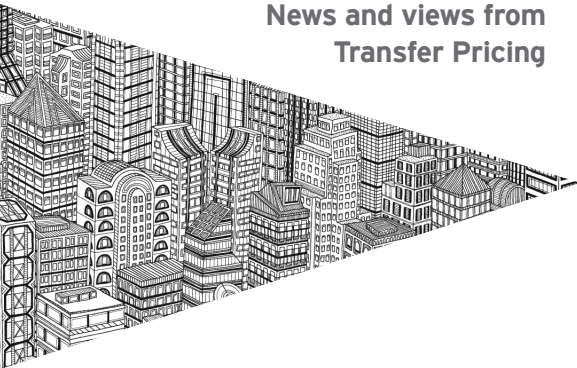


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IRS adopts final cost sharing regulations

Executive summary

On 16 December 2011 the IRS released new final regulations under Section 482 (Treas. Reg. Section 1.482-7 or the final regulations) governing cost sharing arrangements (CSAs). These regulations supersede temporary regulations (Treas. Reg. Section 1.482-7T or the 2009 temporary regulations) that were issued effective 5 January 2009 and were due to expire on 30 December 2011. In addition, on 19 December 2011, the IRS issued new temporary and proposed regulations that add or would add additional provisions to the final regulations.

Generally, the final regulations closely follow the 2009 temporary regulations. However, the final regulations do make a number of changes to the 2009 temporary regulations that are described below. In addition, the new temporary and proposed regulations add or would add additional provisions not found in the 2009 temporary regulations. The preamble to the final regulations also describes certain additional guidance that may be issued in the future.

Compared to the 2009 temporary regulations, the most significant changes made by the three sets of regulations issued on 16 December and 19 December are the addition of a number of new provisions and examples relating to the application of the Income Method. However, additional guidance on the use of contingent payments that adjust in response to market success or failure and determination of Reasonably Anticipated Benefit (RAB) share are also significant. These and other changes are described further below.

In addition, the preamble to the final regulations describes certain issues that the IRS declines to address. The preamble's discussion of these issues provides some insight into IRS thinking.

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The Income Method

The Income Method is specified by Treas. Reg. Section 1.482-7(g)(4) for Platform Contribution Transactions (PCTs). Although the provisions in paragraph (g)(4) have not changed markedly from the 2009 temporary regulations, there have been some additions and clarifications. Further, new examples 4 through 7 were added in the final regulations to illustrate the application of the Income Method. The new temporary regulations add an Example 8, and the new proposed regulations propose to add a new example 9.

Two related amendments emphasize that, in applying the Income Method, cost sharing and the hypothetical licensing alternative should be viewed as closely related, differing primarily in the obligations of the cost sharing participant that is the PCT Payor. Section 1.482-7(g)(4)(iii)B) has been amended to provide that the financial projections used to apply the Income Method should be the same for the licensing and the cost sharing alternatives “except for the licensing payments to be made under the licensing alternative and the cost contributions and PCT Payments to be made under the CSA.” Similarly, Section 1.482-7(g)(4)(vi)F) has been added to provide that the discount rate used in the Income Method may reflect the differing risk profiles of the CSA and the licensing alternative but that these risk profiles would only be expected to differ because of differences in the risk profile of the PCT Payor related to differences in the payment obligations associated with the CSA and the licensing alternative.

The final regulations make extensive additions to the examples illustrating the application of the Income Method. Examples 1 to 3 carry over from the 2009 temporary regulations with minor alterations. Examples 4 through 6 are new and deal with the effect of anticipated tax obligations on the application of the Income Method. Example 4 demonstrates how to calculate PCT payment by taking into account the anticipated tax on income from the CSA and the licensing alternative and grossing up to determine the amount of the pre-tax PCT Payments required to ensure the PCT Payee is indifferent on a post-tax basis under either the licensing or the cost sharing alternative. Example 6 demonstrates that one can achieve the same results as in Example 4 by simply discounting pre-tax income to present value using a post-tax discount rate provided that the tax rate is presumed to be the same for both alternatives and to be constant over time. Example 5 demonstrates that under the Income Method, as specified, it is not appropriate to compare post-tax present value of licensing and cost sharing alternative (without “grossing up” to determine pre-tax payments as was done in Example 4) in order to calculate PCT Payments. Example 7 demonstrates the use of a terminal value calculation to determine the PCT Payments when the platform contribution has an uncertain useful life (this having been an implicit component of example 1 in the 2009 temporary regulations).

