

Cost Sharing Agreements May Allow Multinational Companies To Reap the Benefits of Intangible Asset Investment

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Abstract

As value chains of multinational companies become increasingly dispersed among different countries, owners of valuable intangibles may emerge in multiple taxing jurisdictions. Cost sharing arrangements may become useful to establish a proper compensation of the affiliates responsible for intangibles development, provide a mechanism for sharing the risk of intangible development activities among affiliates, improve the cash position of the intangible-developing entities, and establish more efficient intercompany transaction structures.

Multinational companies often face a locational mismatch between intangible asset ownership and usage. Some of the most common situations of this type are when overseas manufacturing affiliates use the technology created in the home country, or sales affiliates use the marketing intangibles created by the parent company. When the owners and users of valuable intangibles are located in different taxing jurisdictions, the question of the arm's length compensation of the intangible owners becomes a vital part of transfer pricing compliance for the multinational enterprise.

In principle, a business entity that owns valuable intangibles used by another related party, can earn its compensation in one of the following ways: through transfer prices of the products containing the intangibles in question, through royalties, and through cost sharing mechanisms.¹ The following discussion examines the advantages and disadvantages of each of these forms of compensation in more detail.

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Intangible Asset Compensation Through Tangible Goods Pricing

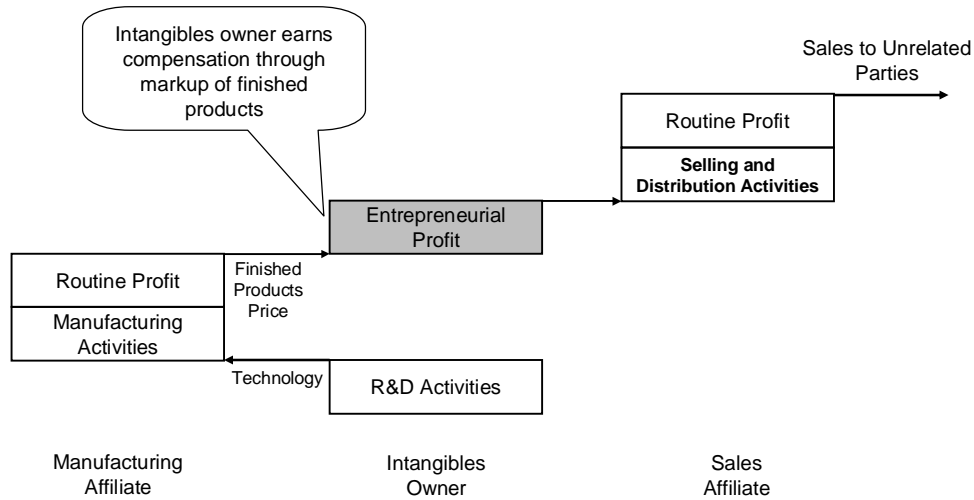
A controlled owner of intangibles can earn its compensation through transfer prices of tangible products. Arrangements of this type are sometimes referred to as the principal-agent structures. When tangible goods using such intangibles are not produced or sold in the taxing jurisdiction of the intangibles owner, this compensation structure implies that in order to measure correctly the benefits from the intangibles in the form of the residual profit, the intangibles owner has to purchase the goods containing such intangibles from a related manufacturer, who earns a routine remuneration, and then sell these goods either directly to unrelated parties or to affiliates at an arm's length discount to the final price to unrelated parties.

Figure 1 depicts an example of the principal-agent structure where both manufacturing and distribution functions are performed by affiliates other than the owner of the valuable intangibles. For the intangibles owner to earn an arm's length return, it must first purchase tangible goods from the related manufacturer at a price that allows the related manufacturer to earn a routine return and then resell the same goods to the related distributor at a different price that leaves the distributor with arm's length return after selling the goods to unrelated customers.

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¹ The term "cost sharing" as used in this article refers to sharing of the costs associated with development of valuable intangibles (i.e., marketing or technology), as opposed to cost sharing for group-wide services.

