

Temporary Cost Sharing Regulations: A Comment

The US Treasury issued cost sharing regulations in 1995, 2005 and 2008. This article considers why these regulations are important for all intangible transfers as well as for the provision of services, and examines the changes in the cost sharing regulations over time. The impact on the future of cost sharing and other issues that are relevant to today's transfer pricing planning and auditing are also considered.

1. Introduction

The US Treasury ended 2008 by issuing temporary cost sharing regulations (the 2008 Regulations) on 31 December. These regulations may be viewed as an extension of the proposed cost sharing regulations (the 2005 Regulations) issued in 2005, but represent a dramatic departure from the 1995 cost sharing regulations (the 1995 Regulations). The 2008 Regulations modify the 2005 Regulations only slightly, but these regulations have significant implications for other long-term intangibles and services transactions between US and non-US related entities. To understand why these regulations are so important for all intangible transfers as well as for the provision of services, the discussion begins by examining the changes in the cost sharing regulations, and is followed by a discussion of the impact on the future of cost sharing and other issues that are relevant to today's transfer pricing planning and auditing.

Before proceeding, please note that the term "cost sharing" means different things in different countries. In the United States, the term applies solely to sharing research and development (R&D) costs associated with the development of intangible property, and the term will be used in this context in all that follows.

2. Origins of Cost Sharing Regulations

The first US transfer pricing regulations were promulgated in 1968, and contained no detail regarding cost sharing arrangements. At the time these regulations were written, cost sharing regulations were proposed, but were never finalized and were ultimately withdrawn, apparently because there was substantial disagreement regarding the proper method of handling such transactions. Cost sharing discussions returned in 1986 when Congress added the "commensurate with income" requirement to Sec. 482.¹

The interpretation of "commensurate with income" has been subject to much debate since 1986. At times, it seems that the IRS believes that the arm's length standard has been replaced with a commensurate-with-income

standard that allows the IRS to disregard third-party evidence (i.e. all comparable third-party transactions) in favour of "economic analysis" that effectively maximizes US income (more on this point below). Indeed, the Tax Court, in its decision in *Xilinx Inc. v. Commissioner*² stated that the commensurate-with-income standard is intended to supplement and support, not supplant, the arm's length standard.

Between 1986 and 1994, the IRS and practitioners continued their discussion of cost sharing arrangements and the application of regulations to cover joint development of intangible property, but once again, cost sharing regulations were not included in the final regulations that were issued in 1994. In 1995, the IRS issued cost sharing regulations (i.e. Treas. Reg. Sec. 1.482-7), effective for taxable years beginning on or after 1 January 1996 (the previously defined 1995 Regulations).

The 1995 Regulations define a cost sharing agreement as a written agreement:

... under which the parties agree to share the costs of development of one or more intangibles 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.³

The 1995 Regulations provided rules for determining the share of costs and benefits based on a payer/payee model. Shared costs were treated as a cost of developing the intangible by the designated payer, and a reimbursement of those costs by the payee. There was flexibility in the assignment of the rights enjoyed by cost sharing participants, which often divided the rights territorially, e.g., each participant was given the right to a bundle of ongoing and historical intangibles necessary to conduct business in its own territory.

Under these regulations, all participants to a cost sharing arrangement were required to compensate a participant that provides pre-existing intangible property to the cost sharing arrangement through an arm's length "buy-in payment". This compensation could be a lump-sum payment, an instalment sale or a royalty. Both the division of costs and benefits, and the buy-in payment were subject

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1. Sec. 482 is the section of the Internal Revenue Code (IRC) that covers intercompany transactions.
2. 125 TC 4 (30 August 2005). This case is currently on appeal, with a decision expected shortly.
3. Treas. Reg. Sec. 1.482-7(a)(1).

to the commensurate-with-income requirement, but were based on the arm's length standard.

As these regulations were used, the IRS became concerned about taxpayers' failure to include stock-based compensation in the cost base that is shared by the participants. This issue was litigated, or nearly litigated, in several cases. The *Xilinx* case cited above was decided by the Tax Court in favour of the taxpayer (Xilinx), i.e. the Court held that stock-based compensation is not included in third-party cost sharing arrangements. It should not, therefore, be included in an intercompany arrangement. As stated previously, this issue is currently being appealed, and a decision is expected shortly.

As is often the case when the IRS loses in Tax Court, it amends the law and/or the regulations to obtain results consistent with its litigating position. As a result of the *Xilinx* case, in 2003 the cost sharing regulations were amended to require inclusion of stock-based compensation in the cost sharing pool that must be shared by the participants.

