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# A New Age in Cost Sharing? The IRS Proposed Regulations

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Would the last three weeks of August 2005 mark the beginning of the end of cost sharing as we know it? Many practitioners and commentators seem to think so. First, on August 9, 2005, the IRS's Large and Midsize Business Division issued its Checklist for Cost Sharing Arrangements. The checklist is intended to aid examiners in assessing a taxpayer's treatment of cost sharing issues and to serve as a guide in determining compliance with cost sharing documentation requirements. The first step in IRS Director, International, Robert Green's initiative to streamline the IRS approach to cost sharing disputes, the checklist would be followed by settlement guidelines. Those guidelines would focus on buy-in [1] issues, which account for $23 billion of the $26 billion in pending cost sharing controversies.[2] IRS scrutiny of buy-ins is nothing new,[3] but the checklist provides further insight into IRS views on how they should be valued. It signals IRS suspicions that many buy-in payments only capture the value of the make and sell rights associated with existing intangibles, and not the potentially much greater value of those intangibles as a research platform.[4] The checklist also sur-

[1] In most cost sharing arrangements, the intangibles to be developed either would depend upon other intangibles owned by one of the parties or would already have been partially developed by one of the parties. In such cases the "participant that makes intangible property available to [the] qualified cost sharing arrangement would 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." Regs. §1.482-7(g)(1). Buy-in payments also are required when a new participant joins an existing cost sharing arrangement. Under the existing cost sharing regulations, whether buy-in payments satisfy the arm's length standard is determined by the rules of Regs. §§1.482-1 and 1.482-4 through 1.482-6. All section references herein are to the Internal Revenue Code of 1986, as amended ("the Code"), and the regulations thereunder, unless otherwise stated.

[2] *See* 14 *Tax Mgmt. Transfer Pricing Rep.* 303 (8/17/05). The IRS plans to issue the guidelines in early 2006. Bennett, "Settlement Guidelines for Cost Sharing Expected in Early 2006, IRS's Green Says," BNA *Daily Tax Rep.* G-7 (10/27/05).

[3] *See, e.g.,* FSA 200023014.

[4] The Guidelines cite TAM 2004440222 for this view

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faces IRS concerns about use of the residual profit split method (RPSM) to value buy-ins, and clarifies that the IRS views periodic adjustments as its prerogative alone.

Two weeks after release of the checklist, on August 22, 2005, the Treasury Department issued proposed cost sharing regulations.[5] The existing regulations date back only to 1995 and were modified in 2003 to address the treatment of stock-based compensation as a cost to be taken into account and shared by the cost sharing participants. However, the IRS has long been concerned that the current regulations enable taxpayers to transfer valuable existing intangibles offshore in the guise of external contributions to cost sharing arrangements (CSAs), and in 2002 began an effort to revise the cost sharing rules to ensure that such transfers are done at arm's length.[6] Accordingly, the main purpose of the proposed regulations is to provide additional guidance on the external contributions — noncash assets and resources (other than research and development services and facilities) that the parties make available to a CSA — for which arm's length buy-ins would have to be provided as a condition of entering into a CSA and on the methods for valuing those external contributions. Revised periodic adjustment mechanisms are incorporated to assess whether, over time, the external contributions prove to be arm's length. Additional changes are proposed to address other issues encountered in administering the existing regulations.

The philosophy of the proposed rules appears to be that a CSA should be analyzed as a financing transaction. As explained in its preamble, "the proposed regulations adopt as a fundamental concept an *investor model* for addressing the relationship and contributions of controlled participants in a cost sharing arrangement." [7] By this, the IRS means that whether a party's investment in a CSA, i.e., its share of ongoing costs plus its external contributions, is arm's length is a function of its expected risk-adjusted return from the CSA. The investor model carries over to the proposed periodic adjustment provisions, where the threshold inquiry for determining if an adjustment is necessary is the ratio of the present value of a participant's total profits from the CSA to the present value of its total investment — that is, its actual investment return.

The practitioner response to the proposed regulations has been less than favorable. Some speculate that, by increasing buy-ins and otherwise eliminating incentives for cost sharing, the regulations would discourage participation in CSAs, potentially causing companies to move their research and development activities offshore.[8] The proposed rules require extensive up-front work on projections and valuations. All this additional effort may, in and of itself, make cost sharing an unattractive option. Taxpayers may take the attitude that, if there is little to be gained from entering a CSA, there is good reason to defer the transfer pricing fights until after the intangibles are developed. On the other hand, at least one commentator believes the proposed rules are overly generous. He argues that they enable a foreign participant to reap half of the profits from foreign sales without doing any of the work.[9] Comments on the proposed regulations were due November 28, 2005, and a public hearing was scheduled for December 16, 2005.

Then, on August 29, 2005, Tax Court Judge Foley issued his opinion in *Xilinx Inc. v. Comr.,*[10] on whether employee stock option costs are costs that must be shared in CSAs. Concluding that at arm's length such costs would not be shared, he held that the IRS's treatment of employee stock options as intangible development costs that had to be shared was arbitrary and capricious. The taxpayer's evidence that unrelated parties in transactions comparable to CSAs do not share option costs persuaded Judge Foley that its CSA allocations were arm's length. The IRS presented no evidence that its allocations were arm's length in the sense that unrelated parties take them into account in their cost sharing arrangements; instead it merely contended that "it is unnecessary to perform any type of comparability analysis to determine . . . whether parties at arm's length would share . . . [the spread of the grant date value]." [11]

*Xilinx* was not subject to the 2003 version of the cost sharing regulations, which requires that employee stock option costs be included in costs under a CSA. The case therefore may not have any bearing on years covered by the 2003 regulations, but it nevertheless undermines the premise of those regulations that including employee stock option costs in the costs to be

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on how taxpayers attempt to value buy-ins.

