INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 12, 2004

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200444022**
Release Date: 10/29/04
Index (UIL) No.: 482.11-08, 927.01-00, 861.15-01
CASE-MIS No.: TAM-101067-0-4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

USCorp =
USCorp-FSC =
ForSub =
Date1 =
Date2 =
CountryA =
TerritoryZ =

QCSA-X =

License-X =

Year1 =
Year2 =
Year3 =
Year4 =
Year5 =

Year6 =
AmountA =
AmountB =
AmountC =
AmountD =
AmountE =
AmountF =
AccountingFirm =
StudyQ =

ISSUE 1:

Whether, pursuant to Treas. Reg. § 1.482-7(g), ForSub is required to make buy-in payments to USCorp for intangible property made available by USCorp for purposes of research under a qualified cost sharing arrangement ("QCSA").

ISSUE 2:

Whether certain payments made by (or owed from) ForSub to USCorp may constitute foreign trading gross receipts ("FTGR") under section 924(a)(2) or 942(a)(1)(B).

ISSUE 3:

Whether ForSub sales of software products that incorporate USCorp intellectual property are included in the sales ratio used to apportion research and experimental ("R&E") expenditures pursuant to Treas. Reg. § 1.861-17(c)(3) for purposes of computing taxable income under section 925(a)(2) of the foreign sales corporation ("FSC") provisions, section 941(b)(1) of the extraterritorial income ("ETI") exclusion provisions, or any other statutory or residual grouping of income.

CONCLUSION 1:

Yes. Pursuant to Treas. Reg. § 1.482-7(g), ForSub is required to make buy-in payments to USCorp for intangible property made available by USCorp for purposes of research under a QCSA.

CONCLUSION 2:

To the extent that payments made by (or owed from) ForSub to USCorp are for the use of USCorp's software intangibles made available for use in R&E activities under the QCSA, such payments do not qualify as FTGR. To the extent that payments made by (or owed from) ForSub to USCorp are for the right to make and sell products that incorporate USCorp's software intangibles developed prior to the QCSA, such

payments may qualify as FTGR, provided that all other FSC requirements are satisfied. Therefore, as explained below, we believe that the payments constitute primarily payments for R&E rights (i.e., an amount determined during the audit by Examination), but also may include some payments for make/sell rights in existing products (i.e., an amount not yet determined by Examination).

CONCLUSION 3:

Once QCSA-X became effective, ForSub was no longer reasonably expected to benefit from USCorp's R&E expenditures as described in Treas. Reg. § 1.861-17(c)(3)(iv); thus ForSub sales are not included in the sales ratio used to apportion USCorp's share of R&E expenses covered by QCSA-X. However, because ForSub was reasonably expected to benefit from USCorp's R&E expenditures for the period preceding the effective date of QCSA-X, ForSub sales are included in the sales ratio used to apportion USCorp's Year1 R&E expenditures incurred prior to Date2.

FACTS

I. In General

USCorp is a domestic corporation engaged in the business of developing source code and other computer software intangibles. USCorp is also engaged in the business of manufacturing, marketing, distributing, selling, and licensing products that incorporate such source code and other software intangibles ("USCorp software products"). On Date1, ForSub was incorporated in CountryA as a wholly-owned subsidiary of USCorp.

Prior to Date2, USCorp conducted sales activities in TerritoryZ directly through certain of its wholly-owned foreign subsidiaries other than ForSub pursuant to sales agency agreements. On Date2 (approximately 30 days after Date1), USCorp and ForSub entered into QCSA-X, a QCSA as defined in Treas. Reg. § 1.482-7(b). Also on Date2, USCorp and ForSub entered into License-X pursuant to which USCorp licensed all of its intangible property rights with respect to TerritoryZ to ForSub in exchange for royalty payments.

On original and/or amended income tax returns for the taxable years at issue, USCorp claimed FSC commission expense deductions for commissions that it paid to USCorp-FSC, its wholly-owned FSC, in connection with portions of the royalty payments received from ForSub. On the same returns, Taxpayer claimed ETI exclusions in connection with other portions of the royalty payments received from ForSub. More specifically, our understanding is that USCorp claimed FSC benefits with respect to the royalty payments attributable to the period before October 1, 2000, and claimed ETI exclusion benefits with respect to the royalty payments attributable to the period after September 30, 2000.

Under QCSA-X, ForSub engages in the business of manufacturing, marketing, distributing, selling, and licensing USCorp software products in TerritoryZ.[1] During the taxable years at issue, ForSub owned or controlled at least one foreign company that manufactured, marketed, and distributed USCorp software products. Each such foreign company was a disregarded entity under Treas. Reg. § 301.7701-2 or 301.7701-3.

Taxpayer[2] identifies the royalty payments made by ForSub to USCorp as "buy-in payments." Taxpayer's transfer pricing documentation shows that Taxpayer applied a residual profit split methodology to derive a single royalty percentage payable by ForSub to USCorp. During the audit process, Examination determined that the Treas. Reg. § 1.482-7(g) buy-in payment properly owed by ForSub to USCorp in connection with QCSA-X for Years1 and 2 is an amount substantially greater than the royalties actually paid. This determination was made jointly by a Service economist, an outside economist, and an outside industry expert. Examination has stated (and we agree) that the payments computed both under Taxpayer's methodology (as shown in Taxpayer's transfer pricing documentation) and under Examination's methodology (as shown in Examination's audit materials) reflect a valuation of R&E rights in the transferred intangibles, not make/sell rights.

In addition, Examination determined that ForSub owes royalties to USCorp under Treas. Reg. § 1.482-4 for the right to make and sell USCorp software products already developed at the time the parties entered into QCSA-X. To clarify, Examination's conceptual separation of buy-in and make/sell payments is based on the following facts: (1) On Date2, USCorp licensed and/or made available all of its software intangibles to ForSub with respect to TerritoryZ; (2) such intangibles included the separate and distinct copyright rights to (a) make and sell existing products that incorporate the transferred software and (b) use the transferred software in R&E activities under QCSA-X (i.e., the Treas. Reg. § 1.482-7(g) buy-in).

Because the USCorp software products that were in existence as of Date2 were nearing the end of their useful lives, Taxpayer knew at the outset of QCSA-X that the existing software would become obsolete and unproductive relatively quickly in comparison with subsequent generations of software that would be developed under QCSA-X.[3] Therefore, Examination believes that the royalties owed with respect to the make/sell rights in the existing software are relatively small in comparison with the buy-in payments owed under Treas. Reg. § 1.482-7 with respect to the software developed

[1] ForSub also engages in certain activities that may constitute development of software. Such activities are not relevant to the issues addressed in this memorandum.

[2] For convenience, we use the collective term "Taxpayer" throughout this memorandum to refer to USCorp and its subsidiaries, regardless of whether each entity is a separate taxpayer for U.S tax purposes.

