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A photograph of the U.S. Capitol building in Washington, D.C., viewed from across the reflecting pool. The building's white dome and neoclassical architecture are prominent against a cloudy sky. The reflecting pool in the foreground shows a clear reflection of the building and the sky. A statue on a pedestal is visible in the middle ground, and some people can be seen walking on the grounds.

Subject: The Temporary Cost Sharing Regulations

On January 5, 2009, the Treasury Department and the Internal Revenue Service published substantial temporary cost sharing regulations in the Federal Register. These regulations are effective as of the date of publication, and contain very significant changes to the previously existing regulations regarding methods to determine taxable income in connection with a cost-sharing arrangement (“CSA”). The new regulations are consistent with the position taken previously by the Service regarding intangibles, namely that the “commensurate with income” standard added to section 482 in 1986 empowers the government to adjust income on a retroactive basis. These regulations use that authority as the basis for the Service’s “periodic adjustment” rules.

Because the regulations were issued as temporary regulations, they will expire within three years of issuance, not later than December 30, 2011. The text of the temporary regulations also serves as the text of proposed regulations, subject to a public comment period and a public hearing before being issued as final regulations. Thus, the temporary regulations may be further modified before they are issued in final form.

In August 2005, the Service and Treasury issued proposed regulations on cost-sharing arrangements that were widely considered to be quite onerous. In issuing the temporary regulations, the Service and Treasury did consider comments received following the issuance of the proposed regulations. However, the general import of the temporary regulations is the same as that of the proposed regulations, and stems from the Service’s view that intellectual property (“IP”) has generally been transferred in CSAs for insufficient compensation. Hence, the major focus of the temporary regulations is on a transaction that is formerly known as the buy in transaction, but that is now referred to as the platform contribution transaction (“PCT”) in the temporary regulations.¹ The most likely result of the changes in the temporary regulations will be significantly increased compensation in PCTs.

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This tax alert discusses:

- Overview and Key Concepts;
- Methods for Determining PCT Payments;
- Division of Interests and Reasonably Anticipated Benefit Shares;
- Use of Interquartile Ranges;
- Periodic Adjustments and the “Commensurate with Income” Rules;
- Grandfathering Provisions for Pre existing CSAs; and
- CSA Documentation and Filing Requirements.

Overview and Key Concepts

The temporary regulations continue the focus of the proposed regulations on three key concepts:

- The “realistic alternative” concept, critical to the Best Method analysis;
- The “best realistic alternative” concept, central to the Income Method; and
- The investor model, central to Best Method considerations.

All of these concepts essentially will serve to increase significantly the amount paid in the PCT. The realistic alternative concept holds that uncontrolled taxpayers dealing at arm’s length would not enter into a transaction unless there was no preferable alternative. The regulations make clear that “the relative reliability of an application of a method also depends on the degree of consistency of the analysis” with this proposition.²

The best realistic alternative concept, embedded within the Income Method, reinforces the realistic alternative concept, and intends to cap the PCT payor’s (the transferee of the platform contribution in the CSA) profit from participation in the CSA at the level it could have earned pursuing its best alternative. The regulations provide that this best alternative for the PCT payor would, in general, involve the entity licensing IP from a third party under a “make-and-sell” arrangement, while the best alternative mentioned for the PCT payee (the transferor of the platform contribution in the CSA) is for the PCT payee to itself invest in the intangible development that would have been shared within the CSA and then license the developed IP to a third party.