A second, more serious, IRS concern related to the buy-in payment. Specifically, the IRS worried that US-owned pre-existing intangible property was contributed to the cost sharing arrangement, and taxpayers' buy-in payments were inadequate to properly compensate the US owner of this property. This led to a revised set of regulations, issued as proposed regulations in 2005 (the previously defined 2005 Regulations).

3. The 2005 Proposed Regulations

The 2005 Regulations were concerned about, and addressed, three issues, namely:

- payment for pre-existing intangibles and other “external contributions”, which are resources or capabilities brought to a cost sharing arrangement, such as in-process R&D or experienced research personnel;
- payment for ongoing R&D costs; and
- payment for acquisition of intangibles after the cost sharing arrangement begins.

The 2005 Regulations significantly redefined cost sharing arrangements in that they introduced the concept of the “investor model”. The investor model moved away from the notion of participants jointly developing an intangible in which each owned an equity share, and replaced it with a model in which participants invest their own pre-existing intangibles or other (including cash) contributions to the development process and expect a return that is commensurate with their contributions. Specifically, each participant is viewed as making an investment that takes into account any intangibles it brings to the agreement, as well as its future investment in the shared intangibles. The 2005 Regulations limit the return that a participant can earn from participation in a cost sharing arrangement to twice its investment.⁴

Overall, the 2005 Regulations contain the following important points:

- R&D costs are to be shared based on benefit (reasonably anticipated benefits (RAB) shares). This is not controversial, nor is it a change from the 1995 Regulations.
- Buy-in payments are required for pre-existing intangibles and “external contributions”. The definition of external contributions is very broad, and includes far more than just pre-existing intangible property. Other resources and capabilities include an experienced research team, a peculiar capability and any other non-cash items that contribute to the ultimate development of the intangible.
- Methods for determining the buy-in (renamed PCT, or platform contribution transaction) include the income method, the acquisition price method and the market capitalization method. These methods supplement the comparable uncontrolled transaction (CUT) method and the residual profit method. The underlying theory is that the buy-in attributes the present value of the income earned by all the intangibles involved in the cost sharing arrangement to the pre-existing intangibles. The 2005 Regulations seemed to incorporate returns to goodwill/going concern value in addition to the return on intangibles (this applies to all but the CUT method). Obviously, these changes result in much larger buy-in payments than under the 1995 Regulations.
- The concept of “best realistic alternative” used in valuing the external contribution. These regulations require the return on the pre-existing intangibles and other property that is used by the cost sharers to be based on the return that the property could have earned if it were separately exploited rather than contributed to the cost sharing arrangement. This concept has been further developed in the 2008 Regulations, as will be discussed later in this article.
- The cost sharing arrangement must be evaluated over the entire life of the agreement (and of the intangibles developed as part of the agreement). Measurement of the expected return on the cost-shared intangibles is based on a risk-adjusted return over the full life of the intangibles. This provision disallows the quickly diminishing royalty model that was often used by taxpayers to compute the buy-in payment under the 1995 Regulations. Further, the returns must be based on a discounted projection of income that must be updated and refined over time. The discount rate is expected to be the firm's weighted average cost of capital (WACC).
- The rights to the intangibles developed under the cost sharing arrangement are exclusive and divided territorially. No other sharing of rights is allowed.

4. The 2005 Regulations allowed a participant to earn more than twice its investment. However, the means to do that would likely have been difficult and contentious.

- Errors in either the buy-in or the shared costs must be retroactively corrected if future events show that the amount paid is not commensurate with the benefits actually received. In other words, periodic adjustments are required. A safe harbour is contained in the 2005 Regulations that protect taxpayers from changes so long as the present value of the returns earned from the cost sharing arrangement divided by the present value of the investment in the cost sharing arrangement remained between 0.5 and 2.0. The counterpart to the safe harbour is that the IRS may make adjustments any time it determines that the ratio falls outside the safe harbour range.

A key component to the determination of the buy-in payments and the safe harbour range is that present value analysis must be used to calculate the current value of all costs and expected returns. The recommended discount rate for computing the present value is the taxpayer's WACC. This requirement was subject to significant controversy as most commentators (the authors included) believe that a company may have many WACCs depending on the transactions in question, and a company-level WACC is often inappropriate for evaluating individual transactions.