[5] REG-144615-02, 70 Fed. Reg. 51115 (8/29/05).

[6] *See* Testimony of Pamela Olson, Department of the Treasury Acting Assistant Secretary for Tax Policy, before the House Ways and Means Committee on Corporate Inversion Transactions, 6/6/02, reprinted in 11 *Tax Mgmt. Transfer Pricing Rep.* 177 (6/12/02).

[7] REG-144615-02, 70 Fed. Reg. 51117, under "A. Overview." (Italics in original).

[8] Moses, "Proposed Cost-Sharing Rules Seen as Attempt to Enlarge Buy-In Payments," BNA *Daily Tax Rep.* J-1 (8/31/05); Kirschenbaum and Rahim, "The IRS Cost Sharing Proposal: Throwing Some Logs on the Fire," 14 *Transfer Pricing Report* 433 (9/14/05); Reams, et al, "Proposed Cost-Sharing Regulations: Are They a Realistic Alternative?," 2005 *Tax Notes Today* 196-24 (10/12/05).

[9] Sullivan, "Economic Analysis," 2005 *Tax Notes Today* 176-8 (9/13/05).

[10] 125 T.C. No. 4 (8/30/05).

[11] *Id.* at pp. 27-28 (slip op.).



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shared produces an arm's length result. Perhaps more importantly, the IRS litigating position in *Xilinx* pervades the proposed regulations. Evidence of what unrelated parties would do in comparable circumstances is dismissed as "not analogous to a cost sharing arrangement in which the controlled participants divided contributions in accordance with reasonably anticipated benefits from separate exploitation of the resulting intangibles." [12] The IRS seems to be saying that unrelated party transactions comparable to CSAs, as it defines them, cannot exist, and therefore an approach under which the IRS prescribes what is arm's length must be used. It will be interesting to see if this stance holds up in any future litigation surrounding buy-ins, or whether arm's length arguments such as those accepted by Judge Foley could be used to attack the validity of the proposed regulations if finalized in their current form.[13]

## CSA DEFINED

As defined in the proposed cost sharing regulations, a CSA would be a contractual agreement under which related parties (controlled participants) agreed to share the costs and risks of developing intangibles in proportion to the benefits that each reasonably expected to derive from exploitation of the intangibles.[14] To qualify as a CSA under the proposed regulations, the agreement would have to satisfy three substantive and four formal requirements.[15] The substantive requirements would be that the controlled participants:

1. At the outset of the arrangement divide among themselves all interests in cost shared intangibles on a territorial basis;
2. Enter into and effect cost sharing transactions (CSTs) covering all intangible development costs (IDCs) and preliminary or contemporaneous transactions (PCTs) covering all external contributions for purposes of developing the cost shared intangibles under the CSA; and
3. As a result, individually own and exploit their respective interests in the cost shared intangibles without any further obligation to compensate one another for such interests.

The formal requirements would be that the participants substantially comply with specified contractual, documentation, accounting, and reporting requirements.

The most significant change from the definition in the existing regulations is the requirement that participants [16] carve the world into nonoverlapping geographic territories.[17] Each participant would have to receive at least one territory, in the aggregate all territories would have to be allocated to participants, and each participant would have to be entitled to the perpetual and exclusive right to all profits earned within its territory from intangibles developed under the CSA. Thus, if any member of the controlled group of which a participant were a member engaged in a transaction with an uncontrolled taxpayer that involved property or services for use, consumption, or disposition within the participant's territory, any profit from the transaction attributable to intangibles developed under the CSA would have to be paid over to the participant. For this purpose the use, consumption, or disposition of property or services would be considered to occur at the location where the uncontrolled taxpayer received notices or other communications under the contractual terms of the transaction.

The territorial rule would prevent taxpayers from entering into CSAs in which participants received nonexclusive, indivisible worldwide rights and from taking the position that such interests could be individually exploited. The IRS apparently believes that separate exploitation is not possible without exclusive rights, and without separate exploitation reasonably anticipated benefits cannot be estimated. The IRS recognizes that parties may enter into joint exploitation or preferential return arrangements; those arrangements just cannot be CSAs. It does admit there may be methods other than territorial divisions for carving rights into exclusive, nonoverlapping segments, and requests comments on possible alternatives.

As in the existing regulations, the IRS could apply the cost sharing rules to any agreement that met the

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[12] REG-144615-02, 70 Fed. Reg. 51117, under "A. Overview."

[13] The IRS has not as of early November 2005 decided if it will appeal *Xilinx*. In making that decision the IRS is "considering whether the opinion limits the government's ability 'to prescribe that certain [transfer pricing] methodologies reach an arm's-length result.' " Moses, "Korb Discusses Considerations of Service in Determining Whether to Appeal 'Xilinx'," BNA *Daily Tax Rep.* G-1 (10/21/05) (quoting IRS Chief Counsel Donald Korb).

