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Cost-Sharing Arrangements Come of Age

by Patricia Gimbel Lewis
and Neal M. Kochman
Caplin & Drysdale, Chartered

INTRODUCTION

An often vexing tax issue for multinational companies is how to handle cross-border transfers of intangibles. The common practice of developing intangibles in one location and licensing them to affiliates in other locations is laced with uncertainty, particularly following the introduction of the commensurate-with-income standard in 1986.1 One way to avoid this uncertainty is to have all affiliates that plan to exploit the intangible enter into a cost-sharing arrangement (CSA) by which each affiliate shares in the cost of developing intangibles and thereby owns rights in the intangibles. If the arrangement is a “qualified” CSA, no intercompany royalties are required, and the Internal Revenue Service (IRS) will generally not make any §482 adjustments except to the extent necessary to make each affiliate's share of the costs equal to its share of the expected benefits from exploiting the intangibles. Qualified CSAs are a creature of detailed new regulations under §482 promulgated in December 1995, effective January 1, 1996.2 The prior regulations (issued in 1968) dealt succinctly and more generally with “bona fide” CSAs.3

Growth in the use of CSAs has been driven by the increased importance, cost, and potential benefit from technology, particularly where U.S.-based multinationals conduct research and development in the United States but manufacture abroad for labor cost, tax, or other locational reasons. In these circumstances CSAs tend to shift income abroad, and increased IRS scrutiny can be expected. The recent appearance of a number of IRS Field Service Advice Memorandums (FSAs) addressing important cost-sharing questions confirms this.4 Three issues getting particular attention are (1) the treatment of compensatory stock options as a cost to be shared, (2) failure to attach a specified statement to a taxpayer's U.S. tax return as a bar to “qualified”treatment of a CSA, and (3) “buy-in” requirements for intangibles developed prior to the effective date of the CSA.

This article analyzes the rather controversial developments in these three areas, along with some additional points. The stock option issue has sparked particular interest because of the increasing use of stock-based compensation in today's “high tech” environment.

WHAT IS A QUALIFIED COST-SHARING ARRANGEMENT?

Regs. §1.482-7 provides that a qualified CSA is a written agreement that:

1. Includes two or more participants;

2. Provides a method for calculating each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect the participant's share of anticipated benefits;

3. Provides for adjustments to shares of intangible development costs to account for changes in economic conditions, business operations and practices, and ongoing development of intangibles under the agreement; and

4. Is recorded in a document contemporaneously with formation of the arrangement that includes:

a. A list of the participants and any other members of the controlled group that will benefit from the use of the intangibles developed under the arrangement;

b. The method for calculating participants' shares of intangible development costs and for adjusting such shares;

c. A description of the scope of the research and development (R&D) to be undertaken, including the intangible or class of intangibles to be developed;

d. A description of each participant's interest in any covered intangible;

e. The duration of the arrangement; and

f. The conditions under which the arrangement may be modified or terminated and the consequences thereof.

The regulations contain detailed provisions regarding definitional matters, rules regarding cost allocations, buy-ins, and character of payments, and accounting and administrative requirements.

Sharing the Cost of Compensatory Stock Options —FSA 200003010

The primary issue in FSA 200003010 5was whether the value of compensatory stock options is a cost that must be shared among affiliates under a CSA. The National Office concluded that sharing was required under the 1968 regulations applicable to the years in issue. Although the 1995 cost-sharing regulations were not directly implicated, there was no hint that a different conclusion would be reached thereunder. The identical issue is the subject of a pending Tax Court case, *Seagate Technology Inc. v. Comr*.6

The FSA has triggered strong adverse reactions from some taxpayers and practitioners. Concerns have been expressed about inconsistent treatment of stock option costs by foreign tax authorities, departure from the application of arm's-length principles, and the proper method for valuing options. These concerns no doubt reflect large amounts at stake: allocation of compensatory stock option costs to foreign affiliates will reduce the amount of their net income and concomitantly increase taxable U.S. income.7 Because stock options are primarily a U.S. phenomenon at this time, including the value of stock options in the cost-sharing pool will reduce deductions for U.S. tax purposes, to the detriment of U.S. multinationals and the benefit of the U.S. treasury.8

The taxpayer in FSA 200003010 was a U.S. corporation that designed, manufactured, and marketed product A. In years 1 and 2 it entered into R&D cost-sharing agreements with two of its controlled foreign corporations (CFCs). Under the agreements, the taxpayer's share of R&D costs was 5%, and the combined share of its CFCs was 95%. In years 1 and 2, the taxpayer claimed deductions under §162 for options exercised by employees whose activities were covered by the cost-sharing agreement. The deductions were attributable to both the exercise of non-statutory stock options under §83(h) and disqualifying dispositions of statutory stock options under §421(b).

