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High Profit Intangibles After the White Paper and *Bausch and Lomb*: Is The Treasury Using Opaque Lenses?

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HIGH PROFIT INTANGIBLES AFTER THE WHITE PAPER AND *BAUSCH AND LOMB*: IS THE TREASURY USING OPAQUE LENSES?

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I. SECTION 482 AND THE WHITE PAPER

A. *The Arm's Length Pricing Methods*

Section 482 of the Internal Revenue Code¹ grants to the Secretary the authority to allocate gross income, deductions, credits, or allowances between related parties if in the Secretary's determination, such distribution, apportionment, or allocation is necessary to clearly reflect income.² In October 1988, the Treasury Department and the Internal Revenue Service [hereinafter Service] issued "A Study of Intercompany Pricing,"³ to examine the current state of transfer pricing, particularly for intangible property.⁴

Due to increasing problems in administering transfer pricing policies for both tangible and intangible property, Congress amended the provisions of § 482 to deal with the lack of specific

1. 26 U.S.C. § 482 (1986). Unless otherwise noted, all code references are to the Internal Revenue Code of 1986, as amended.

2. *Id.*

3. U.S. TREASURY DEPARTMENT, A STUDY IN INTERCOMPANY PRICING (1988) [hereinafter WHITE PAPER].

4. *Id.* at 1.

guidelines available for pricing high profit intangibles.⁵ These particular types of intangibles are described in the *White Paper* as products which generate profits far beyond the normal returns found in the industry.⁶

In 1968, regulations were promulgated under § 482. These regulations apply an arm's length standard as the basis for transfer pricing.⁷ These regulations provide methods to determine transfer prices between related parties for loans or advances, the performance of services, the sale or licensing of intangible property, and for the sale of tangible property.⁸ Intercompany pricing rules for the sale of tangible property include the following:

1. The comparable uncontrolled price method⁹
2. The resale method¹⁰
3. The cost plus method¹¹
4. Other unspecified methods.¹²

Though a description of each of these methods is beyond the scope of this Comment, it is noteworthy that these methods attempt to determine an arm's length price for the sale of tangible property by the use of comparable transfer prices or transactions. Absent such comparables, the regulations lack any specific guidance for establishing a transfer price.¹³

5. *Id.* at 45.

6. *Id.* at 51. The *WHITE PAPER* does not provide a specific definition for high profit intangibles, but gives as examples an AIDS vaccine, or a cure for the common cold. *Id.* at 51 n.138.

7. Treas. Reg. § 1.482-1 (1991). The regulation articulates that its purpose is to place a controlled taxpayer on the same level as an uncontrolled taxpayer. *Id.* § 1.482-1(b)(1).

8. Treas. Reg. § 1.482-2 (1991).

9. Treas. Reg. § 1.482-2(e)(2) (1991). The Comparable Uncontrolled Pricing Method was applied in *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1100 (1985), where the Tax Court determined that a transfer price could be determined based on similar prices established by other manufacturers.

10. Treas. Reg. § 1.482-2(e)(3) (1991). The most noteworthy case involving the Resale Method was *E.I. du Pont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct.Cl. 1979), where the Court of Claims rejected the overriding tax considerations that motivated the petitioner's establishment of their transfer pricing scheme. This case suggests the danger involved in allocating large amounts of income to one of the related parties involved in the transaction.

11. Treas. Reg. § 1.482-2(e)(4) (1991).

12. *Id.* § 1.482-2(e)(1)(iii). The *White Paper* refers to this method as the "fourth method." *WHITE PAPER*, *supra* note 3, at 11.

13. *WHITE PAPER*, *supra* note 3, at 28. The *White Paper* concludes that absent specific comparables, the regulations leave the Service and taxpayers with little guidance. A study by two economists, which revealed administrative problems and general dissatisfaction with the regulations, lends support to the *White Paper's* conclusions. See Gunrther Schindler & David Henderson, *Intercorporate Transfer Pricing, 1985 Survey of Section 482 Audits*, *Tax Notes Today* Dec. 1985 at 1171. In

Although the *White Paper* sets forth a general description of a high profit intangible,¹⁴ it is necessary to look to the Internal Revenue Code for a definition of intangible property. Such property is defined broadly, and includes a:

1. patent, invention, formula, process, design, pattern, or knowhow
2. copyright, literary, musical, or artistic composition
3. trademark, tradename, or brand name
4. franchise, license, or contract
5. method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data
6. similar items.¹⁵

B. Valuation Of Intangible Property

Due to the lack of specific comparables available for determining transfer prices, valuation problems with respect to high profit intangible property has ensued.¹⁶ Section 482 adjustments for intangibles were difficult to perform under the regulations, due to the absence of specific comparables. Similarly, valuation of tangible property became difficult, especially where tangible property was transferred to another party and an intangible was attached. An example of such a situation is where a transfer of tangible property bearing a trademark is made to a related party.¹⁷ The *White Paper* concludes that if no comparable products are identified, isolating the value of the trademark becomes complex.¹⁸

The 1968 regulations attempt to determine guidelines for valuing intercompany transactions¹⁹ by applying an arm's length standard for pricing intangible property. The arm's length standard is the amount which is charged or would be charged in

addition, The *White Paper* presents seven studies showing the percentage of cases in which each of the four methods in the regulations were used. *Id.* at 22. The 1987 survey revealed that the Cost Plus method was used in 37% of the cases, indicating a declining use in the Comparable Uncontrolled Price Method. See *Id.* at 28-34. This declining use is attributable to the general difficulties encountered in finding comparable prices. *Id.*

14. See *supra* note 6.

15. I.R.C. § 936(h)(3)(B) (1986). See also, Treas. Reg. § 1.482-2(d)(3) (1991).

16. *WHITE PAPER*, *supra* note 6, at 12.

17. *Id.* at 19.

18. *Id.* at 19-20. The *White Paper* notes that this situation exists where royalty rates are set for licensed intangibles. See also *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985) (parent manufactured and sold patented products bearing Darvon label).