Figure 1. Compensation of Intangibles Owner via Pricing of Tangible Goods



As this example demonstrates, compensation through the pricing of the tangible goods works correctly only when all of the valuable intangibles are owned by just one entity among the group of affiliates participating in the value chain. Alas, the facts of most multinational taxpayers do not align well with the principal-agent structure without some prior restructuring, e.g., migration of intangibles to a single owner, conversion of full-fledged entities into limited-risk structures such as commissionaires and toll manufacturers. Restructuring of this nature, however, often invites scrutiny by the tax authorities in the countries that stand to lose taxable income. The tax authorities typically try to assert the existence of locally created and highly valuable intangibles (e.g., marketing), and certain tax authorities may also seek buy-out payments to cover the transfer of ownership of these local intangibles to the principal.²

² In recognition of the fact that business restructurings have become a frequently contested issue between tax authorities and taxpayers, OECD has created a working group focused specifically on the

Intangible Asset Compensation Through Fixed Royalty Rates

The royalty method of compensation may rely either upon a fixed royalty or have an adjustment mechanism known as a variable royalty. Fixed royalties are typically derived from analyses of external royalty benchmarks using transfer pricing methods such as the Comparable Uncontrolled Transaction (“CUT”) method described in the U.S. Section 1.482 regulations.³ Benchmarking of uncontrolled royalty rates, however, can be applied only under certain rather narrow sets of circumstances. These circumstances are limited to the transactions when comparable intangibles are licensed in uncontrolled transactions under comparable economic conditions that include similarity of the rights transferred,⁴ similar profit potential, as well as similarity of other relevant conditions. Although in practice it is often difficult to find uncontrolled transactions that satisfy the above comparability criteria in a strict sense, fixed royalties based on external benchmarks remain widely used in intercompany transactions.

To be sure, the intercompany compensation mechanism based on fixed royalty rates has certain advantages. The establishment and implementation of such system is a relatively straightforward task, and the relevant stakeholders (both within the taxpayer’s

transfer pricing issues surrounding business restructuring. In September 2008, OECD has released a discussion draft on the issue of business restructurings (“Transfer Pricing Aspects of Business Restructurings”).

³ Although OECD Transfer Pricing Guidelines do not list a specific method for pricing of intangibles, they provide a detailed guidance on calculation of arm’s length consideration for intangibles transferred in controlled transactions.

⁴ The recent pronouncements by IRS such as the Coordinated Issue Paper “Sec. 482 CSA Buy-In Adjustments” of September 2008 and the regulations on cost sharing arrangements Section 1.482-7T issued in January 2009 give particular attention to the similarity of rights granted to the licensee in controlled and uncontrolled transactions in situations when the CUT method is contemplated. For instance, in cases when the controlled transaction allows the licensee to use the transferred intangibles for development of other intangibles, an unrelated transaction that accords the licensee rights to merely make and sell products based on a given set of intangibles cannot be considered comparable.

organization and tax authorities) may find the royalty rates derived from the industry benchmarks easy to agree upon.

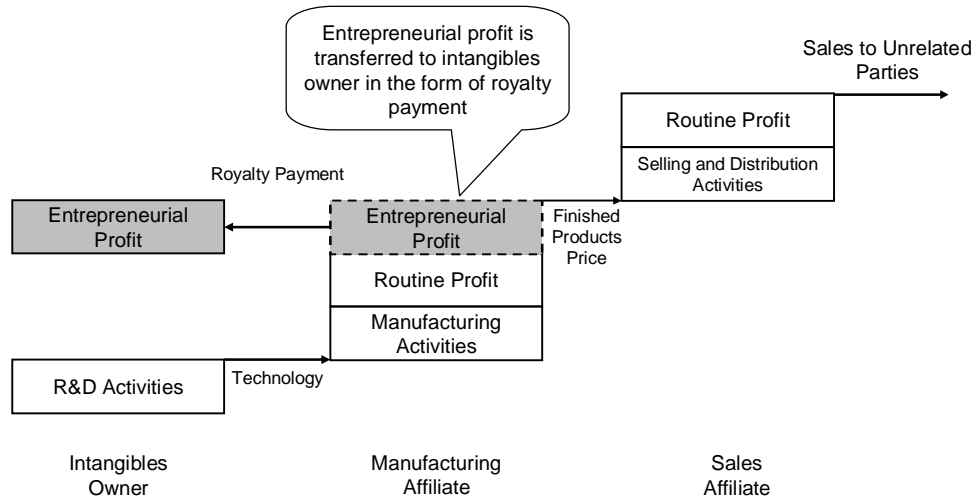
Often, however, managing the compensation structure based on the fixed royalties becomes a challenge during fluctuating economic conditions. In a downturn, fixed royalties may leave the licensee with very low profits or even losses. In boom times, profitability of the licensee may soar above that indicated by the benchmarking studies as being arm's length. In either case, a taxpayer will face difficulties justifying its transfer prices in documentation studies or in transfer pricing audits.

