Cost Sharing Arrangements Are Less Attractive Under New Regulations

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On December 31, 2008, the IRS issued Temporary and Proposed Regulations under Section 482 for research and development (R&D) cost sharing arrangements (CSAs). Although the Temporary Regulations retain virtually all of the concepts and methods of the 2005 Proposed Regulations, they also contain several refinements to those proposals. Moreover, the Temporary Regulations introduce transition rules for existing CSAs that are less draconian than the transition rules of the 2005 Proposed Regulations. The Temporary Regulations, like the 2005 Proposed Regulations, are a radical departure from the 1996 cost sharing Regulations and transfer pricing case law, and are likely to reduce substantially the attractiveness of new CSAs to taxpayers.

The Temporary Regulations were generally effective on January 5, 2009. Taxpayers with pre-existing CSAs must take certain compliance steps during 2009 to maintain qualification of their CSAs. A public hearing on the Regulations is scheduled for April 21, 2009. Written or electronic comments and outlines of topics to be discussed at the hearing must be submitted by April 6, 2009.
Current Cost Sharing Participants

Although the Temporary Regulations grandfather cost sharing arrangements in existence prior to January 5, 2009, they require action on the part of participants in such CSAs to preserve this status. First, by July 6, 2009, participants in grandfathered CSAs must execute a revised cost sharing agreement in accordance with the Temporary Regulations. Second, by September 2, 2009, participants in grandfathered CSAs must file a Cost Sharing Statement providing specific information about the CSA.

Overview

The Temporary Regulations are conceptually based on the IRS's “investor model” introduced in the 2005 Proposed Regulations. Under the investor model, the participants in a CSA are considered to make cost contributions (shares of ongoing R&D costs) and “platform contributions” (existing intangible property and other resources, capabilities, and rights) to the CSA to achieve an anticipated return on those contributions appropriate to the risk of the CSA and the exploitation of the intangibles resulting from the CSA. Valuations of these contributions are to be made based on the forecasted revenues and costs of the CSA at the outset of the CSA. Under the investor model, a participant making cost contributions, but no platform contributions, is generally limited to a fixed financial return and receives no share of the residual profits attributable to the intangible property resulting from the arrangement. Instead, the residual profits are allocated entirely to the parties making platform contributions.

Like the 2005 Proposed Regulations, the Temporary Regulations characterize a participant's commitment of an assembled expert R&D team to a CSA as a platform contribution and require the other participants in the CSA to compensate the contributing participant for that contribution. Thus, the participant actually performing the R&D services under the CSA may effectively be required to earn not simply a reimbursement of its costs but also a profit markup on those costs or a share of the residual non-routine profits of the CSA. Temp. Reg. 1.482-7T(c)(5), Example 2.

The Temporary Regulations, like the 2005 Proposed Regulations, permit the IRS (but not the taxpayer) to make periodic adjustments to the compensation received by the participants making platform contributions if actual results differ substantially from forecasted results. The Temporary Regulations allow the IRS to make periodic adjustments using a variation on the residual profit-split method (RPSM) whereby a party making no platform contributions generally will be limited to a financial return and, if the actual results exceed the forecasted results, will not participate in the unanticipated profits of the CSA. Moreover, the Temporary Regulations significantly narrow the range of deviation from forecasted results permitted before periodic adjustments are imposed. Temp. Reg. 1.482-7T(l)(6).

In response to comments on the 2005 Proposed Regulations, the IRS made several changes in the Temporary Regulations.

Below is a list of the more significant changes introduced by the Temporary Regulations, followed by a more detailed discussion of each:
• The Temporary Regulations give taxpayers more flexibility in dividing the rights to the cost-shared intangibles among the participant by allowing a non-overlapping, exclusive, and perpetual division of rights based not only on territories but also fields of use and certain other bases (such as place of manufacture). However, as in the 2005 Proposed Regulations, the general sharing of non-exclusive worldwide rights is not permitted.

• The Temporary Regulations provide guidance on determining an arm's-length range for a platform contribution transaction (PCT). The 2005 Proposed Regulations did not contain such guidance, or even recognize the possibility of a range in this context.

• While the 2005 Proposed Regulations were based on the premise that platform contributions enhance the value of the cost-shared intangibles in perpetuity, the Temporary Regulations recognize that, depending on the facts or circumstances, a platform contribution may add value to the CSA for only a finite period. Preamble, 74 Fed. Reg. 346. Nevertheless, the examples in the Temporary Regulations indicate that the perpetuity (terminal) value can represent a majority of the consideration for the platform contribution. See Temp. Reg. 1.482-7T(g)(4)(vii), Example 1 (terminal value accounts for 57% of the consideration for the platform contribution).

• The Temporary Regulations give taxpayers greater flexibility to choose the form of consideration for platform contributions. The 2005 Proposed Regulations provided that the form of consideration for a platform contribution from an acquisition of an uncontrolled party must take the same form as the consideration paid to the uncontrolled party in the acquisition. The Temporary Regulations do not dictate the form of consideration for such acquisitions.

• Unlike the 2005 Proposed Regulations, the Temporary Regulations recognize that a participant in a CSA generally bears greater risk than a licensee that does not bear ongoing R&D costs. The bottom line impact of this recognition, however, is relatively modest, as the Temporary Regulations merely suggest that a slightly higher discount rate should be used for CSAs than for licensing arrangements that are considered realistic alternatives.

• The Temporary Regulations substantially narrow the categories of events that can terminate the grandfather status of pre-existing CSAs. The 2005 Proposed Regulations terminated grandfather status on a material change in the scope of the CSA or a 50%-or-greater change in the ownership interests in the cost-shared intangibles. Moreover, the 2005 Proposed Regulations applied the PCT rules retroactively. The Temporary Regulations limit the grandfather status termination events to a material change in scope and apply the periodic adjustment rules of the Temporary Regulations only to platform contributions that occur on or after a material expansion of the scope of the grandfathered CSA.