19. *WHITE PAPER*, *supra* note 3, at 19-20.

independent transactions with unrelated parties under similar circumstances.²⁰ When intangible property is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a controlled group to another member of a controlled group for other than arm's length, the Service is empowered under § 482 to make allocations to reflect an arm's length consideration.²¹ This consideration involves:

1. royalties based on the transferee's output, sales, profits, or any other measure
2. lump sum payments, or
3. any other form, including reciprocal licensing rights which might reasonably have been adopted by unrelated parties under the circumstances.²²

The standard applied in determining the amount of the arm's length consideration is the amount paid by an unrelated party for the same property under the same circumstances.²³ When similar transactions involving unrelated parties are unavailable, the regulations list a dozen factors to be considered in arriving at an arm's length consideration.²⁴

II. THE SUPERROYALTY PROVISIONS: THE TAX REFORM ACT OF 1986

A. The Commensurate Standard

The Tax Reform Act of 1986²⁵ amended § 482 to provide that the income from a transfer or license of intangible property shall be "commensurate with the income"²⁶ (hereinafter referred to as "commensurate standard") attributable to the intangible. The commensurate standard, along with the intangibles listed in § 936(h)(3)(B) of the Code, comprise the "superroyalty" provisions of the 1986 Act. The White Paper notes that the general goal of the commensurate standard is to ensure that each party earns the income or return from the intangible that an unrelated party

20. Treas. Reg. § 1.482-1(d)(3) (1991).

21. *Id.* § 1.482-2(d).

22. *Id.* § 1.482-2(d)(2).

23. *Id.* § 1.482-2(d)(2)(ii).

24. *Id.* § 1.482-2(d)(2)(iii). For example, the regulations consider the prevailing rates in the industry, the uniqueness of the property and the time that it is likely to remain unique, the degree and duration of protection that is afforded to the property under the laws of the relevant country, the value of the services rendered by the transferor to the transferee in connection with the transfer, and the prospective profits to be realized or the costs to be saved by the transferee either through its use or subsequent transfer of the property. *Id.*

25. Tax Reform Act of 1986, Section 1231(e)(1), (P.L. 99-514) [hereinafter 1986 Act].

26. I.R.C. § 482 (1986).

would earn in an arm's length transfer of the intangible.²⁷ Although the commensurate standard was intended to apply to high profit intangibles such as those encountered in *Eli Lilly*,²⁸ this standard will also govern normal profit intangibles.²⁹

The *White Paper* specifically rejects the suggestion that the commensurate standard applies only to high profit intangibles transferred to low tax jurisdictions.³⁰ Since the 1986 Act has decreased United States corporate tax rates, Congress has become concerned that the United States may become a "tax haven" for foreign producers that have a higher marginal tax rate than their domestic subsidiaries. To counter this problem, the commensurate standard is applicable to both inbound transfers of intangible products, as well as to outbound transfers.³¹ In addition, the commensurate standard will apply to both manufacturing and marketing intangibles.³²

B. Transfer Pricing and the White Paper

According to the *White Paper*, application of the commensurate standard for pricing a transferred intangible involves determining the income from the intangible, and then performing an economic analysis of the related party's activities to determine the economic costs and risks incurred in deriving the income from the intangible.³³ Thus, income from the intangible is the starting point for determining the appropriate transfer price under § 482,³⁴ and the *White Paper* accords it primary weight. Since past problems have arisen with regard to finding specific comparables, especially with respect to unique products, the *White Paper* refocuses the analysis away from the often impossible task of finding a true comparable.³⁵

The *White Paper* suggests the retention of the comparable

27. WHITE PAPER, *supra* note 3, at 17.

28. See *supra* note 9. Lilly U.S., pursuant to I.R.C. §351, transferred to its Puerto Rican subsidiary, Lilly P.R., highly profitable patents of the pharmaceutical Darvon and Darvon-N. Congress' concern with this type of situation was that too much of the consolidated profit of an enterprise from the sale of high profit intangibles was shifted to foreign affiliates. Congress believed that income from related parties would not be divided fairly to reflect an arm's length relationship. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1014-1015 (Comm. Print 1986). See also WHITE PAPER, *supra* note 3, at 46.

29. WHITE PAPER, *supra* note 3, at 55.

30. *Id.* at 50.

31. *Id.*

32. *Id.* at 46.

33. *Id.* at 54.

34. *Id.* at 47.

35. *Id.*

uncontrolled pricing method for tangible property.³⁶ However, it bifurcates the arm's length standard as applied to intangible property into two new methods: (1) exact comparables; and (2) inexact comparables.³⁷

Exact comparables involve the transfer of a similar intangible product to an unrelated party that is comparable to the transfer of the same product between related parties.³⁸ The *White Paper* sets forth two tests for determining whether a transfer involves an exact comparable: (1) the external; and (2) internal standards tests.

The external standards test purports to place the comparable transaction and the related party in a substantially similar economic environment as that encountered by an unrelated party under comparison.³⁹ The focus of this test is whether an unrelated party earns substantially similar profits from a comparable transaction. In addition, the level of risks assumed by the related party and the functions performed⁴⁰ must be comparable to the unrelated party under comparison.⁴¹

The internal standards test ensures that the contractual aspects of the transactions under comparison are similar in all respects.⁴² Illustrations contained in the *White Paper* are the amounts and forms of compensation for the transferred intangibles, and the similarity of contractual terms where the transactions involve licenses.⁴³

When one or more of the standards for exact comparables can not be satisfied, inexact comparables should be used.⁴⁴ However, these comparables should not be used solely as the basis for determining transfer prices, but should be employed when

36. *Id.* at 27. The *White Paper* notes that these prices provide the best evidence of what unrelated parties would do in an arm's length transaction. However, the priority of the methods articulated in Treas. Reg. § 1.482-2(e) (1991) for determining the arm's length price for the sale of tangible property is no longer preferred. Rather, the *White Paper* states that the method employed should be the one where the best data are available, or the fewest adjustments need be made. *Id.*

37. *Id.* at 87.

38. *Id.*

39. *Id.* at 88.

40. *See Id.* at 89. The *White Paper* notes that it would be improper to compare a related party transaction that only involves manufacturing activities to a transaction where the related party performs both manufacturing and marketing activities.

41. *Id.* at 88.

42. *Id.*

43. *Id.* at 89.

44. *Id.* at 90.

exact comparables are unavailable.⁴⁵ In addition, use of inexact comparables is appropriate when the external and internal standards parallel, as would occur when the inexact comparable selected is being produced by an unrelated party in the same economic environment or stage of production.⁴⁶

C. The Arm's Length Method

If both exact or inexact comparables are unavailable, the White Paper advocates the use of the Basic Arm's Length Return Method⁴⁷ in applying the commensurate standard. The arm's length method operates to assign market rates of return to identifiable assets and other factors of production of a business.⁴⁸ This differs from using comparables which attempt to assign market prices to the identified comparables.⁴⁹ The first step in using the arm's length method is to perform a functional analysis of the business by separating each line of the business into its component activities.⁵⁰ Thereafter, the income attributable to each of the functions can be assigned according to the market return that would be earned by an unrelated party performing the same function.⁵¹ The returns that are attributable to the various components of the business⁵² can be determined by analyzing the rates of return used in similar activities having comparable risks. Once the returns are identified for all of the affiliate's functions, then any residual income is deemed attributable to the intangible assets. Alternately, it is acceptable to measure the relationship between income and costs to allocate income when assets are difficult to measure or where it is difficult to perform an analysis between

45. *Id.* at 91. (The White Paper notes that this is comparable with the arm's length standard).