[3] In fact, the existing software products were substantially or entirely replaced by new USCorp software products that incorporated two new versions of the contributed intangibles developed during the first two months of QCSA-X.

under QCSA-X. However, Examination has not yet determined the exact amount of the payments owed for the make/sell rights.

USCorp asserts that the intangible property that it licensed and/or made available to ForSub constitutes export property under section 927 or qualifying foreign trade property under section 943. Accordingly, USCorp takes the position that it may claim FSC or ETI exclusion benefits with respect to the payments properly owed by ForSub to USCorp. In computing its taxable income for FSC and ETI exclusion purposes from the payments properly owed by ForSub, USCorp asserts that it must exclude all post-Date2 ForSub sales of USCorp software products in TerritoryZ from the sales ratio used to apportion R&E expenses, pursuant to Treas. Reg. § 1.861-17(c).

For simplicity, throughout this memorandum we use the term "ForSub payments" to refer to all of the payments properly owed by ForSub to USCorp -- as determined by Examination during the audit process – rather than the lesser amount actually paid by ForSub and originally reported by USCorp. Thus, the ForSub payments discussed throughout this memorandum include both the Treas. Reg. § 1.482-7 buy-in payment amount determined by Examination, as well as the presumably smaller – but as yet undetermined – amount owed under Treas. Reg. § 1.482-4 for make/sell rights in the software intangibles transferred by USCorp.

II. The Cost Sharing and Licensing Agreements

QCSA-X reflects the intent of USCorp and ForSub that their cost sharing agreement constitute a QCSA:

> WHEREAS, the parties intend for this agreement to constitute a qualified cost sharing agreement as defined in Section 1.482-7 of the Treasury regulations, and shall make amendments from time to time as necessary to maintain such qualified status.

QCSA-X, p.2. In License-X, USCorp is identified as "Licensor," and ForSub is identified as "Licensee." Under License-X, USCorp granted to ForSub:

> a limited, non-exclusive, non-transferable license to utilize the Covered Intangibles and Licensor's Confidential Information in connection with the Program and to utilize the Covered Intangibles and Licensor's Confidential Information within its territory (i) to manufacture, market, distribute, sell and license Products utilizing, embodying or incorporating the Covered Intangibles, (ii) to use the Covered Intangibles to provide technical support, training, consulting or other services, and (iii) to sublicense the

> Covered Intangibles to third parties for any of the foregoing purposes.

License-X, Art. 2.1. For purposes of License-X, "Covered Intangibles" means

> any and all inventions, patents, copyrights, computer programs (in source code and object code form), flow charts, formulae, enhancements, updates, translations, adaptations, information, specifications, designs, process technology, manufacturing requirements, quality control standards, and other intangible property rights in existence as of the Effective Date of this Agreement; and shall also mean and include any and all trademarks, trade names, copyrights, designs, service marks, applications and registrations therefore, packaging, marketing strategies, customer lists, other marketing information and other similar marketing intangible property relating to any of the Products and used in connection with the Program.

License-X, Art. 1.1. "Licensor's Confidential Information" means "all information, that relates to any or all of the Products and/or the Covered Intangibles, or to business, plans, affairs or activities of Licensor." License-X, Art. 1.4. "Products" means "all products (including updates and upgrades) which utilize, embody or incorporate Covered Intangibles." License-X, Art. 1.6. "Program" means "all intangibles development activity and process development activity as defined in Article 2 of [QCSA-X]." License-X, Art. 1.7. "Intangibles development activity" includes "(i) development of new source code or other intangible property; and (ii) creation of improvements, updates, adaptations, translations or other modifications to existing intangible property." QCSA-X, Art. 2.1. "Process development activity" means "any development or improvement of manufacturing processes . . . for any Product." Id.

In exchange for the licenses of intangible property described in License-X, ForSub was required to pay royalties to USCorp contingent on ForSub's Net Revenues over six years as follows:

Year	Percentage of Licensee's Net Revenues
Year1	AmountA%
Year2	AmountB%
Year3	AmountC%
Year4	AmountD%
Year5	AmountE%
Year6	AmountF%

License-X, Art. 5.1 and Exhibit 5.1. "Licensee's Net Revenues" are ForSub's "total gross revenues from Product licenses and from maintenance contracts, less any credits, discounts, allowances, returns and refunds with respect to such Products." License-X, Art. 1.3. As mentioned above, Examination determined that the payments made by ForSub to USCorp in accordance with this schedule for Years1 and 2 significantly under-compensated USCorp for its making available of software intangibles for use in R&E under QCSA-X, and failed to compensate USCorp at all for its license of make/sell rights in those contributed intangibles for their remaining useful life. This memorandum does not address ForSub payments for Years3 through 6.

III. USCorp's Transfer Pricing Study

USCorp engaged AccountingFirm to perform StudyQ, a transfer pricing analysis, to determine the transfer price for the buy-in transfer under Treas. Reg. § 1.482-7(g). StudyQ states that AccountingFirm is "able to calculate the buy-in payment [ForSub] must make to [USCorp] as compensation for its share of the pre-existing intangible assets." StudyQ, p.62. StudyQ also provides:

> Much of [USCorp's] profitability is attributable to intangible qualities or assets that the Company has developed and innovated from its earliest days of operations and continues to strengthen today. In the parlance of the U.S. Internal Revenue Code ("Regulations"), product R&E efforts as well as any other investments made by [USCorp] in promotion of the Company potentially constitute valuable "pre-existing intangibles" – assets that [USCorp] will bring to the cost sharing arrangement. All affiliates participating in the cost sharing arrangement stand to benefit from these assets; therefore, the cost sharing arrangement must include an arm's-length payment to compensate [USCorp].

StudyQ, p.30. StudyQ summarizes the buy-in concept as follows: "The purpose of the buy-in calculation is to determine all profit that is attributable to intangible spending prior to the buy-in date." Id. at 67.

LAW AND ANALYSIS – ISSUE 1:

The primary issues in this case are whether the ForSub payments constitute FTGR and whether Treas. Reg. § 1.861-17(c)(3)(iv) applies to the ForSub sales for purposes of determining the R&E expenses that are allocated and apportioned to the ForSub payments. Resolution of both of these issues depends, in significant part, on the correct characterization of the property that is the subject of the ForSub payments. In particular, in the context of the FTGR issue, before we can determine whether the

property is export property or qualifying foreign trade property, we must analyze the cost sharing and buy-in provisions of Treas. Reg. § 1.482-7 to determine what property was transferred in exchange for the ForSub payments. Accordingly, our analysis begins with the section 482 issue, followed by the FTGR and R&E expense issues.

I. The Cost Sharing and Buy-In Provisions

Treas. Reg. § 1.482-7(a)(1) provides, in part:

> A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section.

Treas. Reg. § 1.482-7(g)(1) provides, in part:

> A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of § § 1.482-1 and 1.482-4 through 1.482-6, to reflect an arm's length consideration for the transferred intangible property.