The years in issue were subject to the 1968 regulations, which provided that the IRS would make no allocation with respect to intangibles acquired pursuant to a bona fide CSA "except as may be appropriate to reflect each participant's arm's-length sharing of the costs and risks of developing the property." 9An arm's-length share of the costs and risks was defined as involving "terms and conditions ... comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement." 10

The IRS's Rationale

The IRS started with the premise that any cost that would be shared by similarly situated unrelated parties must be shared under a CSA. Then, apparently because "cost" was not defined in the 1968 cost-sharing regulations, the IRS looked to the definition of cost to be taken into account under the §482 regulations that pertain to intercompany services. Those regulations provide that, except in the case of services that are an integral part of the business activity of either the service provider or service recipient, “the arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge.” 11 Where the arm's-length charge is determined by reference to costs or deductions incurred, “it is necessary to take into account on some reasonable basis *all the costs* or deductions which are directly or indirectly related to the service performed”with direct costs including “costs or deductions for compensation, bonuses, and travel expenses attributable to employees directly engaged in performing such services.” 12

Having concluded, based on the intercompany services regulations, that compensation is a cost that must be shared under a CSA, the IRS cited *Comr. v. LoBue* 13 for the proposition that an award of stock options to an employee represents compensation when the employee exercises the options. The IRS also cited *Apple Computer* 14 and *Sun Microsystems* 15 for their holdings that the spread upon the exercise of non-statutory stock options and upon the disqualifying disposition of incentive stock options, respectively, represented wages for purposes of the former §44F or §41 research credit. (Wages for qualified research are included in the expense base upon which the credit is based.) From this, the IRS construed that the value of stock options is compensation that must be included in the costs to be shared under a CSA.

Turning to valuation of the stock options for cost-sharing purposes, the IRS did not specify a particular method but instead concluded that “any reasonable method and timing of valuation may be utilized, so long as it is applied consistently.” In the IRS's view, at arm's length there are at least six points in time when parties could choose to value stock options: (1) when the option plan is adopted; (2) when the options are granted; (3) when employees have performed any conditions precedent to option exercise; (4) when employees may first exercise the options; (5) when the options are exercised; (6) and when the acquired stock is disposed of. Similarly, the IRS stated that the parties could use various methods for valuing the options, including an option pricing model such as Black-Scholes or the spread upon exercise or disqualifying disposition.16

The IRS recognized that there is “no perfect way to match services performed in a given year with the stock option costs related to those services in that year.” The IRS apparently is not bothered by this mismatch, because it believes “consistent application of a selected method over time should tend to mitigate any mismatch.” In support of this view, the IRS cited *Apple Computer* for its holding, albeit counter to its own position in that case, that stock options yield wages for research credit purposes even though some of the services may have been performed in tax years other than the year in which the options are exercised.17

The Taxpayer's Arguments

The primary position advanced by the taxpayer in FSA 200003010 was that stock options are “cost-less” and, therefore, not properly included in costs to be shared. The taxpayer asserted that, during the years at issue, APB 25, the applicable financial accounting guidance, provided that cost was not recognized when options were issued (or at any later date) if the option price was the same as the price of the underlying stock on the date of issue.18The IRS's response was that the Financial Accounting Standards Board had become concerned with this method of accounting for option costs and in FAS 123 adopted a “choice” approach effective December 15, 1995.19 Under that approach, a company may either account for option costs under a fair value-based method or continue to use the APB 25 “intrinsic value-based” method but provide footnotes disclosing net income and earnings under the fair value method and the difference between the compensation costs recognized under the two methods. FAS 123 encourages use of the fair value method and does not allow a change to the APB 25 method once the fair value method is chosen. The IRS further noted that the Tax Court had considered and rejected similar accounting-based arguments in *Apple Computer* on the basis that financial accounting rules were not the pertinent determinant for the tax matter at issue. Ironically, the accounting-based arguments in *Apple Computer* were made by the IRS.