[14] The existing regulations apply to a qualified cost sharing arrangement (QCSA), which is a CSA that (1) includes two or more participants, (2) provides a method for calculating each participant's share of intangible development costs based on the participant's anticipated benefits, (3) provides for adjustments to shares of intangible development costs to account for changes over the course of the CSA, and (4) is recorded in a document contemporaneous with formation of the CSA that contains certain specified information. Regs. §1.482-7(b).

[15] Prop. Regs. §1.482-7(b)(1).

[16] The term "participant" is used herein as shorthand for "controlled participant."

[17] Prop. Regs. §1.482-7(b)(4).




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substantive requirements, notwithstanding a failure to comply with any of the formal requirements. The IRS would have to apply the rules to an arrangement that met the formal requirements if the participants both met the formal requirements and reasonably concluded that the arrangement was a CSA, and could apply the rules to any other arrangement that met the formal requirements.[18] Examples in the regulations seem to indicate that the ''reasonably conclude'' standard means an intent to comply with the substantive requirements, but an unintended failure to provide arm's length terms. That is, if the IRS could turn the arrangement into a CSA simply by adjusting valuations and payments, the IRS would be willing to — and in fact would have to — treat the arrangement as a CSA.

## TERMINOLOGY

Although the proposed regulations are, apart from the new guidance on external contributions, mostly a rework of the existing regulations with many portions surviving intact, they introduce many new terms, requiring that a new vocabulary be mastered. Key terms used include:

*Controlled Participant*. A controlled participant would be any controlled taxpayer that was a party to the contractual agreement underlying the CSA and that anticipated deriving benefits from exploiting intangibles developed under the CSA.[19] Unlike the existing regulations, the proposed rules would not permit uncontrolled participants. Eliminating the possibility of uncontrolled participants would be a simplifying provision that should not cause any hardship: the IRS has indicated that it is not aware of any uncontrolled participants in existing CSAs.

*IDA*. The intangible development activity, or IDA, would be the activity under the CSA of developing or attempting to develop intangibles.[20] IDA would replace the term ''intangible development area'' under the existing regulations.

*Cost shared intangible*. A cost shared intangible would be any intangible developed or to be developed under the IDA.[21] The term would replace the term ''covered intangible'' in the existing regulations.

*CSA Activity*. CSA activity would be the activity of developing and exploiting cost shared intangibles, i.e., the IDA plus the exploitation of the cost shared intangible.[22]

*IDC*. Intangible development costs, or IDCs, would have the same meaning as under the existing regulations. The proposed regulations take care, however, to clarify that IDCs would pertain only to the ongoing costs of a CSA, and not to the value of the external contributions made by the participants. IDCs would be defined as ''all costs, in cash or in kind (including stock-based compensation . . .), but excluding costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on an analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the [IDA].'' [23] IDCs would include arm's length rental charges for land and depreciable property used in the IDA. A cost that was not wholly allocable to the IDA because it also benefited other business activities would be allocated between the IDA and other activities in proportion to the relative economic value each was expected to derive over time on account of the cost.[24] A participant's *IDC share* for a taxable year would be the IDCs directly incurred by the participant for the year plus its cost sharing payments made to other participants minus the cost sharing payments it received from other participants (together, its *cost contribution* for the year) divided by the sum of all IDCs for the year.[25]

*RAB share*. The RAB share would be the proportion of each participant's reasonably anticipated benefits (*RAB*) from exploiting cost shared intangibles to the sum of RABs for all participants.[26] The definition of RAB in the proposed regulations is consistent with that in the existing regulations, but the proposed regulations clarify that at any time RAB shares were determined they would have to be estimated for the entire period over which the cost shared intangibles could be expected to be exploited, both past and present, and would have to be updated using the most reliable data available.

*CST*. A cost sharing transaction, or CST, would be a controlled transaction between or among participants by which they share IDCs in proportion to their RAB shares.[27] Thus, if two controlled participants entered into a CSA, for each year of the CSA that their IDC shares were not equal to their RAB shares, there would be a CST in which the participant whose IDC share was less than its RAB share would have to

[18] Prop. Regs. §1.482-7(b)(5).

[19] Prop. Regs. §1.482-7(j)(1)(i).

[20] Prop. Regs. §1.482-7(d)(1).

[21] Prop. Regs. §1.482-7(j)(1)(ii).

[22] Prop. Regs. §1.482-7(j)(1)(vii).

[23] Prop. Regs. §1.482-7(d)(1).

[24] Prop. Regs. §1.482-7(d)(2).

[25] Prop. Regs. §1.482-7(d)(4).

[26] Prop. Regs. §1.482-7(e)(1).

[27] Prop. Regs. §1.482-7(b)(2)(i).



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make an equalizing CST payment to the other participant. For example, if C and D had RAB shares of 60% and 40% respectively and in the first year of the CSA the IDA incurred total IDCs of $3 million, of which $2 million was initially funded by C, and of which $1 million was initially funded by D, there would be a CST in which D paid $200,000 to C. As a result of the CST payment, each participant would bear the portion of total IDCs in accordance with its respective RAB share.[28] CST payments could not be in stock of the payor.