The new temporary regulations adopt Section 1.482-7T(g)(2)(V)(B)(2) which introduces the idea of an “implied discount rate,” a discount rate applicable to certain activities that can be determined based on explicit calculations contained in an application of the Income Method. This is illustrated by a new Example 8 (added as the only example in a new Section 1.482-7T(g)(4)(viii)) in which the Commissioner undertakes a reevaluation of an application of the Income Method by reviewing the difference between the expected income stream to the PCT Payor under the cost sharing and the licensing alternatives. The Commissioner concludes that the taxpayer’s calculation impliedly discounts this income stream to present value at a discount rate of 34.4% per annum and such discount rate cannot be justified.

The new proposed regulations propose a new application of the Income Method to determine the present value of the PCT Payments as the amount that would make the PCT Payee no worse off by entering into the CSA rather than by entering into the hypothetical licensing alternative. It is, therefore, somewhat novel as it analyzes the PCT Payments from the point of view of the transferor of the platform contribution rather than the point of view of the transferee (as is done in specifying the CUT-based and CPM-based applications of the Income Method in the final regulations).

Payment form

Section 1.482-7(h)(2)(i)(B) has been amended to emphasize that taxpayers have significant flexibility in choosing the form of PCT payments, provided that the form of payment is “consistent with an arm’s length charge as of the date of the PCT” (emphasis added). This point is further elucidated in examples 3 to 7. Example 3 permits the use of an installment payment. Examples 4 permit the use of installment payments that are subject to a mandatory adjustment to reflect the actual results of commercial exploitation of the developed intangibles because the adjustment is adequately described at the time of the PCT in the CSA documentation and the payor pays an additional arm’s length amount for the privilege of making such an adjustment. Examples 5 through 7 are similar to Example 4 except the Commissioner concludes that the compensation arrangement was not arm’s length because, respectively: (1) the additional amount paid by the payor was inadequate to compensate payee for allowing an adjustment; (2) the adjustment payment was optional at the discretion of the payor; and (3) the adjustment was not adequately specified at the time of the PCT in the CSA documentation.

RAB share

Section 1.482-7(e)(1)(i) is amended to explicitly state that a calculation of RAB share, whether used to allocate R&D costs between participants in the CSA or to determine arm’s length PCT payments, should not be updated to take into account information not available at the time that RAB share

needed to be computed. This point is illustrated in example 2 in which the Commissioner rejects an amended return recalculating the allocation of R&D costs in Year 1 based on information that becomes available in Year 4.

Periodic adjustment rules

Section 1.482-7T(i)(6)(A)(3) makes a technical amendment that will have the effect of making a so-called “high-end trigger” (and periodic adjustments) less likely to occur. More specifically, the amendment provides that a periodic trigger will not be considered to occur if there is no trigger after the PCT Payor’s divisional profits or losses are calculated by taking into account expenses on account of operating cost contributions and routine platform contributions. Profits or losses attributable to operating cost contributions are added to the list of types of profits and losses that should be excluded from the calculation of profit or loss.

Miscellaneous changes

The final regulations also make a variety of miscellaneous technical amendments to the 2009 temporary regulations of which the most significant are:

1. Section 1.482-7(c)(4)(i) amends the definition of make-or-sell rights to provide that make-or-sell rights do not include the use of an existing resource, capability or right to conduct cost-shared R&D. Example 3 illustrates this point by concluding that the provision of a research tool to a CSA to be used, without modification, in

the course of cost-shared R&D should be treated as a platform contribution and not as a transfer of make-and-sell rights.

