Overview

• Transfer Pricing Regulations Recap
  – Arm’s Length Standard: OECD, Art. 9 and IRC §482
  – IP Migration: Existing and IPRD
  – Cost Sharing: Current and Proposed Regulations

• Potential M&A “Deal” Structures with IP Migration
  – Pre “Deal”: NOL Utilization
  – Pre and Post “Deal”: By-passing Buy-in/PCT payments

• Summary - Key M&A / Cost Sharing Deal Factors
Transfer Pricing Regulations Recap

• Arm’s Length Standard: IRC 482 and OECD, Article 9, I.

• Purpose of Section 482: to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such [controlled] transactions. [1.482-1(a)(1)]

• Applicable only to "controlled transactions."

• Limitations in Jurisdiction

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<tr>
<th>482-4</th>
<th>Buy-in</th>
<th>PCT</th>
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<tr>
<td>Existing IP</td>
<td>X</td>
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<td>In-Process R&amp;D (IPRD)</td>
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What Is Cost Sharing?

• Joint funding of research and development of intangible property (IP) resulting in joint economic ownership of that IP.
• The parties to the cost sharing arrangement (CSA) agree to share the costs of development in exchange for a proportional share of the anticipated benefits.
• In most cases, one or more of the participants contributes pre-existing intangibles to the arrangement. (Such technology or intangible assets are termed “external contributions” in the proposed regulations.)

What Is Cost Sharing? (Continued)

• CSAs seek to determine not only the appropriate share of ongoing intangible development costs (IDCs) to be borne by each participant, but also to properly value the pre-existing intangibles each party contributes to the arrangement.
• Under the current regulations, these “buy-in payments” (or preliminary and contemporaneous transaction (PCT) payments under the proposed regulations) are subject to the commensurate with income standard.
• In general, CSAs are used by companies to manage the development of their IP in a tax-efficient manner.
Impetus for Change

- The Treasury and IRS have become increasingly concerned that U.S. taxpayers use CSAs to transfer IP offshore without appropriate arm’s length remuneration.
- Specifically, the IRS believes that U.S. taxpayers have historically undervalued their external contributions to CSAs.
- Thus, the government issued the proposed cost sharing regulations which:
  - Provide taxpayers with additional guidance on the types of external contributions for which arm’s-length consideration must be paid; and
  - Present “specified” methods for valuing those contributions.

Cost Sharing Today and Tomorrow

<table>
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<tr>
<th>Current</th>
<th>Key Changes</th>
<th>Proposed</th>
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<td><strong>Buy in Payments</strong></td>
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<td>– Separation between existing and new IP value.</td>
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<td>– Declining royalties.</td>
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<td>– Commensurate with income requirement.</td>
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<td>– Adjustment to achieve arm’s length result.</td>
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<td>– Focused on specific technologies with specific uses.</td>
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<td><strong>PCTs/RTs</strong></td>
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<td>– Do not separate existing and new IP value.</td>
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<td>– No declining royalties.</td>
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<td>– IRS-only initiated adjustments and potential cap on income shift.</td>
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<td>– Adjustments punitive, but safe harbor wide.</td>
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<td>– Reference Transaction allows for full exploitation of IP and broadens definition of IP to be cost-shared (e.g. workforce in place).</td>
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Pre “Deal” NOL Utilization

• The exit strategy for many high-tech’s is to be acquired.
• A common characteristic of high-tech acquisition targets is an existing pool of NOL carryforwards.
• The issue at hand is that a change in control leads to §382 limitations that in turn decrease the value of the target.
• To plan for acquisition, migrate IP off-shore through §482-4 or cost sharing prior to “deal” (before limitations occur).

Example of Pre “Deal” NOL Utilization

• US company holds all existing and in-process IP.
• US company has significant NOLs subject to §382 limitations post “deal”.
• US company shifts IP off-shore all/or in part.
  – All technology (§482-4).
  – Certain technology (§482-4).
  – Non-US rights to all or certain technologies (cost sharing regulations).
• Approach depends on NOL pool relative to IP value, among other factors.
Benefits to Acquiring Company

• Maximize NOL carryforward benefit by reducing rate hit associated with buy-in payments.
• Cash tax savings.
• Establishes or is consistent with structures ready for global business expansion.
• May align with many larger corporate (i.e. acquirers) structures in the high-tech space.

By-passing Buy-in/PCT Payments With Cost Sharing

• Established US hi-techs regularly engage in predatory or expansionary M&A deals.
• US hi-tech Acquirers hold substantial portion of global profits / revenues offshore in low-tax CFCs. (i.e. existing cost sharing arrangements, off-shoring ops.)
• Issue: M&A "deal" itself, combined with US Acquirer’s offshore profits, provide a unique cover opportunity to migrate acquired Target IP offshore at arm’s length, limiting §482 jurisdiction.
• To maximize post-“deal” cost sharing options with respect to Target’s IP, resolve and align certain cost sharing parameters during pre-“deal” planning.
By-passing Buy-in/PCT Payments With Cost Sharing Asset Deals

Key Parameters
- Anticipated Benefits (X, Y): %, Geographies, “best measure”
- Timing of Post-“Deal” CSA: Contemporaneous or Lagged
- Risks: R&D Profile (In-process R&D)
- Flexibility: Future (t₁) IP Structuring / Restructuring Plans

Example: How not to cost share post-“Deal”

- Post-“deal” Contemporaneous Cost Sharing of Target’s IP
- Un-aligned anticipated benefits result in 482 adjustment
Example: Post “Deal” Contemporaneous Cost Sharing

- Aligned “deal” and cost shared anticipated benefits \((X, Y)\)
- Acquirer’s Benefits: No additional PCT / Buy-in required, immediate CSA benefits, no IRS adjustment

Example: Post “Deal” – Lagged Cost Sharing

- Unaligned or Aligned “deal” and cost shared anticipated benefits
- Benefits to Acquirer: Buy-in/PCT options; flexible management of risky new (in-process) IP; Separable transactions
Summary – Main Points

• Consider IP Migration strategies (i.e. CSAs) before and during M&A deal, not after.
• IRC 482 has limited jurisdiction: If no controlled transaction, no transfer pricing, no IRS jurisdiction.
• Proposed CSA (482) regs reduce options for I/C transfers of existing IP
• Cost sharing M&A Target’s IP contemporaneous with M&A deal may reduce USP’s future tax planning and audit defense options
• Waiting to Cost Share T’s IP increases USP’s future flexibility in tax planning and audit defense strategies
• Integrate IP strategy within M&A strategy.
• Plan on-going IP migration in light of proposed changes to cost sharing rules.