*PCT*. A preliminary or contemporaneous transaction, or PCT, would be a controlled transaction through which participants compensate one another for their external contributions to the CSA.[29] A participant that made an external contribution would be referred to as the *PCT Payee* with respect to that contribution, and each of the remaining CSA participants would be a *PCT Payor*. An external contribution would represent the rights that a participant made available to a CSA ''in any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles and that a PCT Payee has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA.'' [30] Rights in depreciable tangible property or land or in other resources acquired by IDCs would not be external contributions. Examples of external contributions are in-process technology, fully developed first generation technology, and an in-place experienced research team. If a participant contributed rights to resources or capabilities that it acquired in an uncontrolled transaction after formation of the CSA, and it was reasonably anticipated at the time of the acquisition that those rights would contribute to developing cost shared intangibles, the external contribution would be referred to as a post formation acquisition (*PFA*).[31] The resources or capabilities underlying a PFA may be acquired directly or they may be acquired indirectly through acquisition of an entity.

*PCT Payments*. The term PCT Payments would replace the term ''buy-ins'' that is used under the existing regulations, and would refer to the arm's length amounts paid by the PCT Payors to the PCT Payee with respect to a PCT. Once a PCT were valued under one of the acceptable methods provided for in the proposed regulations, PCT Payments would be computed so that each participant bore the portion of total PCT value equal to its RAB Share. PCT Payments could not be in stock of the PCT Payor. PCT Payments for PFAs would have to be in the same form as the uncontrolled transaction in which the PFA was acquired.[32] For example, if P and S executed a CSA in Year 1 and in Year 3 P acquired from an uncontrolled party for a lump sum payment technology intangibles that it reasonably anticipated would contribute to the CSA, the external contribution would be a PFA by P. S would have to enter into a PCT under which S would make a PCT Payment to P in a form that mirrored the lump sum form of payment used by P to acquire the technology.[33] Payments for external contributions that were not PFAs could be in the form of a lump sum, a fixed amount payable in installments with interest, a contingent amount based on exploitation of the cost shared intangibles by the PCT Payor, or a combination of fixed and contingent amounts.[34] The form of payment for a PCT would have to be specified no later than the date of the PCT.

*RT*. A reference transaction, or RT, would be a transaction that provided the exclusive and perpetual benefit of all rights (*RT Rights*) in a resource or capability that was brought to a CSA as an external contribution.[35] RT Rights would not include the rights to exploit an intangible without further development (the make-or-sell rights).[36] For example, assume that P and S formed a CSA to develop future generations of ABC, a software program previously developed by P; and that the source code of ABC would serve as the platform for the future generations. Assume further that P licensed to S the right to make and sell copies of existing ABC. The rights to use the ABC source code as a development platform would be RT Rights, but S's rights to sell existing ABC would not be.[37]

According to the preamble to the proposed regulations, the concept of the RT was introduced ''in order to ensure that compensation for external contributions to the CSA reflects the full economic value of resources or capabilities that a participant brings to the CSA.'' [38] Continuing with the above example, the ABC source code would be an external contribution of P, and S would be required to compensate P pursuant to a PCT. The PCT Payment would have to reflect the full economic value of the ABC source code as a development platform. The license of the currently exploitable ABC rights would not be an external con-

[28] Prop. Regs. §1.482-7(b)(2)(ii).

[29] Prop. Regs. §1.482-7(b)(3)(i).

[30] Prop Regs. §1.482-7(b)(3)(ii).

[31] Prop. Regs. §1.482-7(b)(3)(v).

[32] Prop. Regs. §1.482-7(b)(3)(vi)(B).

[33] Prop. Regs. §1.482-7(b)(3)(viii) *Ex. 3*. A tax-free acquisition is considered a lump sum payment for this purpose. Regs. §1.482-7(b)(3)(viii) *Ex. 4*.

[34] Prop. Regs. §1.482-7(b)(3)(vi)(A).

[35] Prop. Regs. §1.482-7(b)(3)(iv).

[36] Prop. Regs. §1.482-7(c)(1).

[37] Prop. Regs. §1.482-7(c)(2) *Ex. 1*.

[38] REG-144615-02, 70 Fed. Reg. 51119, under ''B.2.b. Constituent Elements of a CSA.''



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tribution, and separate arm's length compensation would have to be paid by S to P for the license with respect to such rights. The most reliable method for determining both the PCT Payment for the platform rights (external contribution) and the arm's length charge for the license (make-or-sell rights) might be one that values the two transactions in the aggregate, but a charge based on an uncontrolled license to make and sell copies of existing ABC would not be adequate to capture that aggregate value.[39] The uncontrolled license could be indicative of an arm's length charge for the make-or-sell license between P and S, but it would not account for the arm's length value of the platform rights.