46. *Id.* The White Paper again notes that the regulations contain twelve factors for valuing intangibles in the absence of comparables. See *supra* note 24. The White Paper states that these factors are essentially internal and external standards. These factors are accorded some "weighting" by the White Paper, which were formerly the source of much confusion due to the lack of any priority being assigned to them. For example, prospective profits that are realized from the intangible must be given consideration since the commensurate standard is basically a profits split approach between the related parties. *Id.* at 92-93.

47. *Id.* at 102-103 [hereinafter, the Basic Arm's Length Return Method will be referred to as BALRM].

48. *Id.* at 95.

49. *Id.* Assuming that some type of comparable is available, the White Paper notes that information obtained from it should be given consideration. However, basing a transfer price solely on information obtained from such a comparable is inappropriate. *Id.*

50. *Id.* at 96.

51. *Id.*

52. *E.g.*, plant and equipment, and working capital. *Id.* at 96.

income and assets.⁵³ Since the arm's length method relies on factors of production to perform income allocations, periodic adjustments to reflect changes are necessary.⁵⁴

If a multinational corporation has many affiliates that performs complex functions, bears significant economic risks, and uses significant self-developed intangibles, the *White Paper* states that the arm's length method is inadequate because comparables and rates of return for the complex functions are unavailable.⁵⁵ When the use of the arm's length method is inappropriate, a profit-split method should be applied.⁵⁶ Under this approach, the arm's length method is applied to identifiable functions of the business that do not involve the use of significant intangibles.⁵⁷ Following this functional breakdown, an arm's length return on assets, or an income-to-cost ratio, can be determined for each activity of the business and applied to the appropriate related party factors. The resulting income from this procedure is then allocated to the party performing the activity, which in turn leaves a residual net income.⁵⁸ This income is then assigned to the related parties by using a profit-split, based on the relative values of the unique intangibles employed by the parties.⁵⁹ As with the arm's length method, periodic adjustments are necessary to reflect any changes that arise in the factors of production.⁶⁰ Thus, if the values of the assets change, the profit-split percentage must be adjusted to properly assign the residual income between the related parties.

53. *Id.* at 97. For example, the *White Paper* suggests using the Berry Ratio. This approach uses a ratio of gross profit to operating expenses as a viable method of determining the return on costs. This ratio was used in *E.I. du Pont de Nemours & Co. v. United States*, 608 F.2d 455 (Ct.Cl. 1979). In *E.I. du Pont*, the parent incorporated a Swiss subsidiary, du Pont International S.A. (DISA), which provided marketing support and acted as a distributor of the parent's products. In upholding the Service's reallocation of income between the related parties, the court relied on an economic analysis provided by Dr. Berry that indicated that DISA's gross income to total operating costs, or its "Berry Ratio," was comparable to a survey performed by other management firms that were functionally similar to DISA. See *WHITE PAPER*, *supra* note 3, at 39-40.

54. *Id.* at 102. For example, as an affiliate's sales increase due to manufacturing breakthroughs or an enhancement to its existing technology, the resulting income attributable to the production factors must be increased.

55. *Id.* at 99.

56. *Id.*

57. *Id.* at 100.

58. *Id.*

59. *Id.* at 101.

60. *Id.* at 101-102.

III. THE BAUSCH & LOMB DECISION

The recent case of *Bausch & Lomb*⁶¹ provides a framework to illustrate the problems associated with the arm's length return method. Bausch & Lomb, a New York corporation, manufactures and sells "soft" contact lenses commercially throughout the United States. During the 1950's, Dr. Wichterle, a Czechoslovakian chemist, developed the first soft lenses using a crude spin casting method. Dr. Wichterle obtained patents for both his hydrophilic, or water absorbing materials, and the spin casting techniques. These patents were assigned to the Czechoslovakian Academy of Science (CAS), where he was employed. In the mid-1960's, the CAS entered into licensing agreements which granted Flexible Contact Lens Corporation an exclusive license to manufacture and sell the soft contact lenses in the Western Hemisphere. Flexible sublicensed the lens production to National Patent Development Corporation (NPDC), which in turn granted to Bausch & Lomb an exclusive sublicense to manufacture, sell, use, and distribute the Wichterle patents in the Western Hemisphere.

Bausch & Lomb purchased the spin cast machines from NPDC and invested in improving upon Dr. Wichterle's methods. Employing both a "spin cast" and "lathing" manufacturing process to produce the lenses, Bausch & Lomb established its Softlens Division in 1971 for the purpose of manufacturing the contact lenses. From 1979 to 1982, Bausch & Lomb sold the soft contacts in 64 countries, through approximately 23 subsidiaries. Since the market for soft contact lenses expanded during the 1970's, Bausch & Lomb soon had different varieties of soft contacts on the market, which were either developed, or licensed, by Bausch & Lomb. By improving upon the original spin cast machines, Bausch & Lomb was able to produce soft contacts for \$1.50 per unit while competitors that used the original lathing method incurred unit costs of approximately \$3.50 per unit.

Bausch & Lomb's New York manufacturing facility was the only plant that produced and distributed the lenses to foreign market subsidiaries. Predicting that demand in foreign markets would increase, Bausch & Lomb investigated the possibility of locating a contact lens manufacturing facility overseas, and eventually settled on Ireland for its Softlens manufacturing facility since the Industrial Development Authority of the Republic of Ireland (IDA) and the Irish government offered various incentives. These incentives included a capital grant of 45 percent of the total investment for the facilities in Waterford, Ireland, low cost lease financing on 35 percent of Bausch & Lomb's total Irish investment, costs to cover employee training, and a tax holiday.

61. *Bausch & Lomb, Inc. v. Commissioner of Internal Revenue*, 92 T.C. 525 (U.S.T.C. 1989).

On January 1, 1981, Bausch & Lomb entered into an agreement with its subsidiary Bausch & Lomb Ireland (B&LI), which granted the latter a nonexclusive license to use certain manufacturing intangibles in the production of the soft contact lenses. B&LI was also granted a nonexclusive license to make use of all Bausch & Lomb owned Irish patents, technical information and know-how which related to contact lenses, in addition to the materials used in their manufacture. B&LI was granted the right to use the name of "Bausch & Lomb" and "Softlens," and agreed to pay Bausch & Lomb a royalty of 5 percent of net contact lens sales.