When issued in 2005, these regulations generated much discussion between taxpayers and the IRS. Many taxpayers felt that the proposed regulations were too theoretical, provided the IRS with too much leeway to alter the structure of a taxpayer's cost sharing arrangement, allowed the IRS to make periodic adjustments based on hindsight and allowed the IRS to manipulate discount rates to generate desired results.

The authors have several reactions to these regulations. First, one must recognize that at least two types of cost sharing exist, i.e.

- the cost sharing that the IRS worries about, which involves companies developing high-value intangibles that they wish to make available to non-US companies so that those related parties can exploit them in their territories; and
- companies in low-tech manufacturing industries that use cost sharing to spread the costs of developing incremental improvements to technology. These companies use cost sharing to jointly develop incremental changes in technology (e.g. manufacturing process changes) to be shared among the company's manufacturing plants. The 1995 Regulations allowed these types of cost sharing arrangements, while the 2005 Regulations simply do not. This creates significant problems for these types of companies, without an increase in tax compliance.

Second, the 2005 Regulations begin to blur the treatment of services and intangibles. Specifically, these regulations were seemingly indifferent between treating an experienced research team as an intangible or as a service. Subsequent regulations (Sec. 1.482-9T) further blurred this line by suggesting that many services include an intangible component and should, more properly, be treated as a transfer of intangibles rather than the provision of a

service. In short, the 2005 Regulations begin the process of substantially broadening the definition of intangibles. This was continued with the release of the temporary services regulations and reached full bloom in the 2008 Regulations.

Third, the IRS has been worried about the asymmetry of information, i.e. the taxpayer knows its business and its industry while the IRS does not. Therefore, the 2005 Regulations contain punitive clauses that would not, for example, allow taxpayers to change the structure of a cost sharing arrangement if economic circumstances warrant such a change. The IRS however, is allowed to recharacterize the transaction if the deal is detrimental to the government's interests.

Finally, the 2005 Regulations elevate the importance of "reasonably available alternatives", i.e. the preamble to the 2005 Regulations states that "it is critical to determine what an investor would pay at the outset of a cost sharing arrangement for an opportunity to invest in that arrangement". This suggests that the 2005 Regulations are focusing on the participant's alternatives to the cost sharing arrangement. This concept was expanded in the 2008 Regulations, as is discussed below. The 2005 Regulations conclude that an entrant to a cost sharing arrangement brings very little value to the arrangement and should pay for the business opportunity, i.e. an expectation of future profitability is "commercially transferable property".

4. The 2008 Temporary Regulations

Issued on 31 December 2008, the 2008 Regulations took effect on 6 January 2009. They retained all the key principles of the 2005 Regulations, including the investor model, the expanded definition of external contributions and the evaluation methods. As so often happens these days, many acronyms are contained within the 2008 Regulations. Fortunately, many of these terms are familiar, as they were introduced in the 2005 Regulations. The discussion below will provide an explanation of the terminology, as well as a summary of the provisions and administrative requirements included in the 2008 Regulations. Some of the issues that arise in the 2008 Regulations will also be considered.

The terms of importance in the 2008 Regulations are:

- a "platform contribution" is any resource, capability, or right that is reasonably anticipated to contribute to the intangible development activity (IDA);
- cash contributions and other non-platform contributions are collectively called "intangible development costs" (IDC);
- the payment arrangements that are made to compensate the platform contribution are called "platform contribution transactions" (PCTs); and
- the benefits that result from the development of the intangible property are called the "reasonably anticipated benefits" (RAB) and are based on forecasts of revenue and costs that are established at the time the cost sharing arrangement originates. Each partici-

pany's share of the total benefit is called an "RAB share", as was the case in the 2005 Regulations.

4.1. The Investor Model

Under the 1995 Regulations, a cost sharing agreement was viewed as a pooling of development costs and risks that would be shared by all participants and would, if successful, benefit all participants. The benefits were a result of the R&D activity that took place in the cost sharing arrangement, and the emphasis was placed on these costs as well as on the riskiness of the cost sharing arrangement, i.e. there is no guarantee that research will successfully develop the intangibles it is designed to develop. By sharing the R&D costs and risk, each participant owned an equity share of the developed intangible, and could exploit it in its territory (field of use, or other method by which the rights were divided under the cost sharing arrangement).