The investor model is introduced in Temp. Reg. § 1.482-7T(b)(2)(ii), and makes a method’s reliability dependent on whether each controlled participant’s “aggregate net investment” in the CSA “is reasonably anticipated to earn a rate of return equal to the appropriate discount rate for the controlled participant’s CSA activity over the entire period of such CSA activity.” It clarifies that the period of CSA activity includes the time frame over which any new intangibles developed by exploiting the cost shared intangibles are themselves developed and exploited. Although the Preamble to the temporary regulations acknowledges that there are situations in which the useful life of intangibles is finite, the application of the regulations will most likely result in the use of longer useful lives. For

instance, in one example in the regulations,³ a patent that expires after eight years is still deemed to be a valuable platform that will require compensation throughout the “anticipated period of exploitation,” even beyond the expiration date of the patent when the information in the patent has passed into the public domain.⁴

The temporary regulations also devote considerably more attention than the 2005 proposed regulations to the selection of appropriate discount rates, giving recognition to the fact that, particularly with respect to other new key concepts such as the best alternative and the investor model, it is critical to match up the discount rate used in one’s analysis with the relevant risk profile of the relevant controlled CSA participants. The regulations acknowledge that in many situations it is post-tax (and not pre-tax) discount rates that are publicly available and that this will complicate analyses because transfer pricing analyses are typically done on a pre-tax basis. The regulations suggest some solutions to this issue.

Other critical changes introduced in the temporary regulations involve:

- Revisions to the Residual Profit Split Method;
- The introduction of three new methods, the Income Method, the Market Capitalization Method (only to be used for CSAs involving public companies), and the Acquisition Price Method, all of which were set forth in the proposed regulations;
- Changes to the periodic adjustment rules; and
- Changes to the division of interests and reasonably anticipated benefit (“RAB”) share in developed intangibles on a basis other than by territory.

Before discussing the methods in more detail, there are two additional points to be made. First, at several places in the new temporary regulations it is clear that the answer to a particular problem has not been fully established. As a result, the rules may change further before they are issued in final form. Thus, on several points, taxpayers are still left to speculate on the eventual Service position.

Second, the one major piece of good news for taxpayers is that the “grandfathering” provisions of the proposed regulations have been modified. These provisions had the potential to enable the Service to adjust buy-ins under existing agreements using methods that did not exist when the agreements were entered into. In the case of CSAs existing prior to January 5, 2009, the conditions for avoiding the application of key provisions of the temporary regulations have been softened significantly, although, as discussed later, there are steps that CSA participants need to take to protect their grandfathered status.

Thus, existing CSAs have substantially less risk of being challenged under the temporary regulations, although as a recent coordinated issue paper (the “CIP”)⁵ made clear, the Service has been separately trying to mount a stronger challenge to existing CSAs, pushing a conceptual framework that is similar to that embodied in the temporary regulations.

Methods for Determining PCT Payments

The temporary regulations continue to use the following six methods that were set forth in the 2005 proposed regulations: (i) comparable uncontrolled transaction (“CUT”) method, (ii) income method, (iii) acquisition price method, (iv) market capitalization method, (v) residual profit split method, and (vi) other unspecified methods.

Regardless of the method employed, a taxpayer contemplating transfer of IP in the context of a CSA is likely to face significantly higher buy-in payments under the temporary regulations for determining taxable income in connection with a CSA than under the proposed regulations.

CUT Method

To deal with the fact that some commentators interpreted the proposed regulations as suggesting that any agreement termed a cost-sharing agreement by uncontrolled parties could be considered a CUT, the temporary regulations set forth criteria for determining whether an agreement qualifies as a CUT. These include: similarity of contractual terms, the degree to which the allocation of risks is proportional to RAB shares, similar period of commitment, and similar scope, uncertainty, and profit potential.⁶

Income Method

The temporary regulations provide more guidance on the income method than was initially proposed in the 2005 regulations. The income method, which can only be applied in situations where there is only one controlled participant bringing non-routine platform contributions into the CSA, evaluates whether the amount charged in a PCT is arm’s length by reference to a controlled participant’s best realistic alternative to entering into a CSA. Specifically, the PCT payment will, under this method, be such that a controlled participant earns the same amount in a CSA as it does from its best realistic alternative. Although the best realistic alternative concept applies both to the PCT payor and PCT payee, the regulations prmethod, should reflect a probability-weighted average of possible outcomes and not the most likely outcome. The Service also notes that methods in the temporary regulations, including the income method, are theoretically based on valuation techniques that use cash flow rather than income projections. The Service continues to consider, and solicits comments on, whether and how the cost-sharing regulations could be reliably administered on the basis of cash flows instead of operating income.