The taxpayer next argued that the cost of stock options should not be shared because the costs associated with their exercise do not represent a corporate-level cost but rather represent a “shareholder-level”cost to the extent that they dilute earnings per share. The IRS's response was that options are an opportunity cost to a company. The IRS contended that a company would not expend R&D labor, compensated in stock options, on a project from which it would only receive part of the benefits rather than on another project from which it would receive 100% of the benefits. The IRS also cited *Divine v. Comr.*20 for the proposition that when a corporation issues options that may allow employees to purchase stock in the corporation at a bargain price at some point in the future, the corporation foregoes the opportunity to sell that stock for market price.

Finally, the taxpayer asserted that arm's length CSAs between unrelated parties would not incorporate stock option compensation costs. It argued that it could not identify any actual arm's length arrangements incorporating such costs and that parties at arm's length would not share such costs because of their volatility.

The IRS's response to the first point was that actual comparable third-party transactions need not exist to apply the arm's-length standard. As to the second point, the IRS responded that, even though the value of the options may be volatile, the cost associated with the options is still one that the corporation issuing the options will incur, and it will recover such cost in some reasonable manner when pricing its services at arm's length. The IRS added that there are methods for pricing stock options that take into consideration future volatility.

Commentators' Observations

Commentators have both attacked the FSA as incorrect and pointed out problems with adhering to the IRS's position in practice. The primary arguments against the correctness of the FSA include those of the taxpayer involved — the value of stock options is not taken into account in comparable arm's length transactions and is not a cost required to be shared under the cost-sharing regulations — and criticism of the authorities cited by the IRS.21 Potential practical problems noted include (1) competent authority conflicts because foreign countries may either price options differently or not value options at all and (2) the fairness and consistency of the methods allowed by the IRS for valuing options.22

What Does the Future Hold?

CSAs enable multinationals to operate worldwide without nettlesome royalty determinations. According to one commentator, high technology, manufacturing, retailing, and now e-commerce companies also see these arrangements as a vehicle to attribute significant portions of their worldwide profits to low-tax jurisdictions while avoiding application of the “commensurate with income” standard.23 The latter may not be entirely true if the reasonably-anticipated-benefit requirement is properly applied, but in any case the practical consequences of a CSA for high-value intangibles may still be beneficial.

Understandably, the treatment of stock options in CSAs has been identified by the IRS National Office as one of 10 emerging high-technology issues.24 According to an IRS national industry specialist, the issue has come up in several audits as well as advance pricing agreements and has caught the attention of the National Office because, “with the stock market so high, we're seeing astronomically high deductions for this compensation. It's causing distortion on the return” because U.S. firms claim 100% of a deduction “that primarily benefits the foreign corporation.” 25 The distortion referred to is that all of the option-related deductions are on the U.S. tax return, but only a portion, e.g., 5% in the FSA case, of future income from the intangible is included for U.S. tax purposes.

Despite the recent retreat in the price of technology stocks, many companies are realizing huge deductions as employees exercise nonstatutory stock options or make disqualifying dispositions of stock acquired through the exercise of statutory stock options. Is the IRS's position an overreaching application of the cost-sharing rules in an attempt to reverse some of these deductions, or is it a principled attempt to properly apply the regulations? What are the implications of the current controversy under the new cost-sharing regulations?

Comparative Merits of the Arguments

With some trepidation (not being deeply or directly involved in the instant controversy), the authors offer several observations on the merits of the arguments in FSA 200003010.

Under the language of the 1968 regulations at issue in the FSA, the key determinant should be the arm's length standard, *i.e.* , whether the terms of a similar CSA between unrelated parties would have taken stock option costs into account. The IRS asserts that arm's-length parties would, as a matter of logic, have taken such costs into account but provides no specific proof thereof.26 The taxpayer in the FSA, as well as in *Seagate* , asserts to the contrary, with the taxpayer in *Seagate* noting that in the pertinent years 2,000 firms annually entered into R&D-type service contracts with the U. S. government despite the fact that the Federal Acquisition Regulations precluded payment for compensatory stock options.27 The authors have no independent evidence on this point but believe that the treatment of stock option costs at arm's length is the critical issue for the *Seagate* court, or any pertinent factfinder, to sort out.