Treas. Reg. § 1.482-7(g)(2) provides, in part:

> If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of § § 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's

> share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

Treas. Reg. § 1.482-7(e)(2) defines a controlled taxpayer's reasonably anticipated benefits as "the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles." Treas. Reg. § 1.482-7(e)(1) defines benefits as "additional income generated or costs saved by the use of covered intangibles." The legislative history for section 482 provides:

> In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&E cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986) ("H.R. Conf. Rep. No. 99-841"), reprinted in 1986-3 C.B. (vol. 4) 637, 638.

Throughout this memorandum, we refer to the software intangibles licensed or otherwise made available to ForSub as "pre-existing intangibles," and we refer to the software intangibles developed pursuant to QCSA-X as "cost-shared intangibles."[4] We further subdivide the pre-existing intangibles category into two subcategories – R&E rights in pre-existing intangibles and make/sell rights in pre-existing intangibles.

II. Service Position

The section 482 regulations apply an arm's length standard to dealings between controlled taxpayers.[5] Treas. Reg. § 1.482-7 provides special rules for QCSAs. A QCSA is a cost sharing arrangement that meets certain requirements. Treas. Reg. § 1.482-7(a)(1). In a cost sharing arrangement, parties agree to share the costs of developing intangibles in proportion to the parties' shares of reasonably anticipated benefits from their respective exploitation of the resulting cost-shared intangibles. Id. In order for a QCSA to produce results that are consistent with an arm's length result, the

---

[4] The term "cost-shared intangible," as used in this memorandum, is synonymous with the term "covered intangible" used in Treas. Reg. § 1.482-7.

[5] See Treas. Reg. § 1.482-1(i) for definitions of "controlled" and "controlled taxpayer."

controlled participants[6] not only must share costs in proportion to their shares of reasonably anticipated benefits but also must meet all other requirements of Treas. Reg. § 1.482-7.

Treas. Reg. § 1.482-7(g)(1) requires a buy-in payment from one controlled participant to another where the payee "makes intangible property available to" the QCSA. The conditions under which a buy-in payment is required are further described in "if/then" terms:

> If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner.

Treas. Reg. § 1.482-7(g)(2) (emphasis added). The buy-in payment by each controlled participant, if required, consists of

> the arm's length charge for the use of the intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits.

Treas. Reg. § 1.482-7(g)(2).

Thus, Treas. Reg. § 1.482-7 requires arm's length buy-in payments when a controlled participant makes available a pre-existing intangible to a QCSA. This rule reflects the intent of Congress, which stated with regard to the making available of pre-existing intangibles:

> [T]o the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment.

H.R. Conf. Rep. No. 99-841, at 9 (emphasis added). In other words, the buy-in payment compensates the controlled participant for its contribution of a pre-existing intangible, for which the contributor incurred expenses and/or put its funds at risk by performing research and development activities outside the QCSA. The investor model in the legislative history views a buy-in payment as providing a return to the contributor

---

[6] See Treas. Reg. § 1.482-7(c)(1) for the definition of "controlled participant."

for having invested its funds and engaged in other risky activities. The remaining question is how to calculate this return.

Treas. Reg. § 1.482-7(g)(2) provides that the buy-in payment is based on the arm's length charge for the use of the intangible made available to the other controlled participants in the QCSA. Considering the context of Treas. Reg. § 1.482-7, generally, and Treas. Reg. § 1.482-7(g), specifically, the "use" referred to in Treas. Reg. § 1.482-7(g)(2) must be the use of the pre-existing intangible in R&E activities. Absent a buy-in payment for the use of a pre-existing intangible in the QCSA, a controlled participant that contributes a pre-existing intangible to the QCSA would be under-compensated, and Treas. Reg. § 1.482-7 would not yield a result consistent with an arm's length result.

III. Taxpayer Arguments

In oral and written communications, Taxpayer presented several inter-related arguments to support its position that Treas. Reg. § 1.482-7(g) does not require ForSub to make buy-in payments to USCorp for the use of USCorp's pre-existing intangibles in the QCSA-X R&E activities. Summaries of Taxpayer's arguments, and our reasons for rejecting them, follow:

Argument #1 -- ForSub Did Not Use USCorp's Pre-existing Intangibles in R&E

Taxpayer argues that, because ForSub did not perform QCSA-X R&E activities using USCorp's pre-existing intangibles, ForSub does not owe USCorp a Treas. Reg. § 1.482-7(g) buy-in payment for the use of pre-existing intangibles in R&E. We disagree. Treas. Reg. § 1.482-7(g) contemplates that a buy-in payment is due if a pre-existing intangible is contributed to a QCSA, without regard to whether a particular controlled participant engaged in actual, "hands-on" exploitation of the intangible in R&E activities. Treas. Reg. § 1.482-7(g)(1) provides that

> [a] controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to other participants, and such other controlled participants must make buy-in payments to it. . . . (Emphasis added.)

The requirements for buy-in payments are clearly stated. Regardless of whether a controlled participant formally transfers intangible property to the other controlled participants, such a transfer is deemed to have occurred by virtue of the making available of the property to the QCSA. In exchange for such transfer, the other participants must make buy-in payments.

Treas. Reg. § 1.482-7(g)(2) provides the rules for determining the proper amount of a buy-in payment. The first sentence states the conditions under which a buy-in

payment is necessary:

> If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. (Emphasis added.)

In other words, if a controlled participant contributes a pre-existing intangible to QCSA research activities, then the other controlled participants must pay the owner for such contribution. In the present case, USCorp made certain pre-existing intangibles such as source codes available to QCSA-X for use in the development of other intangibles. Therefore, ForSub owes buy-in payments to USCorp.

The second sentence of Treas. Reg. § 1.482-7(g)(2) states how the amount of a buy-in payment is determined:

> The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). (Emphasis added.)

The legislative history anticipates that contributions of pre-existing intangibles will be compensated: "it would be expected that an appropriate return would be required to such party to reflect its investment." H.R. Conf. Rep. No. 99-841, at 9. Moreover, Taxpayer's own transfer pricing documentation echoes the legislative history and, thus, supports our interpretation of Treas. Reg. § 1.482-7(g)(2) based on the investor model as mentioned above:

> In the parlance of the U.S. Internal Revenue Code ("Regulations"), product R&E efforts as well as any other investments made by [USCorp] in promotion of the Company potentially constitute valuable "pre-existing intangibles" – assets that [USCorp] will bring to the cost sharing arrangement. All affiliates participating in the cost sharing arrangement stand to benefit from these assets; therefore, the cost sharing arrangement must include an arm's-length payment to compensate [USCorp]. (Emphasis added.)

The transfer pricing documentation also provides: “The purpose of the buy-in calculation is to determine all profit that is attributable to intangible spending prior to the buy-in date.” StudyQ, p.30; see also StudyQ, p.67.