*PRRR*. The Periodic Return Ratio Range, or PRRR, would be the range that a PCT Payor's return ratio (profit over investment) with respect to a particular PCT would have to be within for the PCT Payments to be immune from periodic adjustment by the IRS.[40] Normally the PRRR would be from 0.5 to 2.0. However, if the participants did not substantially comply with the documentation requirements in the proposed rules, the PRRR would be reduced to 0.67 to 1.5.[41]

*AERR*. The Actually Experienced Return Ratio, or AERR, would be the ratio of the Present Value of Total Profits (*PVTP*) realized by a PCT Payor to its Present Value of Investment (*PVI*).[42] The AERR would be calculated for the period from the date that IDCs were first incurred (*CSA Start Date*) through the end of the *Adjustment Year*, which would be the open taxable year as of which the need for periodic adjustments is being assessed. If the AERR for the Adjustment Year fell outside the PRRR, there would be a *Periodic Trigger*.[43] Upon a Periodic Trigger, the IRS would determine whether to make periodic adjustments taking into consideration all information known as of the date of the determination (the *Determination Date*).[44]

PVTP and PVI would be computed using the Applicable Discount Rate (*ADR*) taking into consideration all information known as of the Determination Date.[45] In general, the ADR would be the discount rate that reliably reflected the risks that the CSA would not lead to development of a successful intangible based on all the information potentially available at the time the present value calculation was performed.[46] PVTP would be the present value, as of the CSA Start Date, of the PCT Payor's actually experienced territorial operating profits from the CSA Start Date through the Adjustment Year.[47] Similarly, PVI would be the present value as of the CSA Start Date of the PCT Payor's total investment in the CSA Activity from the CSA Start Date through the end of the Adjustment Year. Investment in the CSA Activity would be the sum of the PCT Payor's cost contributions and its PCT Payments.[48]

## COST SHARING UNDER THE PROPOSED REGULATIONS

At formation of a CSA the controlled participants enter into a contract that, inter alia, (1) describes the scope of the IDA to be undertaken and the cost shared intangibles to be developed, (2) specifies the functions to be performed and risks to be assumed by each participant, (3) divides interests in cost shared intangibles on a territorial basis, (4) provides a method for calculating RAB shares, (5) lists the categories of IDCs to be shared, (6) requires the participants to enter into CSTs covering IDCs and PCTs covering external contributions, and (7) specifies the term of the CSA.[49] Each party agrees to contribute to the ongoing costs of the IDA by incurring costs directly, making payments to other participants, or a combination of direct costs and payments. Except in the case of a "green field" development activity, i.e., a start-up without external contributions from any participant, usually at least one participant would agree to make rights in resources or capabilities developed outside the CSA available to the IDA.[50]

During the operation of the IDA, external contributions are used and IDCs are incurred to develop cost shared intangibles. The participants enter into CSTs, as required, to bring their IDC shares into synch with their RAB shares, with those initially bearing less

[39] Prop. Regs. §1.482-7(c)(2) *Ex. 2*.

[40] Prop. Regs. §1.482-7(i)(6)(i).

[41] Prop. Regs. §1.482-7(i)(6)(ii).

[42] Prop. Regs. §1.482-7(i)(6)(iii)(A).

[43] Prop. Regs. §1.482-7(i)(6)(i). An AERR below the PRRR would not cause a Periodic Trigger for any year in the five-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles. Prop. Regs. §1.482-7(i)(6)(vi)(F).

[44] Prop. Regs. §1.482-7(i)(6)(i).

[45] Prop. Regs. §1.482-7(i)(6)(iii)(A).

[46] Prop. Regs. §§1.482-7(i)(6)(iv)(A) and (g)(2)(vi). The proposed rules state that discount rates normally are most reliability determined based on market information, with a preference for weighted average cost of capital (*WACC*) for the relevant activities and transactions as derived using the capital asset pricing model. *Id.* If the PCT Payor is publicly traded, the ADR is the PCT Payor's WACC as of the date of the Trigger PCT, unless the IRS determines or the participants establish that a different discount rate better reflects the risks. Prop. Regs. §1.482-7(i)(6)(iv)(B).

[47] Prop. Regs. §1.482-7(i)(6)(iii)(B).

[48] Prop. Regs. §1.482-7(i)(6)(iii)(C).

[49] Prop. Regs. §1.482-7(k)(ii).

[50] REG-144615-02, 70 Fed. Reg. 51119, under "B.2.a. CSA Transactions in General."



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than their RAB share making cost contributions to those who have initially borne more than their RAB shares. External contributions would be valued based on their RTs, and the participants enter into PCTs under which a contributor (PCT Payee) would receive PCT Payments from the other participants so that each participant bore a share of the total value of the external contribution in proportion to its RAB share.

The controlled participants would have to continuously monitor results under the CSA, timely updating and maintaining documentation sufficient to, inter alia, (1) identify cost shared intangibles, (2) describe the functions performed and risks borne by each participant, (3) establish each participant's IDCs for each taxable year of the CSA, (4) describe the method for calculating RAB shares for each taxable year, (5) describe all external contributions, and (6) describe the RT for each PCT, the form of payment under each PCT, and the method used to determine PCT Payments.[51] The IRS would use this documentation in audits of the CSA to determine whether the CSTs and PCTs produced arm's length results. If, based on actual benefits, the RAB shares used to determine IDC shares proved to be unreliable, the IRS could use adjusted benefit shares, which take into account actual benefits to date, as the most reliable measure of RAB shares and make CST allocations to bring the IDC shares in line with the adjusted benefit shares.[52] If CST allocations were made on account of unreliable benefit projections, correlative PCT allocations would be made to any fixed PCT Payments that were based on RAB shares.[53] CST allocations could also be made on account of redeterminations of IDCs, reallocations of costs between the IDA and other business activities, improvements in the basis for measuring benefits, or allocations of unallocated interests in cost shared intangibles.[54] With respect to PCT Payments, if, based on actual benefits, the AERR were outside the PRRR, periodic adjustments could be made on a going-forward basis. In addition, the IRS could make PCT allocations to the extent that the PCT did not produce an arm's length result.[55]