The IRS's reliance on the intercompany services regulations to define sharable costs is questionable. The cited rules deal with non-“integral” services to which a deemed, rather than actual, arm's length standard applies. This criticism would apply regardless of whether the R&D services at issue are integral or nonintegral services under those regulations. In any event, even if “all the costs”has the same meaning in the intercompany services and the cost-sharing regulations, those costs only need be taken into account under the latter regulations if they would be taken into account at arm's length. It is certainly unclear whether unrelated parties would incorporate all costs associated with stock options into a CSA. However, from equitable and policy perspectives, the inclusion of stock option costs in the R&D tax credit base cries out for symmetry, despite commentators' technical distinctions. Having acquiesced in the *Apple Computer* and *Sun Microsystem* decisions, the IRS's pushing for even-handed treatment of stock option deductions for other Code purposes may appeal to the Tax Court.

Compensatory stock options are without question intended as compensation in the lay sense, despite the notion that options are costless to the corporation, representing only “shareholder-level costs.”Nevertheless, potential mismatches between the costs realized from stock options and the services intended to be rewarded, brought about by employees'control over the time of exercise, should not be minimized, particularly when considering how arm's-length parties would act. It is questionable whether parties at arm's-length would agree to compensate each other for costs that may not be realized until some point long after the end of the agreement, if at all. Moreover, although the development of valuable intangibles can enhance a company's stock price, it may be difficult to tie particular events to particular appreciation. An unrelated party might well hesitate to compensate another party for increases in the stock price of that other party when the fruits of the CSA may have little to do with the increase.

Another important consideration is the potential for inconsistency and controversy with other countries over the tax treatment of the foreign cost-sharing participants.28 While cases to date may primarily involve nontreaty partner countries,29that will not continue to be the case. The IRS may want to sound out its key treaty partners as it pursues the FSA position.

Financial accounting standards, while relevant, have generally been held not to be determinative of tax consequences.30 It is also worth noting that the preamble to the 1992 proposed cost-sharing regulations invited comments on whether GAAP, tax accounting principles, or other principles should be used in determining shareable costs. While the preamble to the final 1995 regulations noted that use of financial accounting rules had been suggested, the regulations did not expressly adopt such a standard, except, as noted above, to require material deviations from GAAP to be explained in the required documentation. To the extent taken into account, however, this factor would appear to favor the taxpayer as to any market-priced options, because the "costless"rules of APB 25, not FAS 123, applied to the years at issue in the FSA.

One other issue to ponder is the appropriateness of distinctions between nonqualified options and disqualifying dispositions of incentive stock options, like those involved in the FSA and *Seagate* , and grants of restricted stock. In the FSA, the IRS, although troubled by unbalanced deductions, seized on the term "costs" in the 1968 regulations. In fact, the regulations refer to "costs or deductions,"and it would not seem a big leap to apply the IRS's economic cost argument to restricted stock on which the deduction is deferred until vesting under §83.31

Implications under Current Regulations

The 1995 regulations adopt more detailed and arguably different standards for sharing costs than the 1968 regulations involved in FSA 200003010. The 1995 regulations no longer contain an explicit arm's length standard. Instead, the 1995 regulations substitute the requirement that the parties share the costs of development "in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement." 32

The thrust of the current regulations is thus that each participant pick up a fair share of the costs based on the benefits that it anticipates receiving. All participants must use a consistent basis for projecting benefits, and, if the projections diverge too much from actual benefits, the IRS may substitute actual benefits.33 There is no requirement that similar terms be incorporated in an arm's-length arrangement, and it seems unlikely that they would. The current cost-sharing regulations by their nature are aligned more with the commensurate-with-income standard (designed to simulate arm's-length behavior) than with the straightforward arm's-length approach of the 1968 regulations.

This change in the regulations' focus makes it much more difficult for either the IRS or the taxpayer to argue for the treatment of stock option costs on the basis of unrelated party practices. Instead, the inquiry should more appropriately shift to interpretation of the new regulations'explicit definition of costs to be shared.