The reference in Treas. Reg. § 1.482-7(g)(2) to “use” is not a requirement of actual use by the buy-in payors but, rather, indicates that the arm’s length charge for “use in R&E activities” is the benchmark for the buy-in calculation. This benchmark is appropriate because the pre-existing intangible (with respect to which the buy-in payment is required) is used in R&E, in part, for the benefit of the buy-in payor.

Argument #2 -- USCorp Did Not Use Its Pre-existing Intangibles in R&E

During the April 19, 2004, conference (“Conference”), Taxpayer implied that USCorp did not use any of its pre-existing intangibles in QCSA-X activities. Taxpayer suggested that its source code and associated software intangibles are not used in the development of new intangibles under QCSA-X. We understand Taxpayer’s argument to be as follows: Assume that USCorp developed source code T prior to QCSA-X and intends to develop the next generation version of T under QCSA-X. The cost-shared intangible will be T+C. Under Taxpayer’s theory, the T portion of T+C was developed prior to the QCSA-X activities, and the C portion of T+C is solely the result of costs shared pursuant to the QCSA-X. Thus, Taxpayer argues that there is no use of T in R&E activities under QCSA-X for which Treas. Reg. § 1.482-7(g) requires buy-in payments because the T portion of T+C was fully developed prior to the QCSA, and the C portion is separate and distinct from T.

Taxpayer’s suggestion that USCorp’s pre-existing intangibles were not used in the research and development of the next generation version of T (or any other new software intangible that uses T as a platform or is otherwise integrated with T) is incorrect. Where a taxpayer seeks to develop a new intangible that is based on (or integrated with) a pre-existing intangible, in conducting such research and development the taxpayer logically would make use of the pre-existing intangible. Treas. Reg. § 1.482-7(g) is premised on the fact that developers of intangible property often use existing intangibles as a platform for (or to otherwise assist or further) their development of new intangibles. Therefore, we reject Taxpayer’s claim that USCorp does not use its pre-existing intangibles in its efforts to develop new intangibles under the QCSA.[7]

Argument #3 -- Buy-in Payments Are Required for Make/Sell Rights

Taxpayer argues that Treas. Reg. § 1.482-7(g) requires buy-in payments for the make/sell rights in the pre-existing intangibles that USCorp made available to the QCSA

---

[7] Our conclusion that a buy-in payment is required where a pre-existing intangible is incorporated into a cost-shared intangible is not intended to imply that a buy-in payment would not be required where the pre-existing intangible otherwise furthers or assists the R&E but is not incorporated into the resulting cost-shared intangibles or, subsequent to entering into a QCSA, the research and development activity diverges from the pre-existing intangible.

and that were used in QCSA-X activities. In support of its position, Taxpayer cites the "commercially transferable interest" language in Treas. Reg. § 1.482-7(a)(2). Specifically, Taxpayer argues: (1) Treas. Reg. § 1.482-7(g)(1) requires buy-in payments for "interests" in intangible property made available to a QCSA; (2) Treas. Reg. § 1.482-7(a)(2) defines "interests" as all commercially transferable interests susceptible of valuation; (3) therefore, make/sell rights necessitate buy-in payments.[8]

We agree that USCorp's make/sell rights in computer software are commercially transferable interests susceptible of valuation. But this fact is irrelevant in the buy-in context, because make/sell rights are not deemed transferred under Treas. Reg. § 1.482-7(g)(1), which provides:

> A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section.

The deemed transfer of interests required by Treas. Reg. § 1.482-7(g)(1) is contingent on the making available of intangible property to a QCSA that governs the sharing of R&E costs. Nothing in Treas. Reg. § 1.482-7 states or implies that make/sell rights should be or may be made available to a QCSA and, therefore, compensated with buy-in payments. The cost sharing rules of Treas. Reg. § 1.482-7 do not apply to the manufacturing, marketing, or distribution of copyrighted articles. Make/sell rights are irrelevant to R&E activities. The cost sharing rules of Treas. Reg. § 1.482-7 apply to the research and development of intangible property.[9] In short, Taxpayer's reading of Treas. Reg. § 1.482-7 is inconsistent with the purpose of the regulation.

Moreover, make/sell rights are economically irrelevant in the Treas. Reg. § 1.482-7 context. Treas. Reg. § 1.482-7(e) provides that reasonably anticipated benefits are the additional income or cost savings that are derived from cost-shared intangibles. Treas. Reg. § 1.482-7(g)(2) provides that a buy-in payment is a portion of

---

[8] The relevant portion of Treas. Reg. § 1.482-7(a)(2) provides: "An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation."

[9] The notion that Treas. Reg. § 1.482-7 cost sharing and buy-in payments are required only with respect to intangible development activities pervades the regulation. Treas. Reg. § 1.482-7's focus on development of intangibles is apparent from the many references to R&E throughout the regulation. See, e.g., Treas. Reg. § 1.482-7(a)(1) (QCSA involves "development of one or more intangibles"), (b)(4)(i) (requiring a list of the parties "that will benefit from the use of intangibles developed under the" QCSA), (b)(4)(iv) (documentation requirement regarding "[a] description of each participant's interest in. . . . intangible property that is developed as a result of the research and development undertaken under the" QCSA), (c)(1)(i) (a controlled participant must reasonably anticipate "that it will derive benefits from the use of covered intangibles), (e)(1) (benefits are additional income or reduced costs resulting from the use of covered intangibles), (g)(2) (requiring buy-in payments as compensation for contributions of pre-existing intangibles for use in R&E under a QCSA).

the arm's length charge for the use of a pre-existing intangible based on the payor's reasonably anticipated share of the benefits under the QCSA. Considering that (1) buy-in payments, in combination with cost sharing payments, entitle the payors to a portion of the reasonably anticipated benefits; (2) reasonably anticipated benefits are derived solely from cost-shared intangibles; and (3) make/sell rights in pre-existing intangibles provide no economic contribution to cost-shared intangibles, the payments with respect to make/sell rights are not directly relevant to achieving an arm's length result under a QCSA.

We conclude that the portion of the payments that are received by USCorp for the use of pre-existing intangibles in R&E activities under QCSA-X are buy-in payments within the meaning of Treas. Reg. § 1.482-7(g). For simplicity, we refer to these payments throughout the remainder of this memorandum as "payments for R&E rights." We also conclude that the portion of the payments received by USCorp for use in make/sell activities does not constitute buy-in payments within the meaning of Treas. Reg. § 1.482-7(g). For simplicity, we refer to these payments throughout the remainder of this memorandum as "payments for make/sell rights in existing products." The arm's length charge for make/sell rights in any intangible, including pre-existing intangibles, is determined under Treas. Reg. § 1.482-4, not Treas. Reg. § 1.482-7.