Intangible Asset Compensation Through Variable Royalties

The notion of a variable royalty arrangement is to provide compensation to the licensor after subtracting the routine profit earned by the licensee. This method of compensation is called a “variable royalty” because the royalty amount earned by the licensor varies depending on the residual operating profit generated in the supply chain. The variable royalty principle is illustrated by Figure 2. This example assumes that the valuable intangibles are related to technology, as opposed to marketing, and thus the manufacturing affiliate is responsible for paying the royalty to the intangibles owner. The amount of the royalty should be such that it leaves the manufacturing affiliate only with the routine return. The manufacturing affiliate can sell finished goods directly to the related distributor at the price that allows the distributor to earn a routine return, and remit the royalty to the intangibles owner. Unlike the principal-agent structure, the variable royalty arrangement allows more than a single owner of intangibles and does not have to involve title passage through the intangibles owner.⁵

⁵ The calculation of the variable royalty rate involves two main steps: in the first one an appropriate amount of the compensation to the intangibles owner is computed and in the second one this royalty is divided by the royalty base (e.g., external sales, value-added by the licensee, etc.) to determine the royalty rate.

Figure 2. Compensation of Intangibles Owner via Variable Royalty



The variable royalty method considers the circumstances of a specific controlled transaction, and therefore, in principle, is capable of measuring the value provided by the licensed intangibles to the licensee more precisely than the fixed royalty. Additionally, the variable royalty method allows for adjustment to the licensor's compensation to model changes in the market value of intangibles over time.

For instance, during business cycles, the variable royalty rate will rise in good economic times and decrease in downturns, possibly to zero, which smoothens fluctuations of the licensee profit. This "shock absorber" effect of the variable royalties can be beneficial when the intercompany prices of tangible goods cannot be easily changed to impact the licensee's profitability due to, for example, a limited volume of tangible goods transferred between the parties or for reasons related to the valuation of tangible goods for customs purposes.

Variable royalty arrangements provide a good “fit” with the profit split paradigm, including the residual profit split method, where the return on entrepreneurial capital can vary according to the profitability of the entire business. If parties can agree that the appropriate payment for the use of relevant intangibles can be subject to profit *actually* earned in the relevant business where such intangibles are exploited, the variable royalty method is an appropriate and transparent mechanism to implement such principles.

Furthermore, variable royalty arrangements can be structured to achieve pricing outcomes similar to those derived from cost-sharing arrangements, namely allowing the licensee to acquire the rights to the intangibles it uses, including the rights to the intangibles developed after the variable royalty arrangement is entered into. The variable royalty arrangement may be set up to allow the licensee to acquire the rights to the intangibles over time on a “pay-as-you go” basis as opposed to making a buy-in payment determined up-front as is the case with cost sharing arrangements.⁶

Variable royalty arrangements are not subject to the prescriptive compliance regime that governs cost-sharing regulations of some countries, and therefore variable royalty arrangements may be preferable in transactions between jurisdictions whose tax authorities do not subscribe to each other’s views of the cost sharing arrangements. On the other hand, in dealing with the U.S. tax authorities, it is reasonable to expect that the variable royalty arrangements will require similar analytical rigor and disclosures as needed for qualified cost sharing arrangements.