Under the 1995 regulations, a participant's intangible development costs mean "all the costs incurred by that participant related to the intangible development area, ..." 34Costs incurred consist of "operating expenses as defined in §1.482-5(d)(3), other than depreciation or amortization expense, plus ... the charge for the use of any tangible property made available to the qualified [CSA]." 35 Under Regs. §1.482-5(d)(3), "Operating expenses includes all expenses not included in cost of goods sold *except for* interest, foreign income taxes ... , domestic income taxes, and any other *expenses not related to the operation of the relevant business activity* ." 36 A financial-accounting argument similar to that made by the FSA taxpayer may be that the value of stock options is not a business activity expense, particularly if the taxpayer chooses to use APB 25 and, thus, never records an expense. The attenuation of the stock option expense from direct costs of the R&D activity — due to timing, triggering, and causation issues, *inter alia* —provides a further argument against cost treatment.37

The 1995 regulations offer several new twists on the accounting issue. The regulations' documentation provisions require the taxpayer to explain any material differences between the accounting method used to determine costs and benefits and GAAP.38 While this provision does not require taxpayers to follow GAAP for CSA purposes, it does give some imprimatur to GAAP accounting. On the other hand, the new cost definition appears in the part of the §482 regulations that deals with the "comparable profits method" (CPM), a method for pricing property transfers that compares the operating profit of the tested party with that of identified comparable companies. In this context, the regulations look to the operating profit of the taxpayer as reflected on its tax return, albeit allowing for adjustments to account for material differences between tax and financial statement amounts if the taxpayer's results are being compared to financial statements of the comparable companies. The tax return data are thus technically the starting point, even though in practice CPM is typically applied using the taxpayer's financial statement data. This derivation suggests that there should be less emphasis on financial statement results, even though there is no direct analogy to the cost-sharing rules because they do not look to comparable data.

Will It All Come Down to Valuation?

The IRS has taken a strong stand that compensatory stock option costs must be shared under a §482 CSA. Even were the IRS to suffer a clear defeat in *Seagate* under the 1968 regulations, it seems unlikely that the IRS would back off from application of its view under the 1995 regulations. The IRS APA Office has made sharing of these costs a prerequisite to obtaining an advance pricing agreement with respect to a CSA.39 Moreover, it would not be surprising to see the IRS assert that the value of stock options must be considered in any dealings between related parties where compensation costs are a factor, e.g., nonintegral intercompany services, property transfers priced under a cost-plus method, and even computation of operating profit for CPM purposes (subject to adjustment for financial statement comparability). Of course, the eventual two-edged-sword nature of the issue should cause the IRS to consider carefully its policy in these regards, particularly as the conduct of R&D by non-U.S. entities increases.

To the extent the IRS prevails, taxpayers are required for APAs, or Appeals settlements to take stock option costs into account, valuation must be considered. The IRS has clearly signaled flexibility on the method for valuing options, stating in FSA 200003010 that “any reasonable method and timing of valuation may be utilized, so long as it is applied consistently”and has indicated that measurement either at grant or upon exercise or disqualifying disposition may be appropriate. Where exercise at grant is appropriate, an option pricing model may be used.40Staggeringly large differences could ride on the choice of measurement date.

Pricing at exercise appears inconsistent with the purposes of a CSA because options awarded with respect to the development activities that are the subject of the arrangement may not be exercised until after the CSA terminates. If costs related to options are to be shared, only those options that pertain to the effective period of the CSA should be considered. The best approach is, therefore, likely to be to price the options under an option pricing model at the time of grant and include only those options that are intended to reward services performed during the term of the CSA by employees developing the intangibles that are the subject of the arrangement.

Whatever method is adopted may conflict with the method used by other countries.41 This could lead to some interesting bilateral (or multilateral) APA negotiations as well as competent authority proceedings. In all events, it appears that the value of stock options will be a top transfer pricing issue for the foreseeable future.

CSA Administrative Requirements — FSAs 200009022 and 200011021

In addition to the substantive requirements for a CSA to be qualified under the 1995 regulations, certain administrative requirements must be met. Specifically, a participant must maintain sufficient documentation to establish that various requirements have been met and must “attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost-sharing arrangement, and listing the other controlled participants in the arrangement.” 42 In two recent FSAs, the IRS concluded that a taxpayer may not claim that a CSA is a qualified CSA if the taxpayer failed to attach such a statement to its return.43

The National Office based its conclusion on the language of Regs. §1.482-7(c)(1)(iii), which states that a taxpayer may be a participant in a qualified CSA only if it “substantially complies with the administrative requirements described in paragraph (j).” Because “substantial compliance” is not defined in the Code or regulations, the IRS looked to case law and identified two constructs for evaluating substantial compliance: a plain-language test and a federal common law doctrine. According to the IRS, the plain-language test generally controls when the statute or regulation refers to substantial compliance,44 whereas the common law test weighs the harm to the IRS from the taxpayer's lack of full compliance by looking at five factors: (1) whether the failure to comply defeats the purpose of the statute; (2) whether the Commissioner is prejudiced by the untimely election; (3) whether the regulation provides detailed specificity on the manner in which the election is to be made; (4) whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and (5) whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with the original action.45

Using *Prussner v. U.S.*46 as a guide, the National Office first concluded that by not attaching the statements the taxpayers failed to comply under the plain language of Regs. §1.482-7(j)(3), noting the "substantial compliance"language in Regs. §1.482-7(c)(1)(iii). The IRS continued on to analyze the failure under the five-factor test to "support" its conclusion.