LAW AND ANALYSIS -- ISSUE 2:

I. The FSC and ETI Exclusion Provisions

Sections 921(a) and 923 and Temp. Treas. Reg. § 1.924(a)-1T(a)(2) and (4) of the FSC provisions provide a partial exemption from income tax with respect to licenses of export property. Section 927(a)(1) defines "export property" for FSC purposes. Sections 114 and 941 provide an exclusion from gross income with respect to licenses of qualifying foreign trade property. See also S. Rep. No. 416, 106th Cong., 2d Sess. 18 (Sept. 20, 2000) ("S. Rep. No. 106-416"), 2000 WL 1368000, *19 (standing for the proposition that the FSC regulations regarding licenses cited in this paragraph apply for purposes of the ETI exclusion). Section 943(a)(1) defines "qualifying foreign trade property" for ETI exclusion purposes. The ETI exclusion provisions apply to transactions entered into after September 30, 2000. Pub. L. No. 106-519, 114 Stat. 2423, § 5(a) (2000) ("ETI Act"); S. Rep. No. 106-416, at 20; Rev. Proc. 2001-37, 2001-1 C.B. 1327, § 2.02.

A. The Copyright Carve-out

Under the FSC provisions, section 927(a)(2)(B) provides that, for gross receipts attributable to periods after 1997, export property does not include:

> patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions,

> and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property.

Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 1171 ("TRA 1997"). Thus, section 927(a)(2)(B) describes two categories of intangible property for FSC purposes. In general, all intangible property is excluded from the definition of export property and, thus, is ineligible for FSC benefits. However, the parenthetical phrase in section 927(a)(2)(B) identifies copyrights on films, tapes, records, and computer software as intangible property that is not excluded from the definition of export property. We refer to this limited category of copyright rights that potentially may qualify as export property as the "copyright carve-out." To clarify the copyright carve-out concept: (1) section 927(a)(2)(B) contains a general rule that intangibles may not constitute export property; but (2) the copyright carve-out of section 927(a)(2)(B) provides that certain copyright rights may constitute export property and, thus, is an exception to the general rule of section 927(a)(2)(B).

Prior to an amendment made by TRA 1997, the copyright carve-out did not include the words "and other than computer software (whether or not patented)." Whether the pre-TRA 1997 version of the copyright carve-out included computer software (without specifically mentioning it) was the question considered by the Ninth Circuit Court of Appeals in Microsoft Corp. v. Commissioner, 311 F.3d 1178 (9th Cir. 2002). The Ninth Circuit held that the copyright carve-out included copyrights on computer software prior to 1998 even though the copyright carve-out did not mention computer software prior to the TRA 1997 amendment.

As explained in the legislative history, TRA 1997 provides that "computer software that is exported with a right to reproduce is eligible for the benefits of the FSC provisions." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 636 (July 30, 1997), reprinted in 1997-4 C.B. (vol.2) 1457, 2106 ("H.R. Conf. Rep. No. 105-220").

Section 943(a)(3)(B) of the ETI exclusion provisions contains a copyright carve-out that is materially similar to the FSC rule in section 927(a)(2)(B). S. Rep. No. 106-416, which states Congress's intent that FSC administrative guidance be applied to analogous concepts under the ETI exclusion provisions in the absence of detailed guidance for the ETI exclusion, expressly endorses the addition of computer software language to the copyright carve-out under TRA 1997:

> [C]onsistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for sale, sublicense, lease, or rental to

> an unrelated person for use outside the United States is not treated as excluded property by reason of the license to the related person.

S. Rep. No. 106-416, p.19.

B. The "Ordinary Course" Requirement

Property may constitute export property for FSC purposes only if, among other things, it is

> held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States.

I.R.C. § 927(a)(1)(B). We refer to the requirement that the property be held primarily for sale, lease, or rental, in the ordinary course of trade or business as the "ordinary course" requirement. A similar requirement for qualifying foreign trade property applies in the ETI exclusion context. I.R.C. § 943(a)(1)(B).

C. The "Ultimate Use" Test

For FSC purposes, gross receipts from a transaction involving export property do not constitute FTGR if such export property is "for ultimate use in the United States." I.R.C. § 924(f)(1)(A)(i). Temp. Treas. Reg. § 1.924(a)-1T(g)(2) provides:

> Property which is sold or leased for ultimate use in the United States does not constitute export property. See §1.927(a)-1T(d)(4) relating to determination of where the ultimate use of the property occurs. Thus, foreign trading gross receipts of a FSC [from a sale or lease of export property] do not include gross receipts of the FSC from the sale or lease of export property.

Temp. Treas. Reg. § 1.927(a)-1T(d)(1)(i) states, with respect to the definition of export property under section 927(a)(1)(B):

> [E]xport property must be held primarily for the purpose of sale, lease or rental in the ordinary course of a trade or business, by a FSC to a FSC or to any other person, and the sale or lease must be for direct use, consumption, or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if the sale or lease satisfies the destination test described in subdivision (2) of this

> paragraph, the proof of compliance requirements described in subdivision (3) of this paragraph, and <u>the use outside the United States test described in subdivision (4) of this paragraph.</u> (Emphasis added.)

Temp. Treas. Reg. § 1.927(a)-1T(d)(4) provides, in part:

> (i) <u>In general</u>. For purposes of paragraph (d)(1) of this section, the use test in this paragraph (d)(4) is satisfied with respect to property which—
>
> * * *
>
> (B) Under subdivision (4)(v) of this paragraph is leased for ultimate use outside the United States.

Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(v) provides, in part:

> For purposes of subdivision (4)(i) of this paragraph, a lessee of property is deemed to use property ultimately outside the United States during a taxable year of the lessor if the property is used predominantly outside the United States (as defined in subdivision (vi) of this paragraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease.

Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(vi) provides, in part:

> For purposes of this paragraph (d)(4), property is used predominantly outside the United States for any period if, during that period, the property is located outside the United States more than 50% of the time.

We refer to the use requirement in section 924(f)(1)(A)(i) and Temp. Treas. Reg. § 1.927(a)-1T(d)(4) as the "ultimate use" test. The "ultimate use" test applies to licenses. Temp. Treas. Reg. § 1.924(a)-1T(a)(2), (a)(4), and (g)(2).

Section 942(a)(2)(A)(i) of the ETI exclusion provisions is materially similar to the FSC rule in section 924(f)(1)(A)(i). Pursuant to Congressional intent and pending the issuance of detailed administrative guidance, the FSC regulations under section 927 that set forth the "ultimate use" test apply for purposes of the ETI exclusion. <u>See</u> S. Rep. No. 106-416, pp.19-20 (expressly adopting the "ultimate use" test of Temp. Treas. Reg. § 1.927(a)-1T(d)(4) for ETI exclusion purposes during the gap period).

II. Threshold Consideration: Applicability of ETI Exclusion Provisions

As a preliminary matter, we note that Taxpayer takes the position that (1) the FSC provisions apply to ForSub payments attributable to the period before October 1, 2000, and (2) the ETI exclusion provisions apply to ForSub payments attributable to the period after September 30, 2000. In its request for advice, Field Counsel did not address this position. Rather, Field Counsel argues that, because the relevant FSC and ETI exclusion provisions are materially similar, the same legal analysis would apply to both regimes.