Acquisition Price Method

The substance of the acquisition price method has not changed from that provided in the 2005 proposed regulations and the CIP. The acquisition price method is more reliable and is recommended for use only when substantially all of the acquired company’s non-routine intangibles and capabilities are contributed to a CSA via a PCT. This method evaluates whether the amount charged in a PCT is arm’s length by reference to the acquisition price or portion thereof in an uncontrolled transaction.

Market Capitalization Method

The application of the market capitalization price method has not changed from that provided in the 2005 proposed regulations and the CIP. The market capitalization method is similar to the acquisition price method, including with respect to the factors that affect reliability, except that the value of the relevant business enterprise is determined by reference to stock market prices, rather than acquisition prices. The market capitalization method evaluates whether the amount charged in a PCT is arm’s length by reference to the average market capitalization of a controlled participant whose stock is publicly traded.

One notable change from the proposed regulations is that the stock price used for calculating market capitalization is the average price for the 60 days preceding the PCT, adjusted for dividends, stock splits, and other transactions for which adjustments should be made.

The estimates made under both the Acquisition Price Method and the Market Capitalization Method are subject to adjustment for tangible assets, allocations of values among intangible assets not covered by the PCT, and liabilities.

Residual Profit Split Method

The residual profit split method under the proposed and the temporary regulations is substantially different from the method with the same name set forth in Treas. Reg. § 1.482-6. Under the temporary regulations, the residual profit split method cannot be used where only one controlled participant makes significant non-routine contributions to the CSA activity.

Another significant implication for the application of the residual profit split method is the Service position with regard to the relative value of the controlled participant’s non-routine contribution to PCT. Although the regulations state that the relative values may be estimated by the capitalized cost of developing the non-routine contributions, they further provide that the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate.

The temporary regulations state that the provisions of the residual profit split method apply to a CSA only to the extent provided and as modified in the temporary regulations, and that any other application to a CSA of a residual profit method not described in the temporary regulations will constitute an unspecified method.

Division of Interests and Reasonably Anticipated Benefit Shares

The proposed regulations took the position that interests in developed intangibles should be perpetual, exclusive, and territorial. Commentators viewed this requirement as unduly restrictive. In response, the temporary regulations amended this rule so that interests, while they still had to be perpetual and exclusive, could be split on other than a geographic basis. Specifically, the temporary regulations introduce the idea of “field of use” as a legitimate basis for determining such divisions and resulting benefit shares. The concept of “field of use” is an old concept in intellectual property law. The concept is that a particular intangible may have multiple applications or “fields of use” and that intellectual property can be divided

along such lines. For example, a manufacturer of integrated circuits may have a particular chip design that can be used in a variety of consumer electronic goods. A division of interest could easily allocate rights for the chip in question to be sold to manufacturers of particular categories of electronic goods, excluding all others. The temporary regulations also allow for other “divisional bases” subject to a number of conditions.

The regulations also provide for review and modification of benefit shares over time. Benefit shares “must be updated to account for changes in economic conditions, . . . business operations and practices of the participants, and the ongoing development of intangibles under the CSA.”

Use of Interquartile Ranges

The concept of the interquartile range is still applicable to determining levels of profits attributable to routine functions using either the Residual Profit Split Method or Comparable Profits Method as part of the overall analysis. However, the use of the interquartile range is also extended to situations involving the use of various “parameters” in other analytical procedures described in the temporary regulations.

“Variable input parameters” are variables in the equations used to determine the value assigned to the PCT payment. When two or more variable input parameters in combination determine the PCT payment amount, the arm’s-length range for such payments is determined by computing the PCT payment amount using all combinations of input parameters. For example, in a situation involving only two variable input parameters, there may be five available arm’s-length values for one parameter and six observations for the other parameter. Thus, in this example, the arm’s-length range is derived from a set of 30 observations.