B&LI sold 61 percent and 56 percent of their total sales of the lenses to Bausch & Lomb in 1981 and 1982, respectively. The transfer price set between the two entities was established at \$7.50 per lens. By 1983, the intercompany price was reduced to \$6.50, to reflect reduced market prices as the competition among the contact lens producers increased. During 1981 and 1985, B&LI paid Bausch & Lomb royalties of \$418,669 and \$1,368,000, respectively, which represented B&LI's sales of soft contacts manufactured in Ireland. All manufacturing, processing, packaging, and other necessary activities to prepare the lenses for sale to optical practitioners and chains in the United States were performed in Ireland.

The Commissioner of the Internal Revenue Service (Commissioner) challenged both these payments under § 482 of the Internal Revenue Code, and the pricing agreement between the parties. As a result, the Commissioner increased Bausch & Lomb's taxable income for 1981 and 1982, which resulted, as the Commissioner contended, from a lack of an arm's length pricing agreement between the related parties.

Procedurally, the Tax Court focused on the Commissioner's contention that the royalty rate and the transfer price should be addressed together, rather than separately. The Commissioner argued that Bausch & Lomb would not have structured the transaction to allow B&LI to produce the lenses for \$1.50, and then have Bausch & Lomb purchase these same lenses from B&LI for \$7.50.⁶² In essence, the Commissioner contended that B&LI was a contract manufacturer with guaranteed production, and was therefore not entitled to a return associated with entities that normally incur the risk of selling a product on the market. However, the Tax Court rejected the Commissioner's argument since a repurchase requirement between the entities that would assure the sale of the subsidiary's production was lacking.⁶³ The court held that B&LI neither had a guarantee that the transfer price it received for the lenses would remain at \$7.50, nor was it guaranteed importation by Bausch & Lomb of substantial

62. *Id.* at 583.

63. *Id.* at 583-584.

quantities of the lenses if demand fell.⁶⁴ Therefore, the Tax Court concluded that due to the independent significance of the transfer price and the royalty rate established by the parties, each should be separately examined.

The court determined that the comparable uncontrolled pricing method of regulation 1.482-2(e)(2)(ii) was mandatory in setting an arm's length price between the parties.⁶⁵ Various third party transactions introduced by Bausch & Lomb provided evidence that the prices charged by unrelated producers represented comparable uncontrolled prices.⁶⁶ The Court found these transactions persuasive to prove that the \$7.50 per lens price charged by B&LI was equal to or below the prices charged for similar lenses in similar uncontrolled sales.⁶⁷

Next, the Tax Court addressed the issue of the royalty payments. Bausch & Lomb maintained that the 5 percent royalty rate charged between the related parties should be based on the Average Realized Price (ARP) of Bausch & Lomb and its subsidiaries from the sale of the contacts to third parties. Bausch & Lomb presented evidence that a 5 percent royalty rate of the ARP constituted an arm's length consideration for the licensing agreement during the relevant years under examination. The Service presented two experts to refute Bausch & Lomb's royalty rate. The first expert calculated a royalty at \$4.50 to \$5.25 per lens. The second expert determined that a royalty necessary to compensate Bausch & Lomb for the use of the intangibles by B&LI was between 27 and 33 percent of the average realized price.⁶⁸ The Court was not persuaded by Bausch & Lomb's contention that the third party agreements contained the same or similar intangible property as contained in the B&LI licensing agreement. In addition, the court rejected the Service's royalty rate as too high. Since the court could not find a sufficiently similar transaction involving an unrelated party on which to rely as evidence of an arm's length rate, the court chose to construct its own rate.⁶⁹

64. *Id.* at 584.

65. *Id.* at 589.

66. *Id.* at 590.

67. *Id.* at 589-590. The Tax Court determined that one agreement in particular, the "Lombart agreement," was closely related to Bausch & Lomb's agreement with B&LI because it provided for a single price to be charged for either standard or thin lenses. Lombart charged \$8.50 per lens, but did not incorporate a charge that Bausch and Lomb was required to pay, such as the \$0.62 for freight and customs duties. Therefore, even though the Court reduced the \$8.50 by the \$0.62, it held that B&LI's price of \$7.50 did not need adjustment since it was less than the United States competitors' prices.

68. *Id.* at 596.

69. *Id.* at 600. See also Treas. Reg. § 1.482-2(d)(2)(iii) (1991).

To construct a royalty rate, the court determined that Bausch & Lomb's projections were the best indication of prospective profits to be anticipated through the use of the spin cast technology and the capital investment required to generate these profits. These projections, known as the Special Expenditure Application (SEA), were originally prepared by Bausch & Lomb for its Board of Directors to determine the feasibility of the Irish investment.⁷⁰

Bausch & Lomb had estimated the capital cost of constructing the Irish facility at \$9,570,000, which included \$2,718,000 of leased assets.⁷¹ The court noted that the leased assets could be obtained under favorable lease terms, since the lessor was entitled to IDA grants of 45 percent of their \$2,718,000 cost. In addition, \$1,511,000 of Section 84⁷² financing would provide working capital and finance start-up costs. Therefore, the \$8,363,000 of capital assets and working capital would be invested in B&LI.⁷³

The SEA contained ten year earnings and cash flow projections, reflecting Bausch & Lomb's estimate of earnings that would be generated from B&LI. The court determined that this report would be a reliable representation of Bausch & Lomb's expectations of the earnings that a hypothetical investor would hope to generate at the time it decided to invest in the Irish facility. A few minor adjustments were made to the report in

70. *Id.* at 600-601. The court cited Treas. Reg. § 1.482-2(d)(2)(iii)(g) (1991) and noted that they could determine prospective profits in constructing the royalty rate.

71. *Id.* at 601. The acquisition of the non-leased assets were to be financed as follows:

	<u>1980</u>	<u>1981</u>	<u>Total</u>
B&LI Capital Stock	213,000		213,000
B&LI Intercompany Loan	5,489,000	(1,933,000)	3,556,000
IDA Grant		3,083,000	3,083,000
TOTAL	5,702,000	1,150,000	6,852,000

Id. at 601.

72. Section 84 financing is part of the Irish Corporation Tax Act of 1976 which allows, in certain instances, Irish banks to receive loan interest tax free. Thus, Bausch and Lomb was able to receive a favorable interest rate on their borrowings in order to make loans to B&LI. Approximately \$4,200,000 was borrowed and subsequently loaned to B&LI. *Id.* at 564.