We agree with Field Counsel that our legal analysis and conclusions would be the same under either regime. However, we are not certain that the parties' underlying assumption – that the ETI exclusion provisions (rather than the FSC provisions) apply to ForSub payments attributable to the period after September 30, 2000 – is correct. We note that, pursuant to section 5(a) of the ETI Act, the ETI exclusion provisions apply to transactions entered into after September 30, 2000. See also S. Rep. No. 106-416, p.20; Rev. Proc. 2001-37, 2001-1 C.B. 1327, § 2.02. USCorp's making available of R&E rights may constitute a single transaction entered into on Date2 (i.e., prior to September 30, 2000). If this were the case, then section 5(a) of the ETI Act would preclude the ETI exclusion provisions from applying to ForSub payments attributable to the period after September 30, 2000.

Because neither party has raised the potential inapplicability of the ETI exclusion provisions as a threshold matter under section 5(a) of the ETI Act, we do not analyze the issue in this memorandum. Rather, for purposes of discussing the substantive issues raised by the parties, we analyze the FSC provisions only, and we note that a similar analysis would apply under the ETI exclusion provisions in the event that it is determined that section 5(a) of the ETI does not preclude the ETI exclusion provisions from applying to the ForSub payments attributable to the period after September 30, 2000.

Accordingly, the following discussion explains the basis for our determination in the FSC context only.[10]

III. Service Position

As explained in the discussion of Issue 1 above, we believe that the ForSub payments were predominantly for R&E rights (i.e., the amount determined during the

[10] We understand that, in its determination of the correct buy-in payments owed for R&E rights, Examination may have taken into account the performance of certain consulting and/or maintenance services. We express no opinion as to whether such services are appropriately the subject of buy-in payments and/or qualify as FTGR. Therefore, solely for purposes of this legal discussion, we treat such services as licenses of R&E rights.

audit by Examination), but also may include some payments for make/sell rights in existing USCorp software products[11] (i.e., the undetermined amount owed with respect to the remaining useful lives of the existing products at the outset of QCSA-X). Accordingly, in determining whether the ForSub payments constitute FTGR and, thus, qualify for FSC benefits, we analyzed the payments for R&E rights and the payments for make/sell rights in existing products separately. In so doing, we determined that the payments for R&E rights do not constitute FTGR.

FTGR include gross receipts from the license of export property.[12] I.R.C. § 924(a)(2); Temp. Treas. Reg. § 1.924(a)-1T(a)(2). Section 927(a)(2)(B) provides a list of intangible property that is automatically excluded from the definition of export property because of its intangible property status. The copyright carve-out in section 927(a)(2)(B) identifies certain intangible property that is carved out from the list of excluded property and, therefore, is not automatically excluded from the definition of export property. The carved-out property includes certain copyright rights in items such as films, tapes, records, and computer software.

The copyright carve-out applies specifically to the copyright right to make and sell copies (as opposed to other copyright rights such as R&E rights). This point is highlighted by the inclusion of the words "similar reproductions" in the copyright carve-out language. In other words, copyright rights in items such as films, tapes, records, and computer software may qualify as export property only if such rights consist of the right to make and sell reproductions.

The Microsoft case involved the application of the copyright carve-out to computer software masters that were licensed for reproduction and sale outside the United States. 311 F.3d 1178. Whereas the present case involves a transfer by a taxpayer of all of its R&E rights with respect to a single geographic area, Microsoft did not.[13] Thus, Microsoft is consistent with our interpretation of the copyright carve-out in that Microsoft allows FSC benefits for a license of copyright rights in computer software that permits reproduction and sales of copies outside the United States.

The legislative histories of the FSC and ETI exclusion provisions support interpreting the copyright carve-out as limited to make/sell rights. For example, H. Conf.

---

[11] We note that USCorp may have provided services to ForSub with respect to existing products after the end of the useful lives of such products. Therefore, service fees from ForSub to USCorp may be required beyond the useful lives of the existing products.

[12] The Service and Taxpayer agree that the transfer of rights in USCorp's pre-existing intangibles was a licensing transaction, rather than a sale transaction, as defined in Treas. Reg. § 1.861-18(f)(1).

[13] The make/sell licenses in Microsoft also permitted minor modification of software (as to allow customization and localization of the final products for particular customers or markets). Microsoft did not involve licenses of the type of "crown jewel" R&E rights that form the basis of a software developer's business such as the rights at issue in the present case.

Rep. No. 105-220 provides that "computer software that is exported with a right to reproduce is eligible for the benefits of the FSC provisions" and that "software licensed for reproduction" may be export property. In amending the copyright carve-out in TRA 1997 to include computer software, Congress sought to ensure that "the benefits of the FSC provisions similarly should be available to computer software" as for reproduction rights in films, sound recordings, and tapes. H.R. Conf. Rep. No. 105-220, at 636.

The legislative history of the ETI exclusion copyright carve-out contains language similar to the description of the FSC copyright carve-out in H.R. Conf. Rep. No. 105-220:

> consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for sale, sublicense, lease, or rental to an unrelated person for use outside the United States is not treated as excluded property by reason of the license to the related person. (Emphasis added.)

S. Rep. No. 106-416, p.19.[14] In both the FSC and ETI exclusion contexts, the copyright carve-out applies to make/sell rights (i.e., rights to make and sell reproductions). In contrast, the copyright carve-out, as indicated by the language of the statutes and the legislative histories, does not apply to R&E rights. Because the copyright carve-out does not apply to R&E rights in computer software intangibles, such property is excluded from the definition of export property under section 927(a)(1).

Even if USCorp's R&E rights in software intangibles were not excluded from the definition of export property by virtue of section 927(a)(2)(B), these R&E rights would nonetheless fail to satisfy the definition of export property. In particular, the R&E rights would fail the "ordinary course" requirement of section 927(a)(1)(B) and the "ultimate use" test of section 924(f)(1)(A)(i) and Temp. Treas. Reg. § 1.927(a)-1T(d)(4).

According to the agreed statement of facts submitted with the underlying request for technical advice, USCorp is engaged "in the business of developing, manufacturing, marketing, distributing, selling, and licensing" computer software. The fact statement does not mention – and Taxpayer has not suggested – that USCorp is in the business of licensing (or otherwise transferring) R&E rights in its pre-existing intangibles.[15]

---

[14] The copyright carve-out language in section 943(a)(3)(B) of the ETI exclusion provisions is identical to the copyright carve-out in section 927(a)(2)(B) of the FSC provisions.

[15] As we understand the facts, USCorp may on occasion license certain limited R&E rights, but does not ordinarily transfer its "crown jewel" rights to develop derivative software or new applications of existing software. Compare note 13, above.

