account items that weren't transferred, like access to the research and development ("R&D") team, or were of insignificant value, such as customer lists and base. It also took into account subsequently developed intangibles, and other intangible assets not covered under Code §936(h)(3)(B) or Treas. Reg. §1.482-4(b), as well as R&D and marketing, in violation of the applicable Code §936(h)(3)(B) condition that these assets lacked "substantial value independent of the services of any individual."

Eight years later, a similar position was taken by the I.R.S. in *Amazon*.[3] In this case, a U.S. parent ("P2") and its Luxembourg subsidiary ("S2") entered into a cost sharing arrangement pursuant to which P2 granted S2 the right to use certain intangibles in exchange for a $254.5 million buy-in. In addition, S2 was also required to make annual payments for ongoing intangible development costs incurred at different centers to the extent that they would benefit S2. The C.U.T. method was used broadly to calculate the buy-in amount. The I.R.S. issued a notice of deficiency claiming that the buy-in amount should have been $3.6 billion, later reduced to $3.468 billion, as measured using the discounted cash-flow method ("D.C.F."). The D.C.F. used was equivalent to the income method application in *Veritas*.

The I.R.S. here too applied an akin to sale theory, which applied an enterprise

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3 For detailed commentary on the *Amazon* decision, see "Amazon Makes the C.U.T. – An Important Taxpayer Win, a Reminder to Consider Transactional Evidence," *Insights* 5 (2017).

valuation that included calculation assets that were either not transferred under the arrangement or not covered intangibles. A covered intangible, as shown in *Veritas*, was defined under Code §936(h)(3)(b) to include the five listed categories that have "substantial value independent of the services of any individual" and "other similar items." In contrast, the I.R.S. enterprise valuation approach took into account items such as goodwill and going concern value, which at that time could not be bought and sold independently as they were inseparable components of an enterprise's residual business value.

AGGREGATION AND REALISTIC ALTERNATIVES

The T.C.J.A. amendment is not the first mention of aggregation in the transfer pricing regulations. Aggregation of transactions is required when transactions are so interrelated that aggregate transaction pricing is the most reliable approach under the best method rule. The decision to aggregate is based on (i) the extent to which the transactions are economically interrelated and (ii) the relative reliability of the measure of an arm's length result. In other words, the taxpayer must determine whether an aggregate analysis of all transactions leads to a more accurate result than a separate analysis of each transaction.[4]

"Companies must be prepared not only to identify the best alternative but to vigorously explain why other alternatives are inferior."

The expanded definition of an intangible asset under Code §936(h)(3)(B) may catch all types of valuable intangible assets, but the use of A.B.O.V. is not explicitly conditional on either some or all asset types being economically interrelated. A.B.O.V. instead assumes economic interrelatedness as a condition for aggregation of assets and is subject to a reliability test. A.B.O.V. would appear to be deficient as a best method in the event that there is insufficient evidence of economic interrelatedness between all the types of intangible assets aggregated for the purpose of using A.B.O.V. However, the I.R.S. is granted the discretion to make the determination.

R.A.P. is also subject to a reliability test under the amended Code §482. Reliability is itself a condition for the selection of the best method, with its two primary factors being the degree of comparability between the controlled and any uncontrolled transactions and the quality of the data and assumptions used in the transfer pricing analysis. Corroboration of a reliable measure using another specified or unspecified transfer pricing method is a further factor affecting reliability.

The term "realistic alternatives" is a familiar concept in the existing transfer pricing regulations. Realistic alternatives are the foundation of the income method used to determine a minimum buy-in or platform contribution transaction ("P.C.T.") payment using an alternative stream of long-term licensing income. This principle is also relied on to guide the selection of a discount rate that is used to calculate the value of the P.C.T., cost sharing payments, and alternative licensing income on the transaction date. It also accurately reflects the risk of a long-term licensing alternative. The income method references a controlled participant's best realistic alternative to entering into a cost sharing arrangement, as distinct from one realistic alternative among many candidates as implied by the language of the amended Code §482. Absent further guidance, controversy may arise when the convention of ranking alternatives commonly assumed to be standard behavior of company decision-makers confronts the ability of the I.R.S. to select any alternative from a set of realistic alternatives. Companies must be prepared not only to identify the best alternative

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[4] Treas. Reg. §1.482-1T(a)(i)(B).

but to vigorously explain why other alternatives are inferior.