## Investor Model

As noted above, the main purpose for proposing new regulations is to provide guidance on valuing external contributions. Underlying that guidance is the investor model, which, according to the preamble, is based on two key principles.[56] First, *ex ante*, a participant in a CSA would expect to earn a rate of return on its aggregate investment in an IDA equal to the appropriate discount rate for the CSA (e.g., the participant's hurdle rate).[57] Applying this principle, a rate of return for a participant that exceeds the appropriate discount rate would, assuming IDC and profit projections are reliable, tend to indicate that the participant's investment in external contributions was undervalued, leading to the conclusion that the method used to value PCTs was unreliable. The second principle is that, *ex ante,* the return would have to be measured over the entire period during which intangibles would be developed and exploited. If the cost shared intangibles are reasonably anticipated to serve as a platform for developing other intangibles, this period includes the period during which those latter, indirectly benefited, intangibles would be developed and exploited.[58]

In applying the investor model to value external contributions, the proposed rules would add a requirement that an arm's length charge for a PCT "take into account the general principle that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of a transaction, and only entered into a particular transaction, if no alternative is preferred."[59] To determine if this "realistic alternative" principle was met, the net present value to a participant from entering into the CSA as of the date of the PCT would be compared to the net present value of the realistic alternative most favorable to that participant. For example, if P owned existing patents and trade secrets that would contribute to development of a product, would conduct all the R&D on the product, and entered into a CSA with its subsidiary S under which P would manufacture and sell the product in country X and S would manufacture and sell the product in the rest of the world, it could instead self develop the product and license the product outside country X. Under the realistic alternative principle, the net present value of P's return under the CSA would have

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[51] Prop. Regs. §1.482-7(k)(2).

[52] Prop. Regs. §1.482-7(i)(2)(ii)(A). As in the existing regulations, projections of benefit shares as applied in a given taxable year would not be considered unreliable if, for all participants, adjusted benefit shares did not diverge from projected benefit shares by more than 20%.

[53] Prop. Regs. §1.482-7(i)(2)(ii)(C).

[54] Prop. Regs. §1.482-7(i)(2)(i).

[55] Prop. Regs. §1.482-7(i)(3).

[56] REG-144615-02, 70 Fed. Reg. 51124-25, under "C.2.h. Valuation Consistent with the Investor Model."

[57] *See* Prop. Regs. §1.482-7(g)(2)(viii) ("valuation of the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in developing cost shared intangibles pursuant to the CSA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate").

[58] *Id.*

[59] Prop. Regs. §1.482-7(g)(2)(iv)(A).




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to be no less than the net present value of its return under the licensing alternative.[60]

Conceptually, it is hard to argue with the investor model and the realistic alternative principle: a company usually doesn't make an investment unless it expects the investment to pay off, and as between two alternatives generally would prefer the one with the greater expected return. Nevertheless, the investor model has come under considerable criticism.[61] One has to assume, however, that the investor model is likely to survive in final regulations, and CSA participants would have to evaluate realistic alternatives and demonstrate rates of return equal to the appropriate discount rate for the CSA. Substantial disagreements over the ''appropriate discount rate'' can be expected, as taxpayers argue for high rates to reflect the risk inherent in developing intangibles and the IRS argues for the more general WACC.

## Valuing External Contributions

The proposed rules identify six methods that could be used to value PCTs: five specified methods (comparable uncontrolled transaction (CUT), income, acquisition price, market capitalization, and RPSM) plus unspecified methods. The income, acquisition price, and market capitalization methods are new and would be specific to cost sharing, and the proposed rules would substantially modify RPSM for use in cost sharing. The best method rule of Regs. §1.482-1 would apply to the choice of method.[62] It appears from the proposed rules, though, that in practice the ''best method'' would boil down to the income method for CSAs in which only one participant makes external contributions and to the modified RPSM for CSAs in which more than one participant makes external contributions. That is because (1) the market capitalization method ordinarily would apply only where there has been an uncontrolled acquisition of an organization (target) and substantially all the target's nonroutine contributions [63] to the PCT Payee's business are covered by a PCT,[64] (2) the market application method ordinarily would be used only where substantially all the PCT Payee's nonroutine contributions to its business were covered by a PCT,[65] (3) application of the CUT method would be limited by the difficulty in identifying comparable uncontrolled transactions, and (4) the modified RPSM could not be used if only one participant made significant nonroutine contributions to the CSA.[66]

### CUT Method [67]

Under the proposed comparable uncontrolled transaction, or CUT, PCT valuation method, the CUT method of Regs. §1.482-4(c) (in the case of a PCT involving intangible property) or the arm's length charge described in Regs. §1.482-2(b)(3) based on a comparable uncontrolled transaction (in the case of a PCT involving the provision of services, i.e., workforce in place) would be used to value a PCT. Proper application of the method should provide the total arm's length value for the external contribution that is the subject of the PCT. PCT Payments would then be determined by multiplying each PCT Payor's RAB share by that total value.

### Income Method [68]

The proposed income method for valuing PCTs would value a PCT by reference to a participant's realistic alternatives to entering into the CSA. The arm's length charge for a PCT Payment under this method would be the amount the present value of which, as of the date of the PCT, equaled the present value of the controlled participant's best realistic alternative to entering into the CSA. For example, assume that USP developed a fabric, USP and FSub entered into a CSA under which FSub would own the rights to exploit future versions of the fabric outside the United States, the next best realistic alternative for USP would be to self-develop and license future versions of the fabric outside the United States, and the present value of the licensing alternative to USP was $100 million. The rights to further develop the existing fabric (the RT Rights) would be an external contribution and, under the income method, an arms' length contingent PCT Payment from FSub would be a sales-based royalty at a rate such that the present value to USP from entering into the CSA would equal $100 million.[69]

The income method typically would be limited to cases in which only one participant made nonroutine contributions. The proposed rules would allow the method to be applied using either a CUT or the comparable profits method (CPM) of Regs. §1.482-5. The CUT application would take the PCT Payee's perspec-

[60] Prop. Regs. §1.482-7(g)(2)(iv)(B) *Ex. 1*.

[61] *See* Moses, ''Musher, Breen Address Cost Sharing Rules,'' BNA *Daily Tax Rep.* G-13 (10/17/05); items cited at fn. 8.

[62] Prop. Regs. §1.482-7(a).

[63] ''Routine contributions'' are contributions similar to those made by uncontrolled taxpayers involved in similar activities for which a market return can be identified. Prop. Regs. §1.482-7(g)(iii)(B). Nonroutine contributions include external contributions and other nonroutine contributions to the relevant business activity in the relevant territory. Prop. Regs. §1.482-7(g)(iii)(C)(1).

[64] Prop. Regs. §1.482-7(g)(5)(i).

[65] Prop. Regs. §1.482-7(g)(6)(i).

[66] Prop. Regs. §1.482-7(g)(7)(i).

[67] Prop. Regs. §1.482-7(g)(3).

[68] Prop. Regs. §1.482-7(g)(4).

[69] Prop. Regs. §1.482-7(g)(4)(ii)(B).



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tive: it would assume that the best realistic alternative would be for the PCT Payee to self-develop and license the cost shared intangibles, and derive PCT Payments that yield value to the PCT Payee under the CSA equivalent to that from the licensing alternative. The CPM application would be from the PCT Payor's perspective; it would derive PCT Payments with a present value equal to the present value of the PCT Payor's expected profit from exploiting the cost shared intangibles. Under the CPM application, PCT Payors that did not make external contributions would be limited to an appropriate risk-adjusted return on their investment in the CSA.[70]

Under both applications, an arm's length PCT Payment would be an *applicable rate* on sales from exploiting the cost shared intangibles. The applicable rate would be the *alternative rate* less the *cost contribution adjustment*. For the CUT application, the alternative rate would be what the PCT Payee would charge an uncontrolled licensee had it self-developed and licensed the intangibles; for the CPM application it would be the ratio of the present value of the PCT Payor's anticipated territorial operating profit, reduced by a market return for routine contributions, to the present value of its anticipated sales from exploiting the cost shared intangibles. In both applications, the cost contribution adjustment would be the present value of the PCT Payor's anticipated cost contributions over the present value of its anticipated sales from exploiting the cost shared intangibles.

**Acquisition Price Method** [71]

Where a participant has acquired an organization or part of an organization (target) in a stock or asset acquisition and the resources and capabilities of target would be an external contribution to a CSA, PCT Payments could be determined by reference to target's *adjusted acquisition price*. Adjusted acquisition price would be the acquisition price increased by target's liabilities on the date of acquisition and decreased by target's tangible property plus any other resources or capabilities that were not covered by a PCT.

**Market Capitalization Method** [72]

Under the proposed market capitalization method for valuing PCTs, the arm's length charge for a PCT covering resources and capabilities of a PCT Payee would be the *adjusted average market capitalization* of the PCT Payee. *Average market capitalization* would be the average daily market capitalization for the period from 60 days prior to the date of the PCT through the date of the PCT. Adjusted average market capitalization would then be the average market capitalization increased by the PCT's liabilities on the PCT date and decreased by the value as of that date of the PCT Payee's tangible property and any resources and capabilities that were not covered by the PCT. The method could be used only for a PCT Payee that was publicly traded.

**RPSM** [73]

The modified RPSM that would be used to value PCTs would be a three-step process for dividing a participant's operating profit or loss from exploiting cost shared intangibles in its territory (*territorial operating profit or loss*) before any expense or amortization of IDCs, routine external contributions, and nonroutine contributions. This method would be applied as follows:

- *Step 1* — each participant would be allocated an amount of income to provide it a market return for its routine contributions other than cost contributions. That amount would be subtracted from the participant's territorial operating profit or loss.
- *Step 2* — each participant would be allocated a portion of its residual territorial operating profit or loss remaining after Step 1 to account for its cost contributions. The allocable portion would be calculated by multiplying the residual by a fraction, the numerator of which would be the present value of the participant's total anticipated cost contributions and the denominator of which would be the present value of the participant's total anticipated territorial operating profit, reduced by the allocation in Step 1. This step would be equivalent to the cost contribution adjustment under the income method, and provides the participants a financing return for their investment in developing intangibles.
- *Step 3* — In this step any residual territorial operating profit or loss would be divided among the participants based on the relative value of their nonroutine contributions. The portion of a participant's territorial operating profit or loss allocated to other participants in this step represents the amount of the PCT Payments due from it to other participants for their external contributions.