**General Rules—Temp. Reg. 1.482-7T(a)**

The Temporary Regulations provide that arm's-length consideration for a controlled transaction reasonably anticipated to contribute to developing intangibles under a CSA must be determined under the methods of the Temporary Regulations. The controlled participants of a CSA must share the intangible development costs (IDCs) of the cost-shared intangibles in proportion to their reasonably anticipated benefits (RABs) from those intangibles. Arrangements that do not constitute CSAs must be analyzed under the other provisions of the Section 482 Regulations.

**Substantive and Administrative Requirements for CSAs—Temp. Reg. 1.482-7T(b)**
Under the Temporary Regulations, an arrangement will qualify as a CSA only if both the substantive requirements (including the divisional interest requirement) and the administrative requirements in Temp. Reg. 1.482-7T(k) are met. Moreover, the controlled participants must enter into a PCT as of the earliest date on or after the CSA is entered into on which a platform contribution is reasonably anticipated to contribute to developing cost-shared intangibles. Temp. Regs. 1.482-7T(b)(1)-(4).

**Divisional interest requirement.**

A new substantive requirement is the divisional interest requirement. The Temporary Regulations require that participants receive a non-overlapping interest in the cost-shared intangibles with perpetual and exclusive rights to the profits. The divisional interest can be divided along territorial lines whereby each participant is assigned at least one non-overlapping territory. Temp. Reg. 1.482-7T(b)(4)(ii). Alternatively, the divisional interest can be divided based on field of use, including anticipated and unanticipated uses. Temp. Reg. 1.482-7T(b)(4)(iii). Under this alternative, the participants divide all interests based on the anticipated uses, with one participant receiving the exclusive and perpetual right to exploit the cost-shared intangibles through any unanticipated uses.

In addition to these two specified ways to assign divisional interests, the Temporary Regulations also allow participants to adopt some other basis on which to divide all interests in the cost-shared intangibles, provided that the following four requirements are met. Temp. Reg. 1.482-7T(b)(4)(iv). First, the basis must clearly and unambiguously divide all interests in the cost-shared intangibles. Second, the consistent use of such basis can be dependably verified from the participants' records. Third, the rights are non-overlapping, exclusive, and perpetual. Fourth, the resulting benefits are predictable with reasonable reliability.

Although, the Temporary Regulations afford greater flexibility to the taxpayer than the exclusive territory requirement of the 2005 Proposed Regulations, Example 3 of Temp. Reg. 1.482-7T(b)(4)(v) illustrates that the divisional interest requirement will not address the need for operational flexibility in many multinational business models and, in particular, disfavors cost-sharing territories based on place of production. In the example, companies P and S enter into a CSA to develop product Z, dividing their interest in product Z based on site of manufacturing. Both companies have their own manufacturing facilities. The manufacturing facilities, however, are not expected to operate at full capacity and production can be shifted at any time between sites, although neither participant intends to shift production. Under these facts, the example concludes that the division of interest does not qualify, since the relative shares of benefits are not predictable with reasonable reliability (regardless that the participants do not intend to shift production).

**Treatment of certain arrangements as CSAs.**

The Temporary Regulations provide rules that clarify when the Commissioner must and may treat an arrangement as a CSA. Temp. Regs. 1.482-7T(b)(5)(i)-(ii). The Commissioner must treat an arrangement as a CSA if the administrative requirements of Temp. Reg. 1.482-7T(k) are met and the taxpayers reasonably concluded that the
arrangement met the substantive requirements (including the divisional interests requirement) and the PCT timing requirement.

The Commissioner may treat an arrangement as a CSA if the Commissioner concludes that the administrative requirements are met, and notwithstanding the technical failure to meet the substantive and PCT timing requirements, the Temporary Regulations provide the most reliable measure of an arm's-length result. In that situation, the contractual provisions will be interpreted based on the economic substance and the parties' actual conduct with reference to the rules on interpretation of contractual provisions of the Temporary Regulations in Temp. Reg. 1.482-7T(k)(1)(iv). The examples illustrating the application of this section forewarn taxpayers that when one or the other substantive requirement is not met, the Commissioner has significant discretion in concluding that the arrangement does not qualify as a CSA rather than treating the arrangement as a CSA subject to an adjustment. In this regard, the examples illustrate that merely taking an aggressive position on the buy-in can cause the CSA to fail the substantive requirements and put the taxpayer at the mercy of the Service as to whether the arrangement will qualify as a CSA.

Moreover, the Temporary Regulations provide that the principles, methods, comparability, and reliability considerations of Reg. 1.482-7T are relevant in determining the best method with respect to transfers of intangible property in an arrangement that is not treated as a CSA under Temp. Reg. 1.482-7T. Temp. Reg. 1.482-4T(g).

**Platform Contributions—Temp. Reg. 1.482-7T(c)**

The 2005 Proposed Regulations introduced new buy-in terminology by referring to transactions in which a controlled participant made an “external contribution” to a CSA as “preliminary and contemporaneous transactions.” The Temporary Regulations replace “external contribution” with “platform contribution” and replace “preliminary or contemporaneous transaction” with “platform contribution transaction” or “PCT.” Although the names have changed, the underlying theory remains the same.

**Terminology.**

The Temporary Regulations define a “platform contribution” as any “resource, capability, or right” that a CSA participant has developed, maintained, or acquired externally to the intangible development activity (IDA) (prior to or during the course of the CSA) that is *reasonably anticipated* to contribute to developing cost-shared intangibles. The determination of whether a resource, capability, or right is reasonably anticipated to contribute to developing cost-shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right determined not to be a platform contribution at an earlier point may become a platform contribution later. Further, the obligation to make buy-in payments for a PCT does not terminate merely because it may later be determined that the resource, capability, or right has not contributed, and is no longer reasonably anticipated to contribute, to developing cost-shared intangibles.

The Temporary Regulations create a rebuttable presumption that the platform contribution is exclusive (i.e., it is presumed that the platform resource, capability, or right is not reasonably anticipated to contribute to any business activities other than the IDA). If the taxpayer rebuts the presumption to the satisfaction of the Commissioner, PCT payments may need to be prorated. For purposes of the best-method rule under Reg. 1.482-1(c), the reliability of the analysis under a method that requires proration is
reduced relative to the reliability of an analysis under a method that does not require proration.

