***92 T. C. 525 (1989)***

The royalty rate for the transfer of intangible property between related entities must be commensurate with the income attributable to the use of that property.

**Summary**

Bausch & Lomb, Inc. (B&L) and its subsidiary Bausch & Lomb Ireland, Ltd. (B&L Ireland) were involved in a dispute over the arm's-length nature of their pricing agreements. B&L Ireland manufactured soft contact lenses using B&L's patented spin cast technology and sold them to B&L for $7. 50 per lens, while paying a 5% royalty on net sales for the use of B&L's intangibles. The court found that the $7. 50 price was at market levels, but the 5% royalty rate was insufficient to reflect an arm's-length transaction. The court determined that a 20% royalty rate on B&L Ireland's sales was necessary to clearly reflect the income attributable to B&L's intangible property, resulting in adjusted royalties of $1,674,000 and $5,541,000 for 1981 and 1982, respectively.

**Facts**

B&L Ireland was established in 1980 as a third-tier subsidiary of B&L to manufacture soft contact lenses using B&L's spin cast technology. B&L granted B&L Ireland a nonexclusive license to use its manufacturing technology and trademarks in exchange for a 5% royalty on net sales. B&L Ireland sold its lenses to B&L and B&L's foreign affiliates at a price of $7. 50 per lens. The Commissioner of Internal Revenue challenged the pricing arrangements, asserting that they did not reflect arm's-length transactions and that income should be reallocated from B&L Ireland to B&L.

**Procedural History**

The Commissioner issued a statutory notice of deficiency to B&L for the tax years 1979, 1980, and 1981, alleging that income should be reallocated from B&L Ireland to B&L under Section 482. B&L filed a petition with the U. S. Tax Court to challenge the Commissioner's determinations. The court heard expert testimony and reviewed financial projections to determine the arm's-length nature of the pricing agreements between B&L and B&L Ireland.

**Issue(s)**

1. Whether the $7. 50 price per lens charged by B&L Ireland to B&L constituted an arm's-length price.
2. Whether the 5% royalty rate charged by B&L to B&L Ireland for the use of its intangibles constituted an arm's-length consideration.

**Holding**

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1. Yes, because the $7. 50 price was consistent with market prices charged by other manufacturers to unrelated distributors for similar soft contact lenses.
2. No, because the 5% royalty rate did not adequately reflect the income attributable to B&L's intangibles; a 20% royalty rate on B&L Ireland's sales was determined to be an arm's-length consideration.

**Court's Reasoning**

The court applied the comparable-uncontrolled-price method to determine that the $7. 50 price per lens was at market levels, citing sales agreements between other manufacturers and distributors as evidence. For the royalty rate, the court rejected both the Commissioner's proposed rate and B&L's proposed rate, finding that neither adequately reflected the value of the intangibles transferred. The court analyzed B&L's financial projections and determined that a 20% royalty rate on B&L Ireland's sales was necessary to provide B&L with a reasonable share of the profits attributable to its intangibles, resulting in an internal rate of return of approximately 27% for B&L Ireland's investment in the manufacturing facility.

**Practical Implications**

This decision underscores the importance of establishing royalty rates that reflect the economic value of intangible property transferred between related entities. Taxpayers should carefully analyze the income attributable to the use of intangibles and consider the risks and potential profits of the licensee when setting royalty rates. The ruling may impact how multinational corporations structure their intellectual property licensing agreements to ensure compliance with Section 482. Subsequent cases may reference this decision when determining arm's-length royalty rates for similar intangible property transfers.

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