73 This was arrived at as follows :

Capital Assets	\$6,852,000
Working Capital	1,511,000
TOTAL	\$8,363,000

Id. at 602.

order to properly reflect market conditions.⁷⁴ The court noted that an arm's length royalty would be based on the price that the licensee was able to realize through the sale of products produced using the licensed technology.⁷⁵ The court promptly rejected the Service's rate since it was too high,⁷⁶ and also rejected Bausch & Lomb's calculated rate of 12.81 percent for 1981, and 11.01 percent for 1982.

The court focused on their understanding that an investor in the Irish facility could expect to earn an internal rate of return of approximately 35 percent, and considered this result generous in light of the moderate risks to which Bausch & Lomb was exposed in the investment.⁷⁷ The Tax Court held that B&LI would have been willing to invest in the facility even if required to share approximately 50 percent of the profits for use of the intangibles.⁷⁸ At trial, an expert testified that a royalty rate generally divided net profits before royalties approximately 25 percent to 75 percent between the licensor and the licensee, respectively. However, since B&LI would have found itself in a much weaker bargaining position than Bausch & Lomb, B&LI would have had to cede more of the profits from plant operations to Bausch & Lomb than the 25 percent, and in fact would have been willing to invest in the facility even if required to share 50 percent of the profits.⁷⁹ Therefore, the Court decided that this result would be achieved by using a 20 percent royalty rate which would generate earnings to cover the

74. For example, the court rejected Bausch & Lomb's assumption that the \$7.50 unit selling price should remain constant over the ten years, and held that an adjustment must be made in order to reduce the selling price to reflect increased competition in later years. *Id.* at 603.

75. The court noted that the price realized by Bausch & Lomb on its resale of the lenses to non-affiliates did not matter. The fact that the purchaser of the product who was also the licensor of the technology was irrelevant as long as the purchaser paid a market price. *Id.* at 605.

76. The court noted that no independent party would enter into a transaction for the license of intangibles under circumstances in which the royalty charged would preclude any reasonable expectation of earning a profit through the use of the intangibles. *Id.* at 607.

77. The Internal Rate of Return (IRR) is the interest rate that equates the present value of the expected future cash flows to the initial cash outlay. The present value of the cash flows from an investment using an arbitrary interest rate is computed and then compared to the present value of the investment's cost. When the present value of the cash flows from the investment equals its cost, the interest rate used to discount the cash flows is equivalent to the IRR. The Tax Court determined that Bausch & Lomb's initial investment of \$8,363,000 in B&LI approximated the net present value of future earnings when discounted at 35%. *Id.* at 608.

78. This was arrived at as follows: the royalty rate, which was 20% of the transfer price, divided by the total 10 year projected operating earnings [\$21,874,000/\$44,320,000 = .49320 or approximately 50%]. *Id.* at 525.

79. Thus, the rule of thumb of a 25% - 75% net profits split between the licensor/licensee was rejected. *Id.* at 608.

\$8,363,000 investment in the facility by the fourth year of operations. This rate translated into an internal rate of return of 27 percent for B&L in the project. The Court noted that the 15 percent "premium", which was in addition to the original 12 percent rate used by B&L, represented compensation for the assumption of risks Bausch & Lomb incurred in the venture.

Thus, the royalty rate determined by the Tax Court became in the court's "best judgment," the rate that would achieve the desired results over the ten year projected period. Using the 20 percent royalty rate, the court concluded that at arm's length, Bausch & Lomb would have received royalties from B&LI of \$1,674,000 for 1981 and \$5,541,000 for 1982.⁸⁰ This was contrasted to Bausch & Lomb's computations based on ARP and a 5 percent royalty rate of \$1,072,552 and \$3,050,028, respectively, for those same years.

IV. THE WHITE PAPER: A FRAMEWORK FOR ANALYSIS

A. Bausch & Lomb After the White Paper

The heart of the *White Paper* is Chapter eleven, which discusses the arm's length methodology for intangible property pricing.⁸¹ Chapter eleven establishes four methods that the Tax Court could have applied to the transactions in *Bausch & Lomb*. These methods are: (1) Exact Comparables; (2) Inexact Comparables; (3) the Basic Arm's Length Return Method (BALRM); and (4) the Basic Arm's Length Return Method Plus a Profit Split.

The *White Paper* would reject use of the Exact and Inexact Comparable methods in *Bausch & Lomb*. Use of the Exact Comparable Method would require that the transaction being considered involve the transfer of the same intangible under the same or similar circumstances.⁸² However, there were no exact comparable transactions available for the Tax Court to examine. The court pointed out that only Bausch & Lomb had been able to successfully mass produce the soft contacts using the spin cast technology.⁸³ Thus, there were no other transfers of this

80. The calculation was based on the following:

1981 - 1,116,000 units sold x \$7.50 transfer price x 20% royalty rate = \$1,674,000.

1982 - 3,694,000 units sold x \$7.50 x 20% = \$5,541,000.

Id. at 607.

81. *WHITE PAPER*, *supra* note 3, at 87.

82. *Id.*

83. *Bausch & Lomb Inc. v. C.I.R.*, 92 T.C. 525, 599 (U.S.T.C. 1989).

technology available for comparison. Similarly, the Inexact Comparable Method would be inappropriate. This method requires that the internal and external standards test be met before it can properly be used. The *White Paper* states that if the intangible property in the unrelated party transaction is at a different stage of development, then it can not be used as a comparable.⁸⁴ The spin cast technology that was licensed to B&LI was at a different stage of development than the two licensing agreements that Bausch & Lomb had presented to the court as similar transactions. Indeed, the court stated that the spin cast method was the most efficient production process then in use, and noted that this process enabled Bausch & Lomb to enjoy significant cost savings over its competitors in the production of the lenses.⁸⁵ Therefore, since Bausch & Lomb would not meet the external standards test, use of inexact comparables would be unacceptable.

The Basic Arm's Length Return Plus a Profit Split Method can also be rejected, since the *White Paper* requires that the manufacturing affiliate perform complex functions, bear significant risks, and own significant intangible assets equal to those of the parent.⁸⁶ In addition, the manufacturing affiliate must possess some type of intangible that has major importance to the enterprise, and which few unrelated parties possess.⁸⁷ B&LI did not perform activities that involved an intangible of significant importance to Bausch & Lomb.

By rejecting the use of the Exact or Inexact Comparable Methods, the remaining approach that the Tax Court could have used is the BALRM. While various scholars have already analyzed the BALRM⁸⁸ and hypothesized as to the outcome that the Tax court could have reached by using this method,⁸⁹ this paper only focuses on the problems that arise when the BALRM is applied to transactions involving high profit intangibles. By isolating this special group of intangibles, the problems associated with the arm's length method become apparent. The *Bausch & Lomb* case is used for illustrative purposes since the related party transaction considered by the Tax Court involved a high profit intangible in the form of soft contact lenses.

84. *WHITE PAPER*, *supra* note 3, at 91.

85. *Bausch & Lomb*, 92 T.C. at 599.

86. *WHITE PAPER*, *supra* note 3, at 99.

87. *Id.*

88. See Philip A. Stoffregen, Et. Al., *The BALRM Approach To Transfer Pricing: One Step Forward, Two Steps Back*, *Tax Notes*, March 6, 1989 at 1257; D. Kevin Dolan, *Intercompany Transfer Pricing For the Layman*, *Tax Notes*, October 8, 1990 at 211.

89. See, e.g., Daniel J. Frisch & Thomas Horst, *Bausch & Lomb And The White Paper*, 43 *Tax Notes*, May 8, 1989 at 735.

Bausch & Lomb presented two problems for the Tax Court. First, an arm's length transfer price between *Bausch & Lomb* and *B&LI* for the soft contact lenses had to be determined. Secondly, the court had to reconstruct an arm's length royalty rate for the use of the intangibles. However, it must be noted that the *Bausch & Lomb* opinion is not reliable for applying *White Paper* methodology. The Tax Court, arriving at the 20 percent royalty rate split between the parties, used their "best judgment" in determining that at arm's length, *B&LI* would have been willing to share in 50 percent of the profits from *Bausch & Lomb* as consideration for the use of the intangibles.⁹⁰ Using "best judgment" does not present concrete guidance when applying the section 482 regulations. Furthermore, there is no basis for the court's determination that the 27 percent internal rate of return, which was 15 percent higher than *Bausch & Lomb's* 12 percent rate, was "wholly adequate to compensate *Bausch & Lomb Ireland*" for assuming the risks in the related party venture.⁹¹

By arriving at the 20 percent royalty rate, the court concluded that an investor in the Irish lens facility could expect an internal rate of return of 35 percent over the life of the project.⁹² The 15 percent premium was considered by the court to be overly generous to *B&LI* in light of the moderate risks to which it was exposed. However, it is questionable whether the 15 percent premium was a correct adjustment in light of the *White Paper's* presumption that an affiliate should be compensated with a return not in excess of the moderate level of risk expected in order to achieve market acceptance.⁹³

90. *Bausch & Lomb*, 92 T.C. at 611.

91. *Id.* at 611.

92. *Bausch & Lomb*, 92 T.C. at 608.

93. *WHITE PAPER*, *supra* note 3, at 105.

The affiliate's return should reflect only the moderate level of risk borne by manufacturers of products that are reasonably likely to achieve market acceptance. Likewise, if there is uncertainty that the product will be marketed unsuccessfully, then the marketing risk also should not be borne by the affiliate but should probably be shared in some fashion by the owner of the manufacturing intangible and the marketer, depending upon the extent to which anticipated profits from the enterprise are attributable to the manufacturing intangibles or the marketing activities. *Id.*

Among other things, the foreign affiliate carries raw material, work-in-process, and finished goods inventories and should receive a normal market return on its activities that reflects its investments in such assets and the moderate risk that manufacturers using routine manufacturing processes bear with respect to their investment in manufacturing facilities and inventories. *Id.* at 95.

The problem of finding such a rate of return becomes more readily apparent when high profit intangibles are involved. The Tax Court concluded that the intangibles encompassed in Bausch & Lomb's spin cast technology were superior to other available methods of producing soft contact lenses.⁹⁴ Bausch & Lomb had been able to successfully mass produce the lenses using the most efficient process in current use. While noting that risk was heightened for a licensee entering the market without any proven technology, the court concluded that B&LI's risk was moderate, as compared to other companies that were not using the advanced technology.⁹⁵ Therefore, it appears that the Tax Court applied a "sliding scale" approach to determine the appropriate risk premium adjustment that would adequately compensate Bausch & Lomb for their risk in the project.

Since the *White Paper* advocates the use of a market rate of return that is comparable to that of an unrelated party bearing similar risks, the Tax Court's conclusion regarding the internal rate of return and the royalty rate is arbitrary under *White Paper* standards. Although the Court arrived at a seemingly calculated internal rate that would allow an investor in B&LI to recover an initial investment through earnings generated from the project, there were no comparable licensing agreements that the court could use to base its decision. Therefore, what the court deemed adequate in light of the risks assumed, a different approach to valuing the intangible, or setting the royalty rate under the arm's length method might yield an entirely different result. This sliding scale approach creates a continuum of acceptable rates. The problem of continuum rates is considered in greater detail in the next section.

As previously noted, the BALRM seeks to identify the assets and other factors of production used by the related parties in the line of business, and then assigns market returns to them.⁹⁶ The *White Paper* recognizes that the current § 482 regulations use a market based approach to income allocation. The *White Paper* notes that the goal of the market based approach is to distribute income in the way that the market would allocate it, and implements this by determining a separate transfer price for each individual transaction.⁹⁷ Due to the uniqueness of an intangible, the *White Paper* recognizes that differences exist in

94. *Bausch & Lomb*, 92 T.C. at 599.

95. *Id.*

96. *WHITE PAPER*, *supra* note 3, at 95.

97. *Id.* at 79.

valuing intangible, as opposed to tangible, assets.⁹⁸

B. The Market Based Approach Of The White Paper and the Continuum Price Problem

The *White Paper* notes that the market based approach has been attacked by commentators⁹⁹ whose criticisms are aimed at the use of such an approach between related parties that conduct transactions within the same entity. The *White Paper* considers a situation where a vertically or horizontally integrated technology is available to a multinational company. If the multinational is able to produce at a lower price because it owns a unique production technology, then an arm's length price may be unavailable. This phenomenon is referred to as the "continuum price" problem.¹⁰⁰ In a recent article, Professor Stanley Langbein describes the continuum pricing problem, and theorizes that the arm's length standard when applied to an integrated business is unworkable.¹⁰¹ Professor Langbein believes that whether the reseller/distributor or the producer/seller is examined, a continuum price arises because the arm's length standard generates a series of prices, not just a single arm's length price that is acceptable to either related party. More importantly, Professor Langbein concludes that neither the taxpayer nor the Service can determine the appropriate arm's length price.¹⁰²

The *White Paper* states that a continuum pricing problem does not arise in an industry with only one production technology that is available to both parties, and where there is no difference in costs between the related and unrelated parties.¹⁰³ Since both the related and unrelated party transactions will have occurred in the marketplace, the arm's length standard can be applied, thereby making it possible to observe the prices that the unrelated party charges.