Intangible Asset Compensation Through Cost Sharing Arrangements

The major difference between the cost sharing and licensing arrangements (of either fixed- or variable-rate type) is that while the licensing arrangements grant the licensee the rights to use existing intangibles in manufacturing and/or marketing activities, the cost sharing arrangements (“CSAs”) involve both exploitation of existing intangibles (by means of a “buy-in” for pre-existing technology or other rights or capabilities

⁶ Buy-in payments are called platform contribution transactions (PCTs) in the U.S. temporary cost sharing regulations.

provided) and the rights of royalty-free use of the future generations of intangibles created through the shared funding of intangible development activities. Many multinational companies have already recognized the need to share the funding of research and development (“R&D”) and other risky activities among affiliates. For some multinationals, particularly those with home markets in Europe and Japan, the size of the operations in the home country market may not be sufficient to support the costs of R&D and other intangible-generating activities. Other multinationals may expect their future growth to come substantially from new markets and may want to contemplate matching funding of the new intangibles development with the markets that are expected ultimately to generate the return on those intangibles.

Another strategic objective that can potentially be achieved using CSAs is improvement of the liquidity position of the intangible-developing entity (or the entity that includes the intangible-developing entity on a country-wide consolidation basis). In addition to reducing the expenses of the intangible-developing entity, CSAs normally involve buy-in payments to the owners of intangibles contributed at the start of a CSA. These buy-in payments may be provided in several alternative forms. Such alternative forms recognized in the new U.S. cost sharing regulations include lump sums, installment payments, and payments conditional on the benefits achieved from the intangibles developed under the CSA. Additionally, the new U.S. regulations contain the provision that allows splitting the benefits either by the field of use of intangibles or by territory. Therefore, cost sharing arrangements, in principle, may contain a wide variety of mechanisms to compensate the entities contributing pre-existing intangibles to the CSA.

In times of economic downturn, revenue projections for many industries have been revised downward for the immediate future, and depending on the industry, the revenue projections may be expected to stay below the norm for several years to come. Accordingly, valuations of intangibles prepared during the bottom of the business cycle, particularly those based on the residual income, will likely be low, which implies that

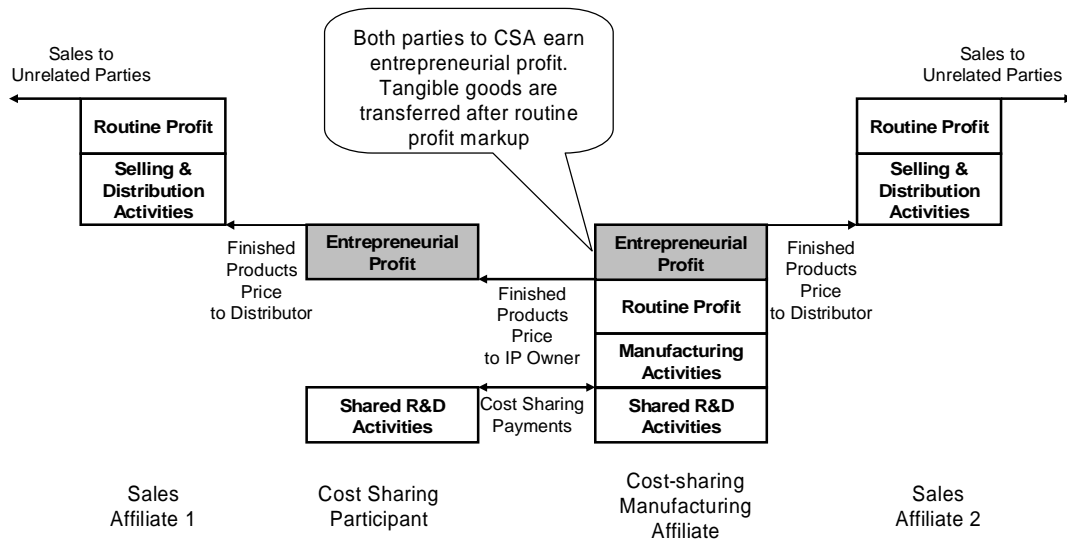
should these intangibles be licensed, buy-in amounts are likely to be more affordable for the licensees.⁷

As illustrated in Figure 3, CSAs can increase transparency and simplify pricing of tangible goods in intercompany transactions. After making the buy-in payment to acquire the rights to the intangibles contributed to a CSA, the cost-sharing manufacturing affiliate will no longer be obligated to pay royalties.⁸ The cost-sharing manufacturing affiliate will sell tangible goods directly to the distribution affiliate at prices that allow the distribution affiliate to earn routine return, and the manufacturing affiliate to retain the residual profit. As required by the new U.S. cost-sharing regulations, each cost sharing participant has a unique sales territory, and thus, if one of the cost sharing participants does not perform its own manufacturing, it will purchase products from the related manufacturer. The intercompany sales from the cost-sharing manufacturing affiliate to another cost-sharing participant will be priced at the level that allows the manufacturer to earn a routine return (e.g., at cost-plus prices), while the other cost sharing participant earns the residual profit.