**Categorization and exclusion of certain make-or-sell rights.**

A PCT must be identified by the controlled participants as a particular type of transaction (e.g., a license for royalty payments). In addition, like the 2005 Proposed Regulations, the Temporary Regulations provide that any right to exploit an existing intangible without further development, such as the right to make, replicate, license, or sell existing products, does not constitute a platform contribution to a CSA, and the arm’s-length compensation for such “make-sell” rights does not satisfy the payment obligation for the PCT. This provision is designed to prevent taxpayers from contending that declining royalties paid over the life of the current generation of product adequately compensate the licensor for providing the right to use the pre-existing intangibles to develop new products. The Temporary Regulations do recognize, however, that arm’s-length consideration for “make-sell” rights and development rights may be determined on an aggregate basis in appropriate cases and are biased heavily in favor of aggregate approaches.

**Compensable assets.**

The 2005 Proposed Regulations provided that external contributions can be routine (e.g., routine manufacturing and distribution capabilities) or non-routine (e.g., pre-existing intangible property, such as promising in-process technology or first-generation platform technology). Moreover, the 2005 Proposed Regulations said that external contributions may include an expert R&D team and suggested that an assembled R&D workforce may constitute a valuable intangible. The Preamble to the 2005 Proposed Regulations stated: “[T]he Treasury Department and the IRS believe that a contribution of such an experienced team in place would result in the contribution of intangible property within the meaning of §1.482-4(b) and section 936(h)(3)(B) (emphasis added).”

The Temporary Regulations do not limit platform contributions that must be compensated in PCTs to the transfer of intangibles defined in Section 936(h)(3)(B). If the PCT payee contributes the services of its research team for purposes of developing cost-shared intangibles pursuant to the CSA, the PCT payor would owe compensation for the services of such team under Temp. Reg. 1.482-9T. The Temporary Regulations provide that treatment of the contribution of services of a research team as controlled services is without any inference concerning the potential status of workforce in place as an intangible within the meaning of Section 936(h)(3)(B). Thus, the Temporary Regulations purport to decouple the compensation due for an assembled workforce and the finding of an intangible transfer, perhaps recognizing that the definition of intangibles under Section 936(h)(3)(B) is not as broad as the Service might have wished.

**Intangible Development Costs—Temp. Reg. 1.482-7T(d)**

The Temporary Regulations adopt a comprehensive approach for defining not only IDCs but also IDA. Costs included in IDCs are determined by reference to the scope of the IDA. The IDA is defined to include the activity under the CSA of developing or attempting to
develop reasonably anticipated cost-shared intangibles. The scope of the IDA includes all of the controlled participants’ activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost-shared intangibles. The Temporary Regulations specify that the IDA cannot be described merely by a list of particular resources, capabilities, or rights that will be used in the CSA, because such a list would not identify reasonably anticipated cost-shared intangibles. Also, the scope of the IDA may change as the nature or identity of the reasonably anticipated cost-shared intangibles changes or the nature of the activities necessary for their development become clearer. The controlled participants may at any time change the reasonably anticipated cost-shared intangibles but must document any such change. By defining the scope of the IDA by reference to reasonably anticipated benefits (as opposed to by activities), the Regulations will make it difficult to exclude activities in the future (e.g., in the context of an acquisition). The definition of IDCs in the Temporary Regulations includes all costs, whether in cash or in kind, including stock-based compensation. The Temporary Regulations further specify that IDCs include costs incurred in attempting to develop reasonably anticipated cost-shared intangibles regardless of whether such costs ultimately lead to the development of those intangibles, other unexpected intangibles, or no intangibles at all.

**RAB Shares—Temp. Reg. 1.482-7T(e)**

The 2005 Proposed Regulations provided that RAB shares, at any given time, must be estimated over the entire period, past and future, of the exploitation of the cost-shared intangibles and must be updated, when appropriate, to reflect the most current reliable data regarding past and projected future results. The definition of RAB shares in the Temporary Regulations is quite similar but the Temporary Regulations provide two new examples to illustrate the use of separate RAB shares for separate product lines. Stated differently, the Temporary Regulations acknowledge that if there are two separate product lines whereby the controlled participants have a different RAB share for each product line, the controlled participants could enter into a separate CSA for each product line that takes into account the different RAB shares. Alternatively, the controlled participants could enter into a single CSA to develop both product lines based on a cumulative RAB share.


As a result of the new divisional interests requirement of Temp. Reg. 1.482-7T(b), the Temporary Regulations also go one step further in defining changes in participation in a CSA that require arm's-length consideration. Temp. Reg. 1.482-7T(f). Two types of changes in participation will require arm's-length consideration. First, consistent with the 1996 cost sharing Regulations, a controlled transfer of interest requires arm's-length consideration. Second, the Temporary Regulations introduce another type of change for which arm's-length consideration is warranted—a “capability variation,” which occurs if the participants have divided the divisional interests under the non-specified basis rules of Temp. Reg. 1.482-7T(b)(4)(iv) (i.e., not along territorial or field-of-use lines) and the division of interests or relative capabilities or capacities to benefit from the cost sharing intangibles are materially altered.
Example 2 of Temp. Reg. 1.482-7T(f)(5) illustrates this principle. Companies P and S previously entered into a CSA to develop product Z, dividing their interest in product Z based on site of manufacturing. Two years after the formation of the CSA, as a result of a change in plans that were not reasonably foreseeable when the CSA was entered into, S acquires additional manufacturing facilities, increasing S's RAB share from 50% to 60%. The acquisition constitutes a capability variation and thus a compensable change under Temp. Reg. 1.482-7T(f).