The opposite of the above situation resembles the Bausch & Lomb transaction. Bausch & Lomb was an integrated manufacturer and distributor of soft contact lenses. During the relevant years that the Tax Court considered, Bausch & Lomb's technology was predominant in the soft lens industry, and had been improved

98. *Id.* at 86. "These [intangible] assets are often unique and it is frequently difficult to decide what returns they would earn if separately employed in the marketplace." *Id.*

99. *WHITE PAPER*, *supra* note 3, at 80.

100. *Id.* at 82.

101. See Stanley I. Langbein, *Current and Quotable: Langbein Says Arm's Length Method is Unworkable*, *TAX NOTES*, Sept. 3, 1990 at 1317.

102. *Id.* at 1318.

103. *WHITE PAPER*, *supra* note 3, at 82-83.

to the point where they were able to produce lenses approximately \$2.50 less than competitors. This technological advantage suggests that since the same technology was not available to both Bausch & Lomb and its competitors, whereby the competitors could produce at the same costs as Bausch & Lomb, a continuum pricing problem results.

As the next section will explore, this continuum pricing problem frequently arises when high profit intangibles are involved. The focus of the next section contemplates setting royalty rates for high profit intangibles in accordance with White Paper methodology. Since a high profit intangible is unique, ownership of such an intangible will provide related parties with a competitive advantage over unrelated parties. Arguably, it is this advantage that creates the continuum pricing problem, and renders the arm's length method functionally inadequate for setting transfer prices for high profit intangibles.

V. HIGH PROFIT INTANGIBLES, ROYALTY RATES, AND THE FAILURE OF THE ARM'S LENGTH METHOD: THE CONTINUUM PROBLEM RESURFACES

A. Transfer Pricing Using Royalty Rates

The *White Paper* recognizes potential problems with high profit intangibles, where related party transfer prices are set in terms of royalty rates.¹⁰⁴ This is inapposite to normal profit intangibles that have comparable third party licensing agreements. Applying the arm's length method to manufacturers with high profit intangibles produces different royalty rates between the related parties. This results from the subjectivity involved in assigning market returns to transactions between related parties, and the lack of comparables and the risks inherent in the transactions.

The *White Paper* contains an example¹⁰⁵ which is similar to the transaction encountered by the Tax Court in *Bausch & Lomb*. In the example, a U.S. corporation has developed and patented a new drug that it plans to manufacture through a foreign manufacturing subsidiary, which will then be returned to the United States for sale. Some of the drug will be shipped from the manufacturing subsidiary to a foreign marketing subsidiary for sale in Europe. The parent structures the transaction so that it will receive a royalty, and then the parent and the marketing subsidiary will pay the manufacturing subsidiary for

104. *Id.* at 51. "[O]wing to the intangible's enormous profitability, an allocation under the commensurate with income standard, if made solely through a royalty rate adjustment, might be so large compared to normal product royalty rates that it does not look like an arm's length royalty." *Id.*

105. *WHITE PAPER*, *supra* note 3, app. E.

the finished product. The *White Paper* determines that the arm's length method is proper for the parent since no comparables exist. After sampling other manufacturers, the parent believes that an average rate of return on the manufacturing assets is 12 percent. A further sample of other marketers and drug distributors indicates an earnings of cost plus a 25 percent markup. Based on these returns, and the income and cost data provided in the example, a royalty rate of 92 percent is deemed appropriate. This high royalty rate is questionable, but the *White Paper* recognizes that such a "super royalty" rate may be required with a high profit intangible if one party performs minor economic contributions.¹⁰⁶ Although the *White Paper* may choose to justify this super royalty rate in terms of an economic split between the parties, only a theoretical, as opposed to a concrete framework is provided for determining how related parties should account for these "economic contributions."

The *White Paper* states that if one of the parties to a transaction bears more risks, then more income should be allocated to that party.¹⁰⁷ This risk allocation should be based on the true economic activities undertaken by the parties, and not on mechanisms that merely shift the underlying risks encountered in the transaction.¹⁰⁸ If the owner of the intangible has developed a manufacturing process without significant contributions from an affiliate, as in *Bausch & Lomb*, then the owner is entitled to an arm's length return. The affiliate should be compensated with a return not in excess of the moderate level of risk that manufacturers of products are reasonably expected to earn in order to achieve market acceptance.¹⁰⁹ It is important to recognize that the above example from the *White Paper* does not indicate how the risk factor was arrived at in determining the 92 percent royalty rate, other than noting that hypothetically, there were other companies that performed similar marketing and manufacturing functions.

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The *White Paper* suggests that a company perform a functional analysis by segregating its component activities involved in the business, and then identifying the measurable assets used in production.¹¹¹ Income is then assigned to these assets by measuring the rates of returns using unrelated party transactions.¹¹² The market rates of returns may be determined

106. *Id.*

107. *Id.* at 104.

108. *Id.*

109. *Id.* at 105.

110. *Id.* at app. E.

111. *Id.* at 50.

112. *Id.*

by analyzing unrelated parties' returns on components used in similar functions, which assumes similar economic risks and comparable returns on the unrelated parties' components.¹¹³

The *White Paper* states that the rate of return used to allocate the income between the related parties includes a return on routine manufacturing intangibles that manufacturers normally possess, plus a return for assuming the normal risks that manufacturers bear with respect to their investment in the facilities and the inventories.¹¹⁴ In addition, the rate of return should be similar to an unrelated party's rate of return used in similar functions.¹¹⁵

The Tax Court in *Bausch & Lomb* segregated the parent company's assets and used a ten year cash flow projection to base their analysis of the related party transactions. Thus, the Tax Court performed the initial step required by the BALRM. The next step of the BALRM is to assign income to these assets by measuring the rates of returns using unrelated party transactions. Theoretically, a rate of return could be calculated that would allow a return on manufacturing intangibles, plus a return for the risks associated with investing in the manufacturing facilities. Therefore, the different risk variables that affect the returns of the unrelated parties' assets must be identified. However, this is extremely difficult to accomplish because a company manufacturing a high profit intangible with a unique production technology or advanced technology is unable to compute a rate equivalent to an unrelated party with inferior technology. *Bausch & Lomb's* venture entailed less risk than other manufacturers had with respect to their technology for producing contact lenses. This resulted from *Bausch & Lomb's* advanced technology and the general demand for the lenses.¹¹⁶ Had the Tax Court accepted one of the licensing agreements that *Bausch & Lomb* presented as a comparable transaction, it is still questionable whether the Court would have been able to determine whether one of the unrelated party

113. *Id.*

114. *Id.* at 97.

115. *Id.* at 96-97.

116. The Tax Court stated:

We thus conclude that the intangible property encompassed in B&L's spin cast technology was superior to that existing on January 1, 1981, with respect to either the cast molding process or the vertical spin cast process. Neither of these technologies had successfully been shown to be commercially feasible over an extended period of time as had the B&L spin cast technology. *Bausch and Lomb Inc. v. C.I.R.*, 92 T.C. 525, 599 (U.S.T.C. 1989).

agreements entailed the same risks as Bausch & Lomb had assumed with B&LI.