Did the IRS Properly Interpret the Law on Substantial Compliance?

The IRS may have misconstrued the law on substantial compliance. Although the case law is hard to reconcile fully, *Gunland* and *Thorrez* do not stand for a simple "plain language"test. Instead, they both held that strict compliance with the reporting requirement at issue was necessary because the requirement went to the essence of the statute, and both dealt with reporting requirements under statutory provisions or "legislative" regulations, not interpretive regulations like those under §482.47 When the requirement relates to "the substance or essence of the statute ...strict adherence to all statutory and regulatory requirements is a precondition to an effective election," but when "the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict, compliance." 48 To require strict compliance whenever the requirements are clear, which is the implication of the IRS's plain language test, would prove too much.

In this dichotomy, the cost-sharing regulations are merely procedural or directory, the essence of the rules being instead the features of the CSA, and Regs. §1.482-7(j) properly requires only substantial compliance. The FSAs, therefore, should have considered only whether a taxpayer that fails to attach the required statement can nevertheless substantially comply with the administrative requirements of Regs. §1.482-7(j), *e.g.* , under the *American Air Filter* five-factor test. The FSAs erred in their position that "the failure to comply with the reporting requirement alone leads to the conclusion that the taxpayer failed to substantially comply with the administrative requirements *in toto* ." 49

Is the IRS Conclusion Correct?

Properly, the issue should be evaluated under considerations like those in the cited five-factor test. In general, an effective election requires only that "a submitted return and its attached schedules ...evidence an affirmative intent on taxpayer's part to make the required election and be bound thereby." 50 Without determining here whether the cited factors are the most appropriate ones, is the FSA's assessment of their application warranted? Would allowing qualified CSA status where no statement is attached to the return —

• *Fully defeat the purpose of the statute?*

The IRS thought so because the statement alerts the IRS of the possible need to investigate and verify the special requirements and issues associated with a qualified CSA. However, that is typically the case with any election on a return and should not alone suffice to satisfy this factor. Taxpayer actions consistent with an executed CSA that meets the substantive requirements of the regulations is the key focus from a statutory perspective.

• *Prejudice the Commissioner?*

Here the IRS reiterated concern with the ability to discern the existence of a CSA and audit it. Yet in a particular case, this concern would be vitiated if the CSA was timely disclosed to or found by the IRS in the course of an audit.

• *Ignore detailed specificity in the regulation?*

The IRS correctly noted that the cost-sharing regulations are clear in this regard and the requirement not particularly burdensome,51 although the requirement does not appear in the paragraph describing the CSA qualification requirements themselves, and the need for its separate satisfaction is by no means obvious.52

• *Be an excessive sanction out of proportion to the default?*

The FSA concluded the sanction was not excessive simply on the basis that the requirement and its consequences were clearly specified in the regulations. That is not the test. Rather, the failure should be viewed in the full context of the taxpayer's actions and intent, as well as the reason for the failure. For instance, disqualifying a CSA for a purely clerical error would almost surely be excessive, whereas an attempted qualification where the underlying CSA itself and the taxpayer's behavior bore only marginal resemblance to the regulatory requirements would be at the other end of the spectrum. Given the other efforts and multiple parties involved in establishing a CSA, the indicated sanction would in most cases clearly be excessive.

• *Allow the taxpayer to benefit from hindsight by adopting an inconsistent position?*

The IRS approached this generically, not by reviewing the situation of the specific taxpayer covered by the FSA. The latter seems the more appropriate standard.

Application of the substantial compliance standard should be made on a case by case basis.53 The FSAs did not follow this approach and did not muster sufficient authority or compelling reasoning to justify the harsh disqualification results. Admittedly, there is an important purpose to be served by the clear statement-filing requirement, and the bar should be high, but substantial compliance does not mean absolute compliance. More careful review and weighing of the particular facts and circumstances in the FSAs was called for to determine whether the taxpayer's affirmative intent was adequately evidenced and how the combination of requirements (documentation and statement-filing) should be balanced. One suspects that a review that carefully considers the pertinent policy issues may reach a different result.