⁷ The buy-in amounts in a recessionary economy may be low for several reasons. One of them is that market value of intangible assets in a recessionary economy may be reduced due to the depressed assessment of the company's overall market value. Additionally, even if the forecasts account for increased benefits from the use of intangibles in post-recessionary years, those benefits will be discounted in the calculation of buy-in payments.

⁸ As in the previous example, this example assumes that the valuable intangibles being developed under the CSA are related to technology, as opposed to marketing.

Figure 3. Compensation of Intangibles Owner via Cost Sharing Arrangement



Compared to variable royalty arrangements, cost sharing agreements may have certain advantages. Cost sharing agreements may provide taxpayers with opportunities to receive compensation for intangibles from taxing jurisdictions that impose explicit or tacit limitations on royalty payments.⁹

The fact that cost sharing arrangements are governed by explicit regulations in many countries provides more certainty in application of such arrangements and increases chances of their recognition by the tax authorities. Cost sharing regulations in many countries are often significantly less detailed than the temporary cost sharing regulations

⁹ One of such countries is China, that is perceived to impose restrictions on royalty payments to foreign affiliates and yet has endorsed cost sharing in its recently published transfer pricing regulations.

drafted by the US Treasury. Thus, it is possible that if a taxpayer's cost sharing agreement has been developed using the principles of the US regulations, tax authorities in other countries, lacking sufficient in-country guidance, may accept the regulatory framework given by the US regulations in non-US applications.

While the application of the U.S. cost sharing regulations may be technically challenging due to the rigorous requirements imposed by these regulations, the U.S. cost sharing regulations allow taxpayers, at least in principle, to avoid periodic adjustments as long as the initial projections of benefits are reasonable.¹⁰ Thus, cost sharing arrangements, compared to the variable royalty licensing model, can give taxpayer a more "predictable" view of the cash flows associated with the transactions involving intangibles for a number of years.

Companies contemplating cost sharing arrangements with foreign affiliates must consider carefully the implications of the joint economic ownership of intangibles developed under such arrangements. Authorities in some host countries may have a markedly different view of the attribution of profit from such intangibles, and, in certain countries, there is a heightened risk of "leakage" of the proprietary know-how to competitors.

Selecting the Best Method to Compensate Intangible Asset Owners

Multinational companies have several different options to compensate controlled entities that own valuable intangibles used by other affiliates. Each of these options has

¹⁰ In practice, taxpayers may want to implement periodic true-ups under the cost sharing arrangements anyway in order to avoid periodic adjustments by the tax authorities authorized by the U.S. cost sharing regulations. Additionally, because negotiation of an advanced pricing agreement ("APA") between a taxpayer and tax authorities, or an APA granted to taxpayer, precludes income adjustments under the cost sharing arrangement, APA may be a preferable solution for certain cost sharing arrangements.

its benefits and disadvantages. The principal-agent structures, while popular, may be prone to frequent disputes with the tax authorities. The fixed royalty arrangements are relatively simple to set up and administer, yet they may not provide the licensee with the appropriate level of income, particularly during the extremes of business cycles.

In contrast, the methods of compensating the controlled intangibles owners through variable royalties or cost sharing arrangements have the flexibility to accommodate various paths of transaction flows, multiple owners of intangibles, and transfer of the rights to further development of the intangibles. Either of these two methods, in principle, achieves the objective of arm's length compensation of the intangibles owners, and the application of both methods requires preparatory efforts of similar scope.

Additionally, cost sharing arrangements may allow taxpayers to achieve a broader scope of business objectives than the intercompany licensing arrangements such as sharing the risk of intangibles development among affiliates expected to benefit from these intangibles, improving the cash position of the intangible-developing affiliates, and streamlining intercompany transfer prices.