Periodic Adjustments and Commensurate with Income Rules

The principle of making periodic adjustments retroactively for transactions involving IP, consistent with the Service’s interpretation of the Commensurate with Income (“CWI”) standard, is not new. Under the former proposed and the new temporary regulations, the Service may make periodic adjustments for an open taxable year (the “Adjustment Year”) and for all subsequent taxable years for the duration of the CSA Activity with respect to all PCT Payments, in the event of a “periodic trigger.” Under the 2005 proposed regulations, a periodic trigger arose if the PCT payor realized, over the period beginning with the earliest date on which any intangible development costs occurred through the end of the Adjustment Year, an actually experienced return ratio of the present value of its divisional operating profits divided by the present value of its investment consisting of the sum of its cost contributions plus PCT Payments, outside the periodic return ratio range of between 0.5 and 2. The temporary regulations narrow the range of return ratios to between 0.667 and 1.5. The range of ratios is further reduced to be between 0.8 and 1.25 if the controlled participants have not substantially complied with the documentation requirements.

While the rules are written mostly with new CSAs in mind, the periodic adjustment rules also can apply to pre-existing CSAs if there is a “material change” in the scope of the CSA.

The regulations list some of the exceptions to the periodic adjustment requirements. These exceptions include situations where:

- There is essentially a CUT, for example, where the same platform contribution is made available on similar terms and circumstances to a third party;
- Unanticipated, extraordinary events contributed to the results;
- The trigger would not have been tripped had one used residual profits instead of divisional operating profits in the trigger calculation; or
- The trigger would not have been tripped if one extended the timeframe of the trigger analysis to include years beyond the Adjustment Year.

The temporary regulations also state that the periodic trigger does not apply if (1) in any year subsequent to the ten-year CSA period beginning with the first taxable year, the actual return is within the periodic return ratio for each year of such ten-year period, or (2) in any year of the five year CSA period beginning with the first taxable the actual return falls below the lower bound of the periodic return ratio.⁷

The Service indicates in the Preamble to the temporary regulations that it intends to issue separate published guidance that provides an exception to periodic adjustments in the context of an advanced pricing agreement (“APA”). The guidance would provide that no periodic adjustments will be made in any year based on a trigger PCT that is a covered transaction under the APA.

Grandfathering Provisions for Pre-Existing CSAs

It is an established principle in United States law and custom that laws should not be imposed retroactively after a transaction has occurred. The proposed regulations included complex “grandfathering” provisions that could have resulted in applying the provisions of the proposed regulations to existing CSAs. In particular, the proposed regulations would not have grandfathered CSAs where there had been either a 50 percent change in ownership, a periodic trigger event, or a material change in the scope of the arrangement. In response to commentators’ objections to these grandfathering termination events, the temporary regulations eliminate those provisions. The risk to taxpayers under the 2005 proposed regulations was that prior PCT (buy-in) payments could be adjusted by the Service using the new proposed methods for pricing such transactions. While the temporary regulations remove this risk, pre-existing CSAs entered into under the prior regulations are still subject to a targeted provision, namely the more complex periodic adjustment rules of the temporary regulations if there be a material change to the CSA.⁸

According to the new grandfathering provisions as outlined in the temporary regulations, PCTs occurring prior to January 5, 2009, are subject to the provisions of former Treas. Reg. § 1.482-7 rather than the new temporary regulations. The temporary regulations indicate that whether a material change in scope has occurred is determined on a cumulative basis. Therefore, even if any one of a sequence of expansions is not viewed as material, the cumulative impact of the sequence may constitute a material change.

