

payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, x% of Company Y's gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in Years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in Year 4. In Year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in Years 7 through 9 and Company Y makes the payments to Company X in Years 7 through 9 that are required under the agreement.

(iii) The years under examination are Years 6 through 9. In evaluating whether the contingent payment terms will be recognized, the Commissioner considers whether the conditions of § 1.482-9(i)(2) are met and whether the specified contingency and basis of payment are consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient's benefit and the renderer's risk. Consistent with § 1.482-1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties' conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. The Commissioner also determines that the arrangement is consistent with terms that uncontrolled parties operating under similar conditions could reasonably be expected to adopt with respect to comparable research and development activities. Based on all these facts, the Commissioner determines that the terms of the contingent-payment arrangement are consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of Years 6 through 9 is

arm's length, the Commissioner evaluates under § 1.482-9 and other applicable rules under § 482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating the reasonableness of the compensation of x% of gross sales that is paid to Company X during the first four years of commercial sales of derivative products, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

*Example 2.* (i) The facts are the same as in paragraphs (i) and (ii) of *Example 1*, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount equal to x% of such costs, with the payment to be made in the first year in which any such sales occur. The x% markup on costs is within the range, ascertainable in Year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In Year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are Years 6 through 9. In evaluating whether the contingent payment terms will be recognized, the Commissioner considers whether the requirements of § 1.482-9(i)(2) were met at the time the written agreement was entered into and whether the specified contingency and basis for payment are consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus x%, representing the markup for

contract research in the absence of any nonpayment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. The Commissioner also determines that the arrangement is not consistent with terms that uncontrolled parties operating under similar conditions could reasonably be expected to adopt with respect to comparable research and development activities. Based on all these facts, the Commissioner determines that the terms of the contingent-payment arrangement are not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and § 1.482-1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment that uncontrolled parties could adopt in similar transactions under similar circumstances, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products developed under the agreement in each of Years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under § 1.482-9 and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products that resulted from Company X's research and development activities under the contingent-payment arrangement.

(j) *Total services costs.* For purposes of this section, total services costs means all costs of rendering those services for which total services costs are being determined. Total services costs include all costs, based on analysis of the facts and circumstances, that can be directly identified with the act of rendering the services, and all other costs reasonably allocable to the services, under the principles of