**Unspecified Methods** [74]

A method other than the specified methods could be used to value PCTs if none of the specified methods

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[70] Prop. Regs. §1.482-7(g)(4)(iv)(A).

[71] Prop. Regs. §1.482-7(g)(5).

[72] Prop. Regs. §1.482-7(g)(6).

[73] Prop. Regs. §1.482-7(g)(7).

[74] Prop. Regs. §1.482-7(g)(8).




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were preferable to it, and the method adequately took into account the realistic alternative principle. The RPSM of Regs. §1.482-6(c)(3), that is, RPSM without the modifications in the proposed regulations, would be an unspecified method.

### Periodic Adjustments

The proposed regulations incorporate a new periodic adjustment [75] provision that would permit the IRS "to impute an arm's length arrangement that appropriately reflects the profit potential of transferred intangibles where the IRS believes that the taxpayers' arrangement does not appropriately reflect such profit potential." [76] This provision would enable the IRS to address concerns raised by *ex post* outcomes that are significantly different from *ex ante* expectations, in effect substituting a mechanical rule for an evaluation of whether the *ex ante* expectations were realistic. The IRS feels that such a rule is necessary to address the problem of information asymmetry [77] and an absence of good comparables. Taxpayers would not be permitted to make periodic adjustments because the IRS believes "it is exceedingly unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result," and because taxpayers are in the best position to evaluate the risks and profit potential and can adopt an arrangement that appropriately reflects those risks and benefits.[78]

As discussed previously, periodic adjustments under the proposed regulations would key off a Periodic Trigger, i.e., an AERR that was outside the PRRR. If there were a Periodic Trigger and no exception to periodic adjustment applied, adjustments would be made to all PCT Payments between all PCT Payors and all PCT Payees for the Adjustment Year and all subsequent years of the CSA Activity. These adjustments would be based on the modified RPSM with certain modifications to the calculation of the cost contribution share of residual profits.[79] If the AERR were less than the PRRR, the present value calculations used to derive the fraction for determining the cost contribution share would be as of the CSA Start Date, with a discount rate that took into consideration any relevant data known as of the Determination Date, substituting actual results up through the Determination Date.[80] If the AERR were greater than the PRRR, the present value calculations would be as of the first day of the Adjustment Year and the summations to determine the fraction would start on the first day of the Adjustment Year.[81]

## EFFECTIVE DATE

The proposed rules would have an effective date of the date they are published as final regulations. A QCSA existing on the effective date would be grandfathered and subject to the existing regulations for CSTs and PCTs occurring prior to the effective date. However, grandfather status would be terminated under certain events, and even grandfathered CSAs would be subject to the new rules for PCTs if there were a Periodic Trigger on account of a subsequent PCT occurring on or after the effective date.[82]

## CONCLUSION

The proposed cost sharing regulations represent an attempt by the IRS to simplify its burden in determining whether CSAs produce arm's length results, particularly with respect to external contributions, as they would be broadly defined in those regulations. However, in trying to guard against bargain transfers of existing intangibles, the proposal would place huge upfront burdens on participants in CSAs and, at least in the eyes of many practitioners, would unduly limit the potential upside from entering into a CSA. If the proposed rules become final in their present form, and the comments made by practitioners to-date concerning the reduced attraction that CSAs might have under

[75] Under the existing regulations the periodic adjustment provision is found in Regs. §1.482-4(f)(2), which in general allows adjustments to insure that consideration charged in the transfer of an intangible is commensurate with the income attributable to the intangible.

[76] REG-1444615-02, 70 Fed. Reg. 51129, under "E.3. Periodic adjustments."

[77] I.e., the taxpayer is in the best position to know its business and the potential return from intangibles development, while the IRS has little ability to determine whether high profit realized by an investor in intangibles development reflects the success of a risky investment or below-market terms for the investment.

[78] REG-1444615-02, 70 Fed. Reg. 51129, under "E.3. Periodic adjustments."

[79] Prop. Regs. §1.482-7(i)(6)(v). Exceptions to periodic adjustments include evidence of results from transactions involving the same external contributions as in the PCT, evidence that the results are due to extraordinary events, demonstration that the Periodic Trigger would not have occurred with appropriate adjustments to the calculation of the PCT Payor's AERR, and if the AERR is within the PRRR for each year of the 10-year period beginning with the first year in which there is substantial exploitation of cost shared intangibles. Prop. Regs. §1.482-7(i)(6)(vi). The 10-year AERR exception replaces the general five-year-plus-or-minus-20% rule for transfers of intangibles. *See* Regs. §1.482-4(f)(2)(ii)(E) (no periodic adjustments for subsequent years if, for each year of the five year period beginning with the first year in which substantial periodic consideration was required, actual profits or cost savings are no less than 80% nor more than 120% of prospective profits or cost savings).

[80] Prop. Regs. §1.482-7(i)(6)(v)(A).

[81] Prop. Regs. §1.482-7(i)(6)(v)(B).

[82] Prop. Regs. §1.482-7(m)(3)(i).



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those rules prove true, the IRS's burden with respect to cost sharing arrangements themselves may, indeed, be extremely simple.



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