Methods Applicable to Platform Contributions—Temp. Reg. 1.482-7T(g)

The Temporary Regulations provide that the reliability of an application of a valuation method depends on whether it is consistent with the concept that each participant's investment in the CSA is reasonably anticipated to earn an appropriate rate of return over the entire period of the CSA. For example, if the taxpayer's application of the RPSM assumes that a participant's platform contribution will benefit the CSA for four years, but the contribution actually is reasonably anticipated to benefit the CSA for ten years, the other participants' rate of return will be greater than appropriate and indicate that the taxpayer's RPSM application is not reliable. Temp. Reg. 1.482-7T(g)(2)(ii)(B).

The Temporary Regulations, like the 2005 Proposed Regulations, mandate that the reliability of a method to value platform contributions must take into account the alternatives realistically available to the participants. Temp. Reg. 1.482-7T(g)(2)(ii)(A). This concept is derived from the "make-or-buy" concept of the current Section 482 Regulations. Regs. 1.482-1(d)(3)(iv)(H), -4(d).

Example. P, a parent corporation, contributes its existing intangibles and current research team to a CSA with S, its subsidiary, which performs only routine manufacturing and distribution activities. Instead of entering into a CSA, P could have funded the development efforts itself and licensed the resulting intangibles to S. Under the Temporary Regulations, the net present values to P and S of the CSA alternative should be the same as the license alternative. Temp. Reg. 1.482-7T(g)(2)(iii)(B).

Discount rates.

The rules for determining discount rates to be used in present-value calculations under the Temporary Regulations are significantly different from the corresponding rules under the 2005 Proposed Regulations. The 2005 Proposed Regulations required that the chosen discount rate should be the rate that most reliably reflects the risk of the activities and transactions. The 2005 Proposed Regulation included examples indicating that discount rates might be considered "most reliable" under certain circumstances including references to the weighted average cost of capital (WACC) and hurdle rates. Commenters heavily criticized the discount rate guidance in the 2005 Proposed Regulations, in particular the references to the WACC and hurdle rate examples that were feared to become defaults. The Temporary Regulations do not refer to the WACC or hurdle rates (except regarding periodic adjustments for publicly traded companies). Instead, they
provide that discount rates are most reliably determined by reference to market information (compare Temp. Reg. 1.482-7T(g)(2)(v) with Prop. Reg. 1.482-7(g)(2)(vi)). The Temporary Regulations also provide that the appropriate discount rate depends on the form of the consideration for the platform contribution (e.g., lump sum, royalty on sales, royalty on profit). Temp. Regs. 1.482-7T(g)(2)(v)(B)(2), (4)(i)(F)(2).

Importantly, the Temporary Regulations recognize that realistic alternatives may have different risk profiles and may be evaluated more reliably using different discount rates than those used for CSAs. For example, the Temporary Regulations recognize that in the example discussed above, P has greater risk in the licensing alternative (where it is bearing the cost and risk of all R&D) than in the CSA alternative (where it is bearing only its RAB share of the R&D). Conversely, S has greater risk in the CSA alternative than in the licensing alternative for the same reasons. Accordingly, a higher discount rate should be used to discount S's projected profits in the CSA alternative than in the license alternative. This use of different discount rates has the effect of narrowing the gap between the present value of the CSA alternative and the licensing alternative and thus reducing the consideration for P's platform contribution. However, the different discount rates used in the examples in the Temporary Regulations (e.g., 15% for CSAs and 13% for licenses) produce only modest reductions (5% or less) of the consideration for the platform contributions in those examples. Temp. Regs. 1.482-7T(g)(2)(v), (4)(i), (vii).

Arm's-length range for CSAs.

The Temporary Regulations, unlike the 2005 Proposed Regulations, contain guidance on the determination of an arm's-length range for CSAs. The analysis of a CSA may involve several input parameters (such as routine returns, discount rates, royalty rates). If there are no variable input parameters (that is, an input parameter having a range of values, for example, from a comparable profits method (CPM) analysis), the arm's-length payment is the single value determined by using the single most reliable value for each input parameter. If there are one or more variable parameters, the arm's-length range is an interquartile range determined by an iterative process of using each value for the variable parameters with the single most reliable values for the non-variable input parameters. Temp. Regs. 1.482-7T(g)(2)(ix), (4)(vii), Example 2.

Comparable uncontrolled transaction (CUT) method.

The Temporary Regulations, like the 2005 Proposed Regulations, provide that the CUT method can be used to determine arm's-length consideration for platform contributions. Each participant is required to pay the total worldwide value of the platform contribution multiplied by its RAB share. The Temporary Regulations add a reference to the comparable uncontrolled services price method and emphasize that comparability and reliability are dependent on the CUT having an allocation of risks consistent with the allocation of risks of the CSA. Temp. Reg. 1.482-7T(g)(3). In an apparent response to assertions from commenters, the Temporary Regulations emphasize the threshold of comparability and list the comparability factors that must be used to evaluate CUTs in the context of a PTC. The Regulations would in fact require the use of “co-develop” CUTs as opposed to “make-sell” CUTs, which would limit the universe of potential CUTs. Accordingly, based on these factors, it will still be difficult to use the CUT or CUSP method to value a platform contribution.
Under the income method, the arm's-length consideration for a platform contribution is equal to the present value of the participant's best realistic alternative. Temp. Reg. 1.482-7T(g)(4). This method is essentially the same as the “foregone profits method” that the IRS has used in pending cases under the 1996 cost sharing Regulations. The income method can be applied using a CUT or the CPM. It is used where only one participant furnishes non-routine platform contributions. (The RPSM can be applied where more than one participant makes non-routine platform contributions.)

Under the 2005 Proposed Regulations, if the income method was used with a CUT, the first step was to determine, based on the CUT, the arm's-length constant royalty rate (expressed as a percentage of sales) that the participant making the platform contribution would have charged if it had developed the cost-shared intangibles on its own, bore all the IDCs itself, and licensed the cost-shared intangibles to the other participants. The second step was to calculate a cost contribution adjustment equal to the present value of the other participants' total cost contributions to the CSA divided by the present value of the anticipated sales from exploiting the cost-shared intangibles. The third step was to reduce the alternative rate by the cost contribution adjustment to yield the applicable royalty rate representing the arm's-length compensation for the platform contribution.