In any event, taxpayers should heed the warning and either comply timely or consider immediately alerting the IRS to any failure (conceivably through attaching the statement to an amended return).

Increasing Scrutiny of the Buy-In Requirement and Other Substantive Rules — FSAs 200001018, 200013010, and 200023014

A spate of recent FSAs signal accelerating audit activity and careful National Office attention to the substantive requirements of CSAs. The IRS is conducting sophisticated analyses on complex and sophisticated transactions, sounding a warning bell that compliance with all aspects of the regulations will be reviewed. The recent FSAs arise primarily under the 1968 regulations. The IRS has not held back pending the effectiveness of the 1995 regulations and is importing a number of 1995 regulation concepts retroactively as well as setting the stage for future interpretation of the 1995 regulations. The details and length of these FSAs and those discussed earlier provide interesting insights, not only into the IRS's analytical framework, but also into the design of CSAs and related agreements.

FSA 200023014 54

In many CSAs, some of the work on the subject intangibles has already been performed by one of the parties; similarly, development of the intangibles may depend on other intangibles already fully developed by one of the parties. In such cases, the "participant that makes intangible property available to [the] qualified cost-sharing arrangement will 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." 55 Payments are also required when participants join or leave an existing CSA.

Buy-in payments are covered by the general transfer pricing rules of Regs. §§1.482-1 and 1.482-4 through 1.482-6, rather than by the cost-sharing regulations *per se* .56 The consideration for the buy-in payment may take the form of a lump sum payment, installment payments spread over the period for the use of the intangibles with appropriate interest charges, or royalties or other payments contingent on the use of the intangibles.57The cost-sharing regulations provide no safe-harbors for buy-in payments.

Evaluating the formula or amount of a buy-in involves complicated transfer pricing issues and is subject to the commensurate-with-income standard. These complexities, and possible approaches to be considered, are illustrated in FSA 200023014.

In FSA 200023014, the taxpayer used a "residual profit split method" under Regs. §1.482-6(c)(3) to determine the required buy-in payment. IRS Examination took issue with the taxpayer's methodology on the basis that the split of the residual was one-sided, attributing an absolute amount of the residual (based on manufacturing cost savings) to the foreign subsidiary, rather than a two-sided relative measure of each party's contribution of intangibles. The National Office seemed inclined toward the latter, although deferring to Examination for determination of the "best method."

The National Office also noted that Examination was considering other methods. One of the alternative methods was based on the taxpayer's market capitalization value in excess of tangible assets, marketing intangibles, and other manufacturing intangibles. Leaving aside the intriguing question which the FSA did not address of how to compute that value, it is interesting to note that the FSA considered that this method might be a comparable uncontrolled transaction (CUT) approach, or possibly an "inexact CUT" or "unspecified method" in transfer-pricing terminology. Characterization as a CUT would require a net present value analysis more clearly than for other possible approaches.

The FSA seemed focused on the present value issue, even though the form of the payment was a royalty and respected as such. The FSA concluded that the useful life of the transferred intangibles should be used for present value purposes and as the period for considering adjustments.

The FSA stressed the importance of convergence of results under various methods. More specifically, the FSA stated that inconsistency of the taxpayer's reported results with available market evidence should be taken into account in the "best method" analysis. This suggests use of the market capitalization method more for verification than as a primary method.

One other noteworthy aspect of FSA 200023014 is its conclusion that the general 1994 transfer pricing regulations applied to evaluate the buy-in payments even though the 1995 cost-sharing regulations were not yet in effect (implying that the year at issue was 1995). The FSA reaches this position analytically by determining that the 1968 cost-sharing regulations relate only to agreements for interests in intangible property to be developed, not preexisting intangibles. This seems correct.

While the IRS's positions in FSA 200023014 are in a sense unremarkable — aside from the budding issues likely to emanate from attempted application of a market capitalization approach — the analysis indicates the sophistication with which both taxpayers and IRS Examination may approach cost-sharing issues. It also stresses the inherent uncertainty and risk in entering into a CSA with significant pre-existing or in-process intangibles. The cost-sharing regulations do not provide any protection for the buy-in payments, and such payments must be evaluated under the commensurate-with-income standard.