If pre-existing intangible property was contributed to the cost sharing arrangement, the contributor was expected to be compensated through a buy-in payment, typically a lump sum or a running royalty that fairly compensated the participant for this intangible contribution. Pre-existing intangibles consisted of the intellectual property listed in IRC Sec. 936(h)(3)(B) and, as such, were limited to commercially transferrable property, i.e. a trained research workforce was not considered to be an intangible, and no buy-in payment was required for it.

The investor model is the theoretical underpinning of the 2008 Regulations, as it was for the 2005 Regulations. This model is quite different from the model just described. Under the investor model, the participants to the cost sharing arrangement are treated as investors, as described above, and are allowed only a return on their investment, with all residual income going to the entity that conducted the R&D. Implicitly, the 2005 Regulations and the 2008 Regulations assume that the US entity conducts the R&D and brings the pre-existing intangibles to the cost sharing arrangement.

The key aspects of the 2008 Regulations include the following.

Each participant must receive a non-overlapping, perpetual and exclusive right to the intangible property without further obligation to compensate for that interest. The rights may be divided along geographical lines or market segment lines. While this requirement is slightly relaxed from the 2005 Regulations, it is still more stringent than the 1996 Regulations that allowed non-exclusive and overlapping rights. This is a response to the IRS belief that companies were taking advantage of the ability to assign non-exclusive rights as a way of allowing non-US based subsidiaries to gain additional revenues from the exploitation of the developed property. The concern here, as it is in many other aspects of the 2008 Regulations, is that this requirement is not consistent with real-world business models. Multiple entities that exploit the technology in different ways, may have overlapping markets, both geographical and otherwise, and it

is natural for their operations to overlap on occasion. To serve their markets, multinationals must use a proliferation of complex licence agreements to provide the intangible property developed under the cost sharing arrangement.

RAB shares must be updated as circumstances change. To compute RAB shares, projections of benefits are required for each year beginning with the inception of the research and continuing throughout the development period as well as the full term of the exploitation of the developed intangibles over which benefits will be received. While taxpayers will set the platform contributions payments and RAB shares in accordance with forecasts determined at the start of the cost sharing arrangement, the IRS may recompute these payments as circumstances change. This requirement means that multinationals must forecast, accurately, as far as 15 to 20 years into the future. The authors' experience is that most companies find it difficult to produce accurate forecasts three to six months into the future, much less 15 to 20 years for technology (and products) that do not exist when the forecasts must be created. This business reality, combined with the punitive nature of the penalties for failure to accurately forecast, make this aspect of the 2008 Regulations wholly unrealistic.

To compute each participant's RAB share, the 2008 Regulations require that the discounted present value of the total forecasted return earned from the development of the technology be divided by the participant's contribution to the cost sharing arrangement. The discount rate used to compute the present value is expected to reflect the risks associated with the activities or contributions of each participant, and may be different for each participant or each activity, to properly reflect the risk undertaken by that participant or activity. The discount rate is no longer limited to the company's WACC, as it was for the 2005 Regulations.

The choice of the discount rate is a vital aspect of the determination of the return on the platform contributions. While this approach is theoretically interesting, the authors believe that it introduces uncertainty, potential mine fields of controversy and full employment for those of us who are economists. Modelling an analysis of this sort will be time consuming and is, at a practical level, very difficult. As a result, it exposes taxpayers to a significant audit risk in that the IRS will likely use its own economists to determine that different discount rates should have been used based, of course, on hindsight. The controversy that will result could have a significant impact on the RAB shares and may lead to disallowance of the entire cost sharing arrangement (see below for administrative requirements). In any event, the computation of the discount rate will likely be the focus of both the taxpayer's planning activities and the IRS audit of any cost sharing arrangements that may be created under these regulations.

As stated above, the 2005 Regulations began, and the 2008 Regulations continued and expanded, the application of the investor model, in which participants are

required to earn a return on their contributions of pre-existing intangibles and cash investment that is based on the risk-adjusted present value of the entire cost sharing arrangement. This raises two controversial points:

- the underlying theory is that most, if not all, of the value created by the cost sharing arrangement is attributable to pre-existing intangibles, not the R&D conducted under the cost sharing arrangement; and
- redefinition of intangible property, and abandonment of the concept that intangible property should be commercially transferable. Also, these regulations continue the blurring of the line between services and intangibles, as discussed above.

In short, the emphasis in the 2008 Regulations is on the initial contributions made by each participant, and not on the risk involved in the development process itself. Participants that contribute cash and share in the risk, but do not make a platform contribution, will earn only a reasonable return on their investment, equivalent to a risk adjusted discount rate. Residual profits under the investor model are directed to the participants that make the platform contributions. The return on the platform contribution is based on the imprecisely defined “reasonably anticipated benefit” that would have been earned if the participant had chosen to exploit the resource itself rather than contribute the property to the cost sharing arrangement.