Under the 2005 Proposed Regulations, if the CPM was used with the income method, the alternative rate could be expressed as a percentage of sales or operating profit. If expressed as a percentage of sales, the alternative rate was the ratio of (1) the present value of the other participants' anticipated operating profit from exploiting the cost-shared intangibles, reduced by a market return (determined using the CPM) for routine contributions (other than cost contributions) ("residual profit"), over (2) the present value of the anticipated sales from exploiting the cost-shared intangibles. This rate was then reduced by the cost contribution adjustment expressed as a percentage of sales. The 2005 Proposed Regulations provided that if the alternative rate was expressed as a percentage of operating profit, the alternative rate was 100% (both the numerator and denominator were the present value of the residual profit), and the cost contribution adjustment was the present value of the other participants' total cost contributions divided by the present value of the residual profit.

The Temporary Regulations reach similar economic results by comparing the present value of the anticipated profits from the CSA to the present value of the anticipated profits from its best realistic alternative (presumed to be a licensing agreement with terms comparable to the CSA except that PCT payee bears all costs and risks of developing the intangibles). The present value of the PCT payor's CSA alternative is the present value of the reasonably anticipated divisional profits or losses, less operating cost contributions, less cost contributions, less PCT payments, over the duration of the CSA. The present value of the PCT payor's licensing alternative, using the CUT method, is the present value of the reasonable anticipated divisional profits, less operating cost contributions, less license payments under the CUT method, over the duration of the CSA. The present value of the PCT payor's licensing alternative, using the CPM, is the present value of the routine contributions determined under the CPM. The present value of the PCT payment is the excess of (1) the present value of the reasonably anticipated divisional profits or losses, less operating cost contributions, less cost contributions, over the duration of the CSA,
over (2) the present value of the licensing alternative. Temp. Reg. 1.482-7T(g)(4)(iv). Consistent with the 2005 Proposed Regulations, this methodology allocates all of the non-routine residual profits to the PCT payee.

**Acquisition price method.**

The Temporary Regulations leave the acquisition price method unchanged from that provided for under the 2005 Proposed Regulations. Under the acquisition price method, the arm's-length charge for PCTs from an acquired company ("target") is the adjusted acquisition price for the target divided among the participants based on their RAB shares. Temp. Reg. 1.482-7T(g)(5). The adjusted acquisition price is the acquisition price of the target increased by assumed liabilities and decreased by the value of the target's tangible property and any other resources and capabilities of the target not included in the platform contribution to the CSA. As with the 2005 Proposed Regulations, the Temporary Regulations recognize that the reliability of this method is reduced if a substantial portion of the target's non-routine contributions to the participant's business is not contributed to the CSA and cannot reliably be valued, or if a substantial portion of the target's assets consists of tangible property that cannot reliably be valued. The Temporary Regulations also provide that the reliability of this method is reduced if the date that the target is acquired and the date of the PCT are not contemporaneous.

**Accounting principles.**

Consistent with the 2005 Proposed Regulations, the Temporary Regulations state that purchase price allocations or other valuations undertaken for financial accounting purposes provide a useful starting point, but will not be conclusive for valuations of PCTs, "particularly where the accounting treatment of an asset is inconsistent with its economic value." Temp. Reg. 1.482-7T(g)(2)(vii). Accordingly, the portion of the purchase price of a target allocated for financial accounting purposes to goodwill or acquired assets later abandoned may be reallocated to the acquired technologies of the target contributed to a CSA.

The Temporary Regulations acknowledge that if a taxpayer participating in a CSA acquires a mature business that is successfully marketed under a recognized trademark, and this business is continued by the acquirer following the acquisition, a significant amount of the non-routine contributions to the acquirer's business activities is likely to consist of goodwill and going-concern value economically attributable to the existing business rather than to the platform contributions consisting of rights in the acquired technology and research workforce. Conversely, if the same taxpayer acquires a target solely to exploit certain technology owned by the target and, after consummating the acquisition, terminates the target's employees and discontinues the target's business, the Temporary Regulations purport to attribute the entire purchase price, adjusted for assumed liabilities and the value of acquired tangible assets, to the technology. See Temp. Regs. 1.482-7T(g)(2)(vii)(B), Examples 2 and 3.

**Market capitalization method.**

The Temporary Regulations leave the market capitalization method unchanged from the 2005 Proposed Regulations as a specified method for valuing platform contributions to a CSA. Temp. Reg. 1.482-7T(g)(6). This method remains consistent with the IRS position taken in controversies under the 1996 cost sharing Regulations. The market capitalization method tests whether the payment for a platform contribution is arm's length by reference to the average market capitalization (using a lagging 60-day average, adjusted
for liabilities, tangible assets, and other non-compensable intangible assets) of a CSA participant whose stock is regularly traded on an established securities market. The PCT is calculated as the adjusted average market capitalization multiplied by each CSA participant's RAB share.

The Preamble to the Temporary Regulations notes that, as with the acquisition price method, the reliability of the market capitalization method is reduced if a substantial portion of the PCT payee's non-routine contribution to business activities is not required to be covered by a PCT or if a substantial portion of the PCT payee's assets consists of tangible property that cannot reliably be valued. Based on the foregoing caveat, one would reasonably conclude that if the publicly held participant has (1) other non-routine intangible assets (e.g., goodwill and going concern) that are not reasonably anticipated to materially contribute to the business activity of the CSA, or (2) substantial business activities not involved in the CSA, the market capitalization method would not apply. However, as with the acquisition price method, the IRS can be expected to try to reallocate the value of goodwill and going concern to platform contributions in many cases. The reliability of the method is further reduced if the facts and circumstances demonstrate the likelihood of a material divergence between the PCT payee's average market capitalization and the value of its underlying resources, capabilities, and rights for which reliable adjustments cannot be made.

RPSM.

The Temporary Regulations adopt the position in the 2005 Proposed Regulations that substantially modifies the traditional RPSM in Reg. 1.482-6 (1994). Many taxpayers have used the RPSM to evaluate the arm's-length buy-in payment for pre-existing intangibles made available to a CSA under existing law. Temp. Reg. 1.482-7T(g)(7); Reg. 1.482-6(c)(3)(i). Their application of this method relied on the notion that even if both CSA participants did not contribute pre-existing intangibles to a CSA, once cost-sharing began, both parties would develop intangibles; and that this development of intangibles by both participants entitled both to earn a share of any non-routine profits. Of course, the contribution of pre-existing intangibles by any participant generally would entitle that participant to a larger share of non-routine profit, but that share of the non-routine profit would decrease over time by virtue of the other participant's sharing of ongoing intangible development costs.

The Temporary Regulations effectively prevent the future use of this approach. Under the new rules, the RPSM is an allowable method only when all CSA participants contribute non-routine intangibles to the CSA endeavor. If the RPSM is applied when one or more participants contribute no pre-existing, non-routine intangibles to the CSA, it will be interpreted as an unspecified method for purposes of Sections 482 and 6662(e), and the best-method principles articulated in the Temporary Regulations will likely result in another method—most probably the income method—being judged the "better" method, thereby trumping the RPSM.

It is also significant that the examples in the Temporary Regulations point to two kinds of non-routine contributions that would enable the use of the RPSM: (1) circumstances in which one party contributes pre-existing technology requiring further development and the other party contributes local marketing intangibles; and (2) circumstances in which both parties contribute pre-existing technology intangibles (along with operating intangibles). This reinforces the belief that one form of cost sharing adopted by taxpayers in the past—in which only one party contributes pre-existing intangibles—cannot be undertaken under the Temporary Regulations, unless the income method, or another method other than RPSM, is used to value the parties' contributions.
In those limited circumstances in which the RPSM will be used, the method has been modified to comport more closely with the calculation steps specified in Reg. 1.482-6. Thus, the Temporary Regulations apply a two-step approach for determining compensation to the participants:

- **Step 1: Routine profit.** The first step requires an allocation of profit to routine contributions.
- **Step 2: Non-routine contribution share.** The remaining share of the residual is to be divided based on the relative value of the non-routine contributions to the relevant business activity.

The Temporary Regulations delete an additional step included in the 2005 Proposed Regulations and do not require that the intangible development costs obtain a return before any other intangible contributions are rewarded.

In practical terms, the only taxpayers likely to successfully use the RPSM for CSAs are those whose CSA participants are operating subsidiaries with a history of sales, distribution, manufacturing, service, or technology development operations; or otherwise, subsidiaries that own or have otherwise acquired various non-routine intangibles.

**Traditional RPSM—unspecified method status.**

As noted above, the Temporary Regulations introduce a modified RPSM compared to the traditional RPSM of the 1996 cost sharing Regulations. Although the traditional RPSM has now been demoted to unspecified-method status, the “best method” rule has survived, so the traditional RPSM may still be relevant in some circumstances, for example where both CSA participants make substantial non-routine contributions.

**Form of Payment Rules—Temp. Reg. 1.482-7T(h)**

The Temporary Regulations specify that CST payments may not be made in the stock of the payor or of any of the related parties in the controlled group that contains the participants to the CSA. More importantly, the Temporary Regulations reverse the position staked out in the 2005 Proposed Regulations with respect to the form of payment for external contributions resulting from a post-formation acquisition (PFA). The 2005 Proposed Regulations required that a PFA-related PCT be paid in the same form as the uncontrolled transaction in which the PFA was acquired. Instead, the Temporary Regulations retain the flexibility that taxpayers have had under the 1996 cost sharing Regulations for all types of PCTs, regardless of the timing of the PCT. Specifically, taxpayers may make PCT payments as (1) lump sums, (2) installment payments, or (3) contingent payments, such as royalties. Although taxpayers generally are entitled to choose their payment forms, the form of the payment must be specified no later than the date of the tax return reflecting the PCT. The only prohibition is that PCT payments may not be made in the form of stock of any of the parties in the related group.

**CSA Allocations by the Commissioner—Temp. Reg. 1.482-7T(i)**

The Commissioner may make allocations to one or several of the various items that affect the allocations of income to CSA participants, including the forecasts and cost allocations used to calculate RAB shares and cost sharing transaction payments (CST payments); and the forecasts, cost allocations, and assumptions used to determine PCT payments.
among CSA participants. More specifically, the Temporary Regulations cite several areas where adjustments may be made:

- Redetermination of intangible development costs either by adding costs that are determined to be directly related to the IDA or removing costs that are determined to be unrelated to the IDA.
- Reallocation of costs between the IDA and other business activities.
- Improvement of the reliability of the computation of a controlled participant's RAB share.
- Improvement of the reliability of the projections used to estimate RAB shares.

The Temporary Regulations place particular emphasis on the basis by which to evaluate the reliability of projections used to estimate RAB shares and PCT payments. The analytic approach specified for PCT payments is especially and unnecessarily complex.

**Reliability of projections used to estimate RAB shares.**

If the observed actual benefits (adjusted benefit shares) are different from the projected RAB shares applied in a CSA, the Commissioner may use the adjusted benefit shares as the most reliable measure of RAB shares and make adjustments to the IDC shares in a particular year. Temp. Reg. 1.482-7T(i)(2)(ii)(A). The RAB shares will not be considered unreliable, however, unless the divergence from the adjusted benefit shares for every controlled participant is greater than 20% of the participant's projected RAB share. Temp. Reg. 1.482-7T(i)(2)(ii)(A). Where RAB share estimates are considered unreliable, the Commissioner may adjust projections of benefits used to calculate benefit shares. No adjustments will be made if the divergence from the adjusted benefit shares is due to an extraordinary event beyond the control of (and not reasonably anticipated by) the participants. However, the 20% "safe harbor" does not apply where the Commissioner determines that the basis on which RABs were computed is not the most reliable. Temp. Reg. 1.482-7T(i)(2)(ii)(A).