Outside of the popular cost sharing option, intangible asset sales and licensing guidance under Treas. Reg. §1.482-4 require that an unspecified method used to value an intangible asset transfer should result in prices or profits that are preferable to those otherwise obtainable from choosing a realistic alternative to the controlled transaction.[5] Here, again, the taxpayer faces an explicit ranking condition among realistic alternatives, this time expressed in terms of prices or profits. An unspecified method is one of four possible methods used to determine the arm's length amount charged in a controlled intangible property transaction. An application of any of the other three candidate methods under the best method rule requires the consideration of "the alternatives realistically available to the buyer and seller."[6]

Finally, alternatives are the basis for recharacterizing a transaction when economic substance is lacking. The cost or profit associated with an alternative may be used to adjust the consideration charged in a controlled transaction.[7] In this instance, the selection of an alternative to the actual transaction depends on whether either "would be acceptable" if evaluated by an uncontrolled taxpayer operating under comparable circumstances. While the term "reasonable" is not used here to describe candidate alternatives, it is clear that the selection of the price or cost arising from an alternative transaction must be a process of rational choice modelled on the behavior of a similar taxpayer and constrained by the circumstances of the actual transaction.

IS A.B.O.V. AN INEVITABLE APPROACH UNDER R.A.P.?

Assuming an outright sale of intangible property is a realistic alternative, as was the I.R.S. view in *Amazon* and *Veritas*, is it necessarily the case (as was also the I.R.S. view) that A.B.O.V. would be used to determine the price of the intangible assets being sold? First, it is not clear that an outright sale was the highest ranking or best alternative. Setting this important consideration aside, given the reasonable alternative is a sale, three specified transfer pricing methods and one unspecified method must be considered under Treas. Reg. §1.482-4. Only the unspecified method allows for an approach approximating A.B.O.V. The comparable profits method and profit split method appear to be non-transactional methodological options in view of their ability to capture (though not necessarily to explain) returns to a wide range of intangible asset types. Applying the best method rule and the relevant comparability criteria, it is not a foregone conclusion that A.B.O.V. should be selected as the best method.

ARM'S LENGTH STANDARD OR R.A.P.?

While at first reading the A.B.O.V. and R.A.P. appear to tend toward an *ipse dixit* approach echoing the treatment of stock option costs in cost sharing arrangements invalidated in *Altera* and the introduction of the commensurate-with-income standard,

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[5] Treas. Reg. §1.482-4(d)(1).

[6] Treas. Reg. §1.482-1(d)(3)(iv)(H).

[7] Treas. Reg. §1.482-1(f)(2)(ii)(A).

closer analysis suggests otherwise.

Elements of intangible asset pricing guidance now appear in Code §§936 and 367, but consistency with Code §482 is maintained by the T.C.J.A. While the amendments signal a frustration with the arm's length standard exemplified elsewhere in the T.C.J.A. and in other O.E.C.D.-member Diverted Profits Tax regimes, the implementation of the Code §482 amendments is explained by existing definitions in the current regulations under Code §482. How the amendments will work with the existing regulations is another matter. The issuance of updated regulations may provide clarity over time. Until that clarity is achieved, companies should interpret the amended Code §482 and existing regulations in a forward-looking manner consistent with the I.R.S. positions in *Amazon* and *Veritas*.

R.A.P. and A.B.O.V. are not replacements for the arm's length standard and must meet the conditions of the best method approach to achieve a reliable outcome. For the time being, it looks like the arm's length standard has beaten the R.A.P. Future controversy is likely to focus on the reliability of the intangible asset valuation and the abuse of discretion exercised by the I.R.S. in determining an alternate means of valuation.