B. The Failure Of The Market Based Approach

The market based approach seeks to assign a rate of return that assumes similar risks between related and unrelated parties. In capital budgeting, the internal rate of return is the rate that equates the present value of an investment's inflows with its outflows. The rate of return the investor seeks in evaluating an investment is called the "hurdle" rate, or the minimum rate that must be earned for a project to be accepted. Estimating cash flows can become difficult. When a firm employs capital, it receives cash flows from the capital, which in reality will vary. Two factors that produce these uneven flows are the firm's competitive position in the market, and the existing state of the economy. The rate of return also encompasses investments risks. The greater the risk of an investment, the greater the expected return. In determining the appropriate risk adjusted discount rate to evaluate an investment project, analysts frequently adjust this rate to take into account the differences in risks.

The *White Paper* uses a market rate of return to evaluate a company with a high profit intangible. However, this rate is the average rate of return for similar technologies. For high profit intangibles, this average rate must be used since these intangibles will not have comparable technologies in order to make unrelated party comparisons. However, in capital budgeting the hurdle rate used is industry specific, and takes into account the risks and the market conditions that affect the rate that a firm will employ to measure projects. The problem with using an average rate to allocate income is that it will not effectively measure the risks inherent in a project. The average rate of return will require some "risk premium" to be added in order to account for the risks that a company will incur in undertaking a project. In other words, the *White Paper* recognizes that an industry specific rate of return for two companies can not be ascertained, and therefore uses an average rate of return with the requirement that a risk premium be added to adjust for the risks undertaken in a project.¹¹⁷ For example, the Tax Court tried to accomplish this by adding a risk premium to the 12 percent rate of return that Bausch & Lomb had arrived at through the ten year SEA projections.

This risk premium adjustment contributes to the continuum pricing problem because it creates a range of acceptable rates.

117. Example 7 in appendix E arrives at the hypothetical rate of return of 12% by using an average rate of return on manufacturing assets. *WHITE PAPER*, *supra* note 3, app. E at 8.

Any rate that is acceptable within a given range will be considered an arm's length rate. For example, consider a company that has a high profit intangible. Using the arm's length method, the company derives a 20 percent "comparable" rate of return from an unrelated party's assets, which translates into a 10 percent royalty rate. However, based on *White Paper* theory, this assumes that the 20 percent rate of return is an average rate of return. Suppose that the company adds a 5 percent risk premium since they are using high-tech equipment that is previously untested. With a 25 percent rate of return, the company computes a 15 percent royalty rate. Theoretically, any rate between the 10 percent and 15 percent royalty rate is arguably at arm's length. Thus, a continuum of acceptable royalty rates is created.

Other commentators, using *Bausch & Lomb* data, have also presented alternate approaches to the arm's length method that would be acceptable under *White Paper* theory. Although these commentators do not analyze the *White Paper's* shortcomings by focusing on the theoretical problems underlying the market based approach, their conclusions are illustrative of the fact that a series of acceptable rates can be calculated using the arm's length method.¹¹⁸

One particular commentator recognized that a market based approach rarely quantifies the specifics inherent in individual licensing agreements.¹¹⁹ In a hypothetical the author used simple capital budgeting techniques and evaluated the component assets used by *Bausch & Lomb* by the weighted average cost of capital (WACOC) and discounted cash flows technique. By using the WACOC, the author was able to incorporate both systematic and unsystematic risks in arriving at an average rate of return of 12 percent that he noted would have been reasonable for the Tax Court to employ.¹²⁰ Consequently, the author determined that a 12 percent royalty rate was appropriate, and the 20 percent rate used by the Tax Court was extreme.

Frisch & Horst¹²¹ used a different approach to the *Bausch & Lomb* facts. They noted that the return on a project such as *Bausch & Lomb's* involved an internal rate of return, which when applied to discounted cash flows, resulted in a present value that equated the cash flows to the initial capital outlay of the investment. Although they accepted the 27 percent rate arrived at by the Court, they made various adjustments to B&L's estimated cash flows. Frisch & Horst arrived at a 34 percent

118. Cf. Langbein, *supra* note 101.

119. See Lawrence P. Shanda, *Taxes*, THE TAX MAGAZINE, September, 1989 at 576.

120. *Id.* at 581.

121. See *supra* note 89.

royalty rate, which they believe correctly reflected any changes in the original ten year projection determined by Bausch & Lomb, and which the Tax Court used to base its royalty rate calculation.¹²²

VI. CONCLUSION

This Comment focused on the problems associated with the arm's length method when applied to high profit intangibles. Since the *White Paper* fails to provide specific guidance when related parties seek to determine royalty rates, establishing a true arm's length rate becomes extremely difficult, especially when a high profit intangible is involved. The Tax Court's holding in *Bausch & Lomb*, particularly as it dealt with royalty rates, was used as an illustration of the many problems that would occur if *White Paper* methodology had been used to calculate an arm's length rate.

Determining a royalty rate under the *White Paper* involves segregating the various components of the business used in production, and assigning market rates of return to the components. The *White Paper* requires that the rate of return used to allocate income between the related parties involve similar economic activities with similar economic risks of the unrelated party under comparison. However, determining this rate of return is what creates a continuum pricing problem. This arises because under the arm's length method, the *White Paper* uses an average rate of return for a high profit intangible, but requires a risk premium adjustment to compensate a party for the risks involved in the transfer. Since a high profit intangible normally does not have a related party transaction for comparison, it becomes difficult to estimate the true risks incurred by the unrelated party. Therefore, the risk adjustment becomes arbitrary, with the result that many, theoretically correct arm's length royalty rates are established.

Two alternate approaches by commentators have been presented to illustrate that other technically correct methods can be employed to calculate arm's length royalty rates. As compared to the Tax Court's calculations, one commentator believed that a 12 percent royalty rate would have been appropriate, while the other determined that a 34 percent rate was correct. These different royalty rates reiterate the hypothesis that the arm's length method will generate a series of royalty rates for high profit intangibles.

Thus, while the *White Paper* attempts to provide a method for establishing a true arm's length transfer price between related

122. *Id.*

parties, the arm's length method may produce nothing more than a "best judgment." Ironically, the *White Paper* notes that where no comparables exist, the regulations leave the Service and more importantly the taxpayers, with no guidance. While the *White Paper* is an admirable examination of the theory and administration of transfer pricing, it serves little more than to foster more uncertainty in these already troubled waters.

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