An important issue that arises from differences between projected RAB shares and actual RAB shares is that they may create a situation where a participant consistently bears IDC shares that are materially higher or lower than its actual RAB share. Consistent with the 1996 cost sharing Regulations, the Commissioner may conclude that the economic substance of the transaction is inconsistent with the terms of the CSA. If so, the Commissioner may disregard terms of the CSA and impute terms that are consistent with the economic substance of the arrangement. For example, the Commissioner could assert that the participant that bore IDCs greater than their RAB shares should receive a greater share of the cost-shared intangibles and be compensated by those parties bearing IDC shares lower than their actual RAB shares. Temp. Reg. 1.482-7T(i)(5).

**PCT payments.**

As with the 2005 Proposed Regulations, the Temporary Regulations allow the Commissioner to make periodic adjustments related to all PCT payments if the participant that is responsible for PCT payments (the PCT payor) earns a rate of return (the “actually experienced return ratio” or AERR) on its investment in the CSA (i.e., CST and PCT payments) that is outside a specified range (the “periodic return ratio range” or PRRR).
Under the 2005 Proposed Regulations, the PRRR extended from 0.5 to 2.0 but has been narrowed to .667-1.5 in the Temporary Regulations. Temp. Reg. 1.482-7T(i)(6)(ii). As explained in the Preamble to the Temporary Regulations, the PRRR was narrowed because “[t]he Treasury Department and the IRS consider that the periodic return ratio range under the Temporary Regulations more realistically targets the threshold at which periodic adjustment scrutiny is appropriate.” The PRRR is increased if the taxpayer has not substantially complied with the documentation requirements at Reg. 1.482-7(k), in which case the PRRR will be 0.8 to 1.25. As stated in the Preamble, “[t]his is intended to isolate situations in which actual results suggest the potential of an absence of arm’s length pricing as of the date of the PCT.”

The computations necessary to determine the AERR and PRRR are complex, although the objectives are straightforward. To the extent that the return earned by a PCT payor is below -33% or above 50% (i.e., a PRRR less than .667 or greater than 1.50), the Commissioner has the option to further evaluate whether a periodic adjustment should be made. As indicated below, the periodic adjustment is based on a comparison of actual PCT payments to those that would have been made if the most current actual and forecast divisional profit and loss information were used. The contingent payment computation can result in additional payments by PCT payors to PCT payees or vice versa.

The periodic adjustment calculations related to PCT payments, including computation of the AERR, rely extensively on present-value analysis, which requires use of a discount rate to convert future income streams to a present value. The Temporary Regulations provide guidance on the criteria for selecting an appropriate discount rate. For members of a publicly traded group, the PCT payor weighted average cost of capital (WACC) is presumed to be the appropriate discount rate, unless “…the Commissioner determines, or the controlled participants establish to the satisfaction of the Commissioner, that a discount rate other than the PCT payor WACC better reflects the degree of risk of the CSA Activity as of such date.” Temp. Reg. 1.482-7T(i)(6)(iv). The presumption in this case seems inconsistent with the determination of the “most reliable” discount rate for the initial PCT payment.

**Determination of periodic adjustments.** Assuming that for a particular PCT payment (“Trigger PCT”) the AERR falls outside the PRRR, the Commissioner may make periodic adjustments with respect to all PCT payments between all PCT payors and PCT payees for the particular year under exam (“Adjustment Year”) and all subsequent years for the duration of the CSA activity applying a variation of the RPSM. Further, the Commissioner may make a periodic adjustment for a particular tax year regardless of whether the tax years of the Trigger PCT or other PCTs remain open for statute of limitation purposes. Temp. Reg. 1.482-7T(i)(6)(v).

Periodic adjustments are determined through a multi-step process:

- **Step 1:** Determine the present value (PV) at the date of the Trigger PCT (“Determination Date”) of the PCT payments computed pursuant to the RPSM. The actual results through the Determination Date and the projected results for the balance of the CSA after the Determination Date will be used in the RPSM computation. The RPSM calculation is addressed in Temp. Reg. 1.482-7T(g). For purposes of this computation, the requirement of Temp. Reg. 1.482-7T(g)(7)(i)
that at least two controlled participants make significant routine contributions does not apply.

- **Step 2:** The results under Step 1 are converted into a stream of payments over the entire duration of the CSA, using a level royalty rate applied to the divisional profits and losses (net of IDCs or PCT payments).

- **Step 3:** Apply the royalty rate computed in Step 2 to the PCT payor's actual profit or loss for years prior to and including the year in which the adjustment is being made (Adjustment Year) and convert the resulting stream of payments to a present value as of the commencement of the CSA.

- **Step 4:** Convert actual PCT payments made in all years prior to and including the Adjustment Year to a present value as of the commencement of the CSA and subtract this amount from the amount computed in Step 3 and convert to a nominal value for the Adjustment Year. This amount is the periodic adjustment in the Adjustment Year.

- **Step 5:** Apply the royalty rate computed in Step 2 to the actual divisional profits or loss for each tax year after the Adjustment Year through the tax year that includes the Determination Date. The periodic adjustment for each of these tax years is determined by subtracting from the computed amounts the actual PCT payment made for the same year.

- **Step 6:** For each tax year subsequent to the year that includes the Determination Date, the periodic adjustment equals the royalty rate computed in Step 2 applied to the actual divisional profit or loss for that year. This payment amount is in lieu of any PCT payment that otherwise would be payable for that year under the taxpayer's position. Temp. Reg. 1.482-7T(i)(6)(v).

The Temporary Regulations specify numerous instances where periodic adjustments will not apply to CST payments. These include:

- The same platform contribution is provided to an uncontrolled taxpayer under substantially the same circumstances as is provided the controlled taxpayer; that this third-party transaction serves as the grounds for applying the CUT method in the first year and all subsequent years in which substantial PCT payments were required to be paid; and the amount of the PCT payments in the first year was arm's length. Temp. Reg. 1.482-7T(i)(6)(vi)(A)(1).