CSA Documentation and Filing Requirements

The temporary regulations provide that the controlled participants must timely update and maintain sufficient documentation to establish that the participants have met the CSA contractual requirements. The temporary regulations also provide that an arrangement in existence on January 5, 2009, will be considered a CSA “if, prior to such date, it was a qualified cost sharing arrangement under the provisions of former Treas. Reg. § 1.482-7 . . . , but only if the written contract . . . is amended, if necessary, to conform with, and only if the activities of the controlled participants substantially comply with, the provisions” specified in the temporary regulations.⁹ The deadline for recordation of the revised contractual agreement for the existing CSAs is July 6, 2009.

In addition, the temporary regulations require that each controlled participant file with the Service a “Statement of Controlled Participant to § 1.482-7T Cost Sharing Arrangement” (“CSA Statement”) “no later than 90 days after the first occurrence of an IDC to which the newly-formed CSA applies . . . or, in the case of a taxpayer that became a controlled participant after the formation of the CSA, no later than 90 days after such taxpayer became a controlled participant.”¹⁰

The temporary regulations require that a copy of the original CSA Statement that the controlled participant filed in accordance with the 90-day rule be attached to the United States income tax return for each taxable year for the duration of the CSA. In addition, each controlled participant is required to file annually a schedule to the CSA Statement that documents any changes to the original CSA. The regulations provide that for a controlled participant that is not required to file a United States income tax return, a copy of the CSA Statement and any updates is to be attached to Schedule M of Form 5471 or Form 5472, or Form 8865, filed for that participant.¹¹

As indicated above, taxpayers with existing CSAs are required to put in place the revised contractual agreement for the existing CSAs no later than July 6, 2009. A CSA Statement with respect to the revised written contractual agreement should be filed no later than September 2, 2009.¹²

Action Items for Taxpayers in Pre-Existing CSAs

There are a number of action items that taxpayers with pre-existing CSAs need to take to preserve their positions, namely:

1. Review their existing CSAs, participants, and RAB shares to ensure that their CSAs are consistent with the facts as they may have evolved, to identify and correct any issues with respect to potential “material changes;”
2. Review the actual intercompany CSAs in light of the requirements of the temporary regulations as required, and amend those agreements if necessary by July 6, 2009;
3. Prepare and submit the required reports by July 6, 2009. If the contracts are amended under item 2 above, the deadline for submitting the required reports is extended to September 2, 2009; and
4. Comply with the annual reporting requirements thereafter.

MFA has professionals with broad experience in cost-sharing matters and would be pleased to assist taxpayers comply with the new temporary regulations, both in the context of future planning and in the context of existing CSAs.

1 In the proposed regulations the platform contribution was referred to as an external contribution. Platform contributions are not limited to intangibles defined in section 936(h)(3)(B).

2 Temp. Reg. § 1.482-7T(g)(2)(iii).

3 Temp. Reg. § 1.482-7T(b)(5)(iii), Ex. 4.

4 The regulations repeatedly refer, both implicitly and explicitly, to situations in which future IP is based on the preceding generation of IP, and postulates that the useful life is the period over which one can draw what one might think of as an unbroken line of causality. One example (Temp. Reg. § 1.482-7T(g)(2)(ii)(B)) involving genetic testing postulates that the platform contribution software (DEF) will only reach to the next generation software (GHI) because it is expected that the succeeding generation of genetic testing will be unrelated to DEF or GHI. The useful life of DEF would not, therefore, include the genetic testing following the GHI generation.

5 Section 482 CSA Buy-In Adjustments (LMSB-04-0907-62), effective September 27, 2007.

6 Temp. Reg. § 1.482-7T(g)(3).

7 Temp. Reg. § 1.482-7T(i)(6)(vi)(B).

8 Temp. Reg. § 1.482-7T(m).

9 Temp. Reg. § 1.482-7T(m)(1).

10 Temp. Reg. § 1.482-7T(k)(4)(iii)(A).

11 Temp. Reg. § 1.482-7T(k)(4)(iii)(B).

12 Temp. Reg. § 1.482-7T(m)(2)(vi) and (viii).

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