2. Section 1.482-7(g)(1) is amended to state the general principle that the application of each transfer pricing method specified to determine the arm’s length price for a platform contribution should yield results consistent with the value of the anticipated income attributable to the cost-shared intangible that are anticipated to be created.
3. Section 1.482-7(g)(7)(iii)(B) and (C)(4) are amended to clarify that the market return from operating cost contributions are subtracted from the calculation of residual profit in the application of the Residual Profit Split Method.
4. The definition of CSA Start Date in 1.482-7(j)(1)(i) is modified to mean the earlier of the CSA Contract date and date the first intangible development cost is incurred (rather than being the latter).

Potential future guidance

The preamble to the final regulations indicates that the IRS may issue more guidance germane to CSAs. The first would be a regulation addressing the valuation of stock options (which would presumably be relevant to a CSA in terms of calculating intangible development costs). The second would be a Revenue Procedure that would explicitly provide that CSAs covered by APAs would not be subject to the periodic adjustment rules

of 1.482-7(i)(6). This Revenue Procedure might also provide that such a CSA would not be subject to the administrative requirements of Sections 1.482-7(k)(2) through (k)(4) (dealing with documentation to be retained and the filing of annual CSA Statements). The preamble asks for further comments on the last issue.

Declines to address

The preamble to the final regulations also mentions certain issues that the regulations do not address. The preamble to the 2009 temporary regulations asked for comments on whether guidance should be provided on the application of the Income Method and the Residual Profit Split Method (as specified in Section 1.482-7(g)(7)) based on projected cash flow, rather than accrued income. However, the preamble to the final regulations notes that no such comments were received. The preamble to the final regulations notes that the IRS continues to believe these methods could be applied based on projected cash flow but has decided that published guidance should concentrate on the application of these methods using projected accrued income.

Several comments asked for a clarification of the role of tax adjustments in the application of the Acquisition Price Method (APM) and the Market Capitalization Method (MCM). Although, as described above, the final regulations include significant guidance on tax adjustments in the application of

the Income Method, the preamble declines to give such guidance with respect to the APM and the MCM on the grounds that such determinations are based on the facts and circumstances and are adequately addressed under the general comparability guidance of Section 1.482-1(d)(1). Indeed, any reference to such tax adjustments for the APM and the MCM is removed from the final regulations.

Certain comments asked that the methods specified in Section 1.482-9 (dealing with services) be specified in the final regulations for the purposes of determining the arm's length price for the provision of services as part of a PCT (e.g., the provision of an extant research team to the CSA). The preamble concedes that the -9 methods could theoretically be used. However, it concludes such methods should not be specified in the final regulations as the experience of the IRS is that the methods already specified in the final regulations, which determine the arm's length price for such platform contributions (including such services) in the aggregate, are typically more reliable.

Implications

As noted previously, the final regulations generally follow the 2009 temporary regulations. Among other things, the transition rules of the 2009 Temporary Regulations are unchanged. Consequently, CSAs that predate the 2009 temporary regulations and complied with the

transition rules of the 2009 temporary regulations will also have complied with the transition rules of the final regulations.

Most of the changes represent technical amendments, particularly with respect to the determination of arm's length PCT Payments. Of these, perhaps the most significant is identification of the "implied discount rate" in the new temporary regulations. This construct will probably be used frequently by the IRS in assessing the different discount rates used in the application of the Income Method to compare the results of the CSA and the licensing alternative. Note that the analysis presumes that the PCT Payment must be sufficiently large so that the PCT Payor is made no better off by entering into the cost sharing rather than the licensing alternative. Consequently, the analysis is closely aligned with the newly described application of the Income Method in the new proposed regulations.

From a broader perspective, the main implication of these regulations is that the IRS continues to believe that the Transfer Pricing Methods first specified in the 2009 Temporary Regulations are likely to be the "best methods" for intangible assets or, at least, technology intangibles that are subject to further development. Impliedly, the IRS's emphasis on transfer pricing compliance, particularly with respect to technology intangibles, is also likely to continue.

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