- The difference between the AERR and the nearest bound of the PRRR is due to extraordinary events beyond the control of the controlled participants that could not reasonably have been anticipated. Temp. Reg. 1.482-7T(i)(6)(vi)(A)(2).

- The Periodic Trigger would not have occurred had the PCT payor's divisional profits or losses excluded those profits or losses attributable to the PCT payor's routine activities, operating cost contributions, and non-routine contributions to the CSA. Temp. Reg. 1.482-7T(i)(6)(vi)(A)(3).

- The Periodic Trigger would not have occurred had the PCT payor's divisional profits or losses included its reasonably anticipated divisional profits or losses from routine activities, operating cost contributions, and non-routine contributions after the Adjustment Year of the CSA. For this item, the controlled participants have the option to assume that the average yearly divisional profits or losses for all tax years prior to and including the Adjustment Year will continue to be earned in each year over a period of years equal to 15 minus the number of exploitation years prior to and including the Determination Date. Temp. Reg. 1.482-7T(i)(6)(vi)(A)(4).

- No Periodic Trigger will be deemed to occur in any year subsequent to the ten-year period beginning with the first tax year in which there is substantial exploitation of cost-shared intangibles, if the AERR determined is within the PRRR. Temp. Reg. 1.482-7T(i)(6)(vi)(B)(1).
• No Periodic Trigger will be deemed to occur in any year of the five-year period beginning with the first tax year in which there is substantial exploitation of cost-shared intangibles, if the AERR falls below the lower bound of the PRRR. Temp. Reg. 1.482-7T(i)(6)(vi)(B)(2).

In addition, the Preamble to the Temporary Regulations states that Treasury and the IRS intend to issue specific guidance under a Revenue Procedure that provides an exemption to periodic adjustments in the context of an advance pricing agreement.

CSA Administrative Requirements—Temp. Reg. 1.482-7T(k)

The administrative requirements under the Temporary Regulations are heavy compared with the 1996 cost sharing Regulations. First, like the 1996 cost sharing Regulations, the Temporary Regulations require a written cost sharing agreement. Importantly, this agreement must be “contemporaneous.” Temp. Reg. 1.482-7T(k)(1)(iii)(A) provides that such agreement must be in place no later than 60 days after the parties first incur IDCs. Thus, the taxpayer practice of signing agreements at year-end, which are “effective as of” the start of the tax year, will not be treated as contemporaneous. One example in the Temporary Regulations indicates that if an agreement fails to meet the contemporaneous requirement, the arrangement cannot be a CSA. The example does not indicate the transfer pricing result if the CSA fails to qualify as such under Reg. 1.482-7.

The administrative requirements list a significant amount of documentation required for CSAs. The Temporary Regulations indicate that this documentation is designed to demonstrate that the controlled participants in the CSA have complied with the cost sharing agreement. There are many required pieces of information required for documentation, including listings of cost-shared intangibles and each controlled participants' interest in those intangibles and descriptions of further developments of intangibles already developed pursuant to the CSA. These documentation rules do not exist in the 1996 cost sharing Regulations and will give rise to an additional reporting requirement for cost sharing participants.

The administrative provisions also call for the separate filing with the IRS of a CSA Statement, which will include the names of the controlled participants in the CSA, the earliest date that any IDC was incurred, and the date that the CSA was formed or revised. It must be signed by the taxpayer under penalty of perjury and generally must be filed with the IRS no later than 90 days after the first occurrence of an IDC to which the CSA applies. The taxpayer also must attach a copy of the CSA Statement to its annual tax return, along with a schedule documenting any changes to the initial information that have occurred over time.

Transition and Grandfather Rules—Temp. Reg. 1.482-7T(m)

The effective date of the Temporary Regulations is January 5, 2009. Since the Regulations were issued on December 31, 2008, taxpayers have had little time to react to these Regulations. Importantly, the Temporary Regulations indicate that a qualified cost sharing arrangement in place on January 5, 2009, and meeting the requirements of the 1996 cost sharing Regulations will remain a qualified cost sharing arrangement for
purposes of the Temporary Regulations ("grandfathered CSA"). CSTs and PCTs that took place prior to January 5, 2009, are subject to the 1996 cost sharing Regulations. Moreover, unlike the 2005 Proposed Regulations, the Temporary Regulations explicitly provide that grandfathered CSAs will be subject to the periodic adjustments provisions of Reg. 1.482-4(f)(2) of the 1996 cost sharing Regulations, and not to the periodic adjustment provisions included in the Temporary Regulations.

The Temporary Regulations indicate that the divisional interests provisions of Temp. Regs. 1.482-7T(b)(1)(iii) and (b)(4) do not apply to grandfathered CSAs. Thus, territorial divisions that do not comply with the Temporary Regulations can remain in place for grandfathered CSAs. Temp. Regs. 1.482-7T(m)(2)(iii) and (iv).

Grandfathered CSAs must be amended to conform with Temp. Reg. 1.482-7T(k), which imposes most, but not all, of the new administrative requirements. Further, the parties must enter into this amended agreement by July 6, 2009. Finally, taxpayers must file a CSA Statement as described in those administrative provisions for grandfathered CSAs with the IRS by September 2, 2009.

Unlike the 2005 Proposed Regulations, a material change in scope or a 50% change of ownership will not result in the termination of grandfather status. Instead, the Temporary Regulations provide that for a material change in scope of a grandfathered CSA, the periodic adjustment provisions of the Temporary Regulations (and not the current Regulations at Reg. 1.482-4(f)(2)) will apply to any PCTs that occur on or after the date of a material change in the scope of the CSA from its scope as of January 5, 2009. Temp. Reg. 1.482-7T(m)(3). The grandfather status, however, is not terminated. The Temporary Regulations provide that a material change in scope is a “material expansion of the activities undertaken beyond the scope of the intangible development area.” Temp. Reg. 1.482-7T(m)(3). In determining whether there has been a material expansion of the CSA activities, a series of expansions can be aggregated to constitute a material expansion.


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