Licensing R&E rights in pre-existing intangibles is not the ordinary course of trade or business for USCorp. The "ordinary course" requirement of section 927(a)(1)(B) is analogous to the "ordinary course" rule in section 1231(b)(1)(B). In the section 1231(b) context, "property used in a trade or business" is defined as certain property that is not "held. . . primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business." In other words, the concept of property held for use in a taxpayer's business is antithetical to the concept of property held for sale or license in a taxpayer's business. Thus, because the R&E rights are held primarily for use in USCorp's business, the R&E rights do not satisfy the "ordinary course" requirement of section 927(a)(1)(B).

By licensing its R&E rights to ForSub, USCorp surrendered its right to exploit and benefit from future intangibles derived from its pre-existing intangibles with respect to TerritoryZ. The license of R&E rights did not follow USCorp's ordinary practice of using such rights to develop new software intangibles that USCorp then incorporated into new software products that it manufactured, marketed, distributed, sold, and licensed. In fact, with respect to TerritoryZ, USCorp's making available of R&E rights permanently altered USCorp's ordinary course of business within the meaning of section 927(a)(1)(B).

One of the primary uses of pre-existing intangibles in the hands of USCorp was to serve as the basis for R&E activities and the development of subsequent generations of software. Therefore, it is reasonable to conclude that (1) USCorp did not hold its R&E rights "primarily for sale, lease, or rental, in the ordinary course of trade or business;" (2) the R&E rights do not constitute export property under section 927(a)(1)(B); and (3) payments for R&E rights do not constitute FTGR under section 924(a)(2).[16]

USCorp's R&E rights also fail the definition of export property under the "ultimate use" test of section 924(f)(1)(A)(i). Under this rule, licensed property may qualify as export property only if, among other requirements, it is ultimately used outside the United States. Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(i)(B). Property is ultimately used outside the United States during the license period if it is used predominantly outside the United States during such period. Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(v). For this purpose,

> property is used predominantly outside the United States for any period if, during that period, the property is located outside the United States more than 50% of

[16] We also note that the R&D rights were not held "for direct use, consumption, or disposition outside the United States" within the meaning of section 927(a)(1)(B) considering that all of the R&E activities involving USCorp's R&E rights occurred in the United States. See also, the discussion of the "ultimate use" test, below.

the time.

Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(vi). Taxpayer concedes that the actual use of USCorp's R&E rights was limited to USCorp. USCorp's QCSA-X activities using the R&E rights occurred only within the United States. Therefore, the R&E rights were used predominantly within the United States within the meaning of the "ultimate use" test and, thus, do not constitute export property.

IV. Taxpayer Position

As a general proposition, Taxpayer asserts that the copyright carve-out and the holding in Microsoft state that all transactions involving computer software automatically qualify for FSC benefits. In the following discussion, we summarize Taxpayer's general proposition as well as Taxpayer's position with respect to the "ordinary course" issue described above.[17] We also explain why we disagree with Taxpayer's arguments.

A. Computer Software Always Qualifies for FSC Benefits

Under Taxpayer's view, the copyright carve-out in section 927(a)(2)(B) provides that any licensing of software intangible copyright rights – involving some connection to a foreign market -- always qualifies for FSC benefits. Taxpayer asserts that the holding in Microsoft supports its position that the copyright carve-out requires the Service to grant FSC benefits with respect to any transaction that involves software intangible copyright rights and a foreign market nexus. Taxpayer misconstrues the plain language of the copyright carve-out and the Microsoft opinion.

The copyright carve-out in section 927(a)(2)(B) identifies certain intangible property that may qualify as export property. But the copyright carve-out does not provide that the carved-out property always constitutes export property. Rather, like any other property, carved-out property must meet all other requirements of section 927 and the regulations thereunder to qualify as export property. Furthermore, even if carved-out property constitutes export property, the taxpayer must meet all other requirements under the other FSC provisions if gross receipts from the sale or license of the property are to constitute FTGR.

As explained in the discussion of our position above, the copyright carve-out applies to reproduction (make/sell) rights, rather than R&E rights. Our position is not inconsistent with Microsoft because Microsoft involved licenses of make/sell rights (with some incidental rights to make minor modifications) whereas the present case involves

[17] Because the "ultimate use" issue was not addressed in the submitted position papers or during the Conference, we do not know if Taxpayer has a counter-argument regarding the issue. However, as stated in our analysis above, we note that Taxpayer's own position (and the agreed facts) regarding Issue 1 indicate that 100% of the use of the R&E rights occurred within the United States.

the making available of R&E rights in a buy-in and a separate license of make/sell rights.

B. "Ordinary Course" Requirement

Taxpayer argues that the pre-existing intangibles are copyright rights and, as such, are held primarily for license in the ordinary course of business within the meaning of section 927(a)(1)(B). In making this argument, Taxpayer considers the copyright rights in the aggregate rather than distinguishing between R&E rights and make/sell rights.

As explained above, in light of the fact that the Treas. Reg. § 1.482-7 buy-in payments determined by Examination are for R&E rights (and the undetermined payments for make/sell rights in existing products are for make/sell rights), the two types of rights are distinct. Thus, we must apply the "ordinary course" requirement separately to the R&E rights and make/sell rights. Under this analysis, the R&E rights are not held by USCorp for license in the ordinary course of business.

We note that the United States Supreme Court has stated repeatedly the "familiar rule" that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer. See, e.g., INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Taxpayer has the burden of establishing whether (and what amount of) the licensed rights qualify as export property under the FSC provisions and, thus, generate FSC commission expense deductions. Although Taxpayer has made conclusory statements that all of the rights transferred by USCorp to ForSub constitute export property, Taxpayer has not made a cogent or logical argument to support its conclusions. On the contrary, as set out in this memorandum, we have determined that the great majority of the property transferred fails the definition of export property in several respects.

LAW AND ANALYSIS – ISSUE 3:

I. The R&E Expense Provisions

Section 861 and the regulations thereunder apply for the purpose of determining the combined taxable income of a FSC and its related supplier. Treas. Reg. § 1.861-8(f)(1)(iii). Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D) provides:

> Costs (other than the costs of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part

> of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Pending the issuance of detailed administrative guidance under the ETI exclusion provisions, similar rules apply for the purpose of determining taxable income under the ETI exclusion provisions. See S. Rep. No. 106-416, p.20.

R&E expenses are allocated and apportioned in accordance with Treas. Reg. § 1.861-17. See also Treas. Reg. § 1.861-8(e)(3). The first two sentences of Treas. Reg. § 1.861-17(a)(1) state the basic premises underlying the attribution of R&E expenses:

> The methods of allocation and apportionment of research and experimentation expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories).

Based on those principles, the regulation allocates R&E expenses on the basis of broad product groups set forth in the Standard Industrial Classification ("SIC") codes. See also Boeing Co. v. U.S., 537 U.S. 437 (2003) (upholding validity of regulation's prohibition against subdividing product categories for purposes of allocating and apportioning research expenses). Treas. Reg. § 1.861-17(a)(4) provides a limited exception permitting a direct allocation of expense relating to research that is undertaken solely to meet legal requirements imposed by a political entity and that cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source to gross income within that geographic source as a class. R&E expenses conducted with respect to a product category are then apportioned between the statutory and residual groupings of income therein in a two-step process. First, a certain percentage of the R&E expenses may be exclusively apportioned to the grouping of income arising from the geographic source where certain research activities are performed. Treas. Reg. § 1.861-17(b). The

remaining R&E expenses are then apportioned between or among the statutory and residual groupings based either on relative sales or gross income attributable to those groupings. See Treas. Reg. § 1.861-17(c) and (d).

Taxpayers that apportion R&E expenditures under the sales method must include in their apportionment calculation sales made by controlled and uncontrolled parties under specified circumstances. Treas. Reg. § 1.861-17(c). Under these rules, the sales of controlled parties are included in the apportionment fraction

> if such corporation can reasonably be expected to benefit directly or indirectly . . . from the taxpayer's research expense connected with the product category . . . . A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to that corporation. Past experience . . . shall be considered in determining reasonable expectations.

Treas. Reg. § 1.861-17(c)(3). The regulation further provides that an entity with which the taxpayer has entered into a "bona fide cost-sharing arrangement, in accordance with the provisions of section 1.482-7 . . . shall not reasonably be expected to benefit from the taxpayer's share of research expense."[18] Treas. Reg. § 1.861-17(c)(3)(iv).

II. Service Position

Under Treas. Reg. § 1.861-17(c)(3), the sales of a controlled party may, in appropriate circumstances, be treated as sales of the taxpayer for purposes of apportioning the taxpayer's R&E expenses between the statutory and residual groupings of income. This rule is designed to address circumstances in which controlled parties sell the products that result from the taxpayer's research expenditures. However, the sales of a controlled entity are taken into account only where it is reasonably expected to benefit from the R&E expenses attributable to the relevant product category (or categories) that are being apportioned. Treas. Reg. § 1.861-17(c)(3)(iv) provides that a controlled party is not reasonably expected to benefit from the taxpayer's share of research expenses incurred pursuant to a QCSA as defined in Treas. Reg. § 1.482-7(g). Under a QCSA, each party bears a portion of the shared costs in proportion to its reasonably anticipated benefits from the research covered by the QCSA, and the amount paid to the taxpayer by the controlled party for its share of the R&E expenses is treated as a reimbursement that reduces the taxpayer's potential deduction under section 174. Assuming costs are shared properly, no party to the arrangement is reasonably expected to benefit from the costs borne by

---

[18] The concept of a "bona fide cost-sharing arrangement" in Treas. Reg. § 1.861-17(c)(3)(iv) is the predecessor of (and is materially similar to) the current concept of the QCSA in Treas. Reg. § 1.482-7.

another party to the arrangement. Therefore, a taxpayer does not take into account sales by a controlled party in apportioning the taxpayer's share of research expenses under a QCSA.

In this case, USCorp and ForSub entered QCSA-X on Date2 to share research costs based on each party's share of reasonably anticipated benefits. The QCSA required the sharing of all R&E expenses "in the field of software" after Date2. USCorp and ForSub also entered into License-X on Date2. Under License-X, USCorp licensed with respect to TerritoryZ all of its existing intangible property and confidential information to ForSub in return for royalties.

A. Apportionment Ratio for Taxpayer's Share of QCSA-X R&E Expenses

With respect to the apportionment of USCorp's share of R&E expenses incurred pursuant to QCSA-X (i.e., USCorp's R&E expenses net of reimbursements under QCSA-X), we agree with Taxpayer's position that sales made by ForSub are not taken into account in USCorp's apportionment ratio. Treas. Reg. § 1.861-17(c)(3)(iv) provides that a controlled party is not reasonably expected to benefit from a taxpayer's share of research expenses under a QCSA. Therefore, the apportionment of USCorp's share of research expenses under QCSA-X should not take into account any sales made by ForSub after the agreement took effect because ForSub was not reasonably expected to benefit from such expenses.

The fact that ForSub was required under Treas. Reg. § 1.482-7(g) to make buy-in payments to USCorp to compensate for USCorp's previous investment in the pre-existing intangibles does not affect the determination of whether ForSub could be expected to benefit from USCorp's share of post-Date2 R&E expenses. The inclusion of a controlled party's sales in the apportionment of R&E expenses for the year requires a reasonable expectation of benefit to the controlled party arising from the taxpayer's research expenses relating to the product category. ForSub is not reasonably expected to benefit from USCorp's share of R&E expenses incurred under QCSA-X because USCorp and ForSub each bear the portion of total R&E expenses that reflects their respective anticipated benefits from the arrangement. While the buy-in payment represents compensation for a benefit received by ForSub, that benefit necessarily relates to property arising from expenses incurred prior to Date2 and, therefore, does not affect the apportionment of post-Date2 expenses.

B. Apportionment Ratio for Taxpayer's non-QCSA-X R&E Expenses

Treas. Reg. § 1.861-17(c)(3) provides that the sales made by a controlled party are included in a taxpayer's sales ratio for apportionment purposes "if the taxpayer can be expected to license, sell, or transfer intangible property to that corporation." In this case, USCorp's conduct in Year1 leaves no doubt that it expected to license any intangible property arising from its pre-Date2 expenditures to ForSub. USCorp licensed with respect to TerritoryZ all of its existing intangible property and confidential

information to ForSub under License-X. Accordingly, Treas. Reg. § 1.861-17(c)(3) requires that the ForSub sales in Year1 be included in the sales ratio used to apportion any R&E expenditures other than USCorp's share of expenses under QCSA-X – i.e., those incurred prior to Date2.

USCorp argues that its Year1 expenditures should be apportioned as if its taxable year was divided into two short years for apportionment purposes and, therefore, any sales made by USCorp and ForSub after Date2 would not be taken into account in apportioning USCorp's pre-Date2 expenses. We disagree. Nothing in Treas. Reg. § 1.861-17 suggests that taxpayers are permitted to adopt such an accounting fiction. On the contrary, the regulation operates on the general premise that annual research expenses relating to a broad product category must be apportioned on the basis of annual sales within such product category, regardless of whether the research relates to the particular products that are sold. See Boeing, 537 U.S. 437. Accordingly, the regulation provides that, once the reasonable expectation of benefit is established with respect to a given year's R&E expenditures, the sales made by controlled parties must be taken into account, except as provided in Treas. Reg. § 1.861-17(c)(3)(iv). That exception, by its terms, applies only to a taxpayer's share of R&E expenditures under a QCSA. Therefore, the R&E expenses incurred by USCorp in Year1 that were not subject to the QCSA remain subject to the general apportionment rules. As stated above, those rules require that USCorp apportion its R&E expenses based on sales of both USCorp and ForSub, within the SIC code category, during the taxpayer's entire tax year, including sales made by ForSub after the effective date of QCSA-X.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.