4.2. Administrative requirements

A cost sharing participant is required to substantially comply with the contractual, documentation, accounting and reporting standards of the 2008 Regulations. The administrative requirements are significant both in complexity and sheer volume of paperwork. Even for a sophisticated taxpayer, the administrative requirements, and the exposure to penalties if there is any dispute with or even modification of the documentation, may be enough to convince a company to forgo using cost sharing.

First, a written contract must be signed contemporaneously (within 60 days) with the formation of a cost sharing arrangement and must include a list of participants, their risks and the respective anticipated benefits and costs for each participant, including the method of calculation of the risks and benefits. While these are basic tenets of a cost sharing agreement, the important thing is that this allocation of risk, and the detailed long-term forecasts that are used to derive each participant’s benefits, must be assigned before the outcome of the development is known. If there are changes in these forecasts, which there most likely will be, the 2008 Regulations allow the IRS either to nullify the entire agreement or substantially to change it. This produces enormous exposure for companies. As stated above, the IRS is asking companies to produce something that is essentially impossible to do, an accurate long-term forecast for the exploitation of an intangible that has not yet been developed, with the kicker that it can go so far as to nullify the agreement if these forecasts are not accurate.

The contract must further describe the scope of the intangible development activity (IDA), the platform contributions that are made, the anticipated intangibles that will be developed and the details of the division of rights to the shared property that will be granted to each participant. In short, the economic substance of the cost sharing arrangement must be presented in detail, and if this is later determined to be inconsistent with the actual conduct of the cost sharing arrangement, the IRS may once again deem the contract to be invalid or disregard the contractual terms and impute terms that it determines are consistent with the conduct of the parties.

While the key concerns in the documentation section relate to the ability of the IRS to modify or nullify an agreement if forecasts change, the sheer volume and complexity of the other administrative requirements are staggering and include:

- the documentation must be timely updated and maintained to describe the scope of the IDA, account for the costs (including stock-based compensation) and identify the further development of intangibles;
- the documentation must establish that each participant reasonably anticipates a benefit. It must describe the functions and risks of each party. An analysis of the economic and legal factors that affect the cost sharing transactions and PCT pricing must be included. Each participant’s RAB share must be estimated for each year, and the documentation should include all projections, updates and an explanation of why the method selected provides the most reliable measure;
- updates must describe the platform contributions and the form of payment due for each PCT, the type of method used to value each PCT, economic analyses, data, projections, alternative methods considered, the discount rate, estimated arm’s length values of any platform contributions, why transactions were or were not aggregated, method payment form and any conversions, WACC or other discount rates, and data after the cost sharing arrangement takes effect.;
- the participants must maintain books and records to prove a consistent method of accounting was used, contingent PCT payments were properly determined and foreign currencies were translated on a consistent basis, as well as to explain any material differences in accounting methods from US GAAP. The accounting method used must clearly reflect income.

Complying with all these requirements will likely prove very difficult, and may play a major role in determining whether companies engage in cost sharing in the future.

4.3. Methods of evaluation

The 2008 Regulations retain the CUT method and the residual profit split method (RPSM) for establishing arm’s length PCTs, and continue to use the three methods contained in the 2005 Regulations, namely the

income method, the acquisition price method, and the market capitalization method.

The CUT method is the method of first choice, as it provides the most reliable arm's length measure for valuing contributions and returns. However, the 2008 Regulations stress that the reliability of this method is highly dependent on the degree of comparability, which is measured by the similarity of contractual terms, risks and benefits, period of commitment, scope, uncertainty and profit potential. The authors believe that the CUT method remains the best method of evaluating contributions to a cost sharing arrangement, but there is concern that the IRS will be aggressive in determining that CUTs do not meet the comparability standard and cannot be applied. In fact, the preamble to the 2008 Regulations states plainly that the IRS does not believe that unrelated third parties enter into cost sharing arrangements that are comparable to related party cost sharing arrangements. The authors' guess is that companies that use the CUT method will likely find themselves explaining their method to a Tax Court judge.

The income method is based on the use of a "best realistic alternative available" analysis. This concept was introduced in the 2005 Regulations, but is taken to a higher level in the 2008 Regulations. Specifically, under this method, the supplier of pre-existing intangibles (platform contributