

Year 7, substantially all the premium return from the YY trademark in the U.S. market is attributed to FP, for example through an increase in the price paid per watch by USSub, or by some other means.

(iii) In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, USSub's undertaking the incremental marketing activities in Years 1 through 6 is a course of conduct that is inconsistent with the parties' attribution to FP in Year 7 of substantially all the premium return from the enhanced YY trademark in the United States market. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the YY trademark wristwatches. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in Years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term exclusive U.S. distribution agreement to exploit the YY trademark that allows USSub to benefit from the incremental marketing activities it performed. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term distribution agreement, an agreement that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

**Example 4. Contractual terms imputed from economic substance.** (i) FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries worldwide. In Year 1, FP licenses to its newly organized U.S. subsidiary, USSub, exclusive rights to certain manufacturing and marketing intangibles (including the AA trademark) for purposes of manufacturing and marketing athletic gear in the United States under the AA trademark. The contractual terms obligate USSub to pay FP a royalty based on sales, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities. Unrelated foreign businesses license independent U.S. businesses to manufacture and market athletic gear in the United States, using trademarks owned by the unrelated

foreign businesses. The contractual terms of these uncontrolled transactions require the licensees to pay royalties based on sales of the merchandise, and obligate the licensors and licensees to undertake without separate compensation specified types and levels of marketing activities. In Years 1 through 6, USSub manufactures and sells athletic gear under the AA trademark in the United States. Assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangibles, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts.

(ii) In Years 1 through 6, USSub performs incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the license agreement. FP does not directly or indirectly compensate USSub for performing these incremental activities during Years 1 through 6. By Year 7, AA trademark athletic gear generates a premium return in the United States, as compared to similar athletic gear marketed by independent licensees. In Year 7, USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during Years 1 through 6, and to compensate USSub on a cost basis for any incremental marketing activities it may perform in Year 7 and thereafter. In addition, the parties revise the license agreement executed in Year 1, and increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States.

(iii) In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit. In this case, USSub's undertaking the incremental marketing activities in Years 1 through 6 is a course of conduct that is inconsistent with the parties' adoption in Year 7 of contractual terms whereby FP compensates USSub on a cost basis for the incremental marketing activities that it performed. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the AA trademark athletic gear. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for the incremental activities it performed during Years 1 through 6, which

benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term exclusive U.S. license agreement that allows USSub to benefit from the incremental activities. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term U.S. license agreement, a license that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in this particular case.

**Example 5. Contractual terms imputed from economic substance.** (i) Company X is a member of a controlled group that has been in operation in the pharmaceutical sector for many years. In Years 1 through 4, Company X undertakes research and development activities. As a result of those activities, a compound is developed that may be more effective than existing medications in the treatment of certain conditions.

(ii) Company Y is acquired in Year 4 by the controlled group that includes Company X. Once Company Y is acquired, patent rights with respect to the compound in several jurisdictions are registered by Company Y, making Company Y the legal owner of such patents.

(iii) In determining whether an allocation is appropriate in Year 4, the Commissioner may consider the economic substance of the arrangements between Company X and Company Y, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in research and development activities to develop a patentable compound to be registered by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, Company X's undertaking the research and development activities is inconsistent with the registration of the patent by Company Y. Therefore, the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights. For example, the Commissioner may impute a separate services agreement that affords Company X contingent-payment compensation for its research and development activities in Years 1 through 4, which benefited Company Y by creating and further contributing to the value of the patent rights ultimately registered by Company Y. In the alternative, the Commissioner may impute a transfer of patentable intangible rights from Company X to Company Y immediately preceding the registration of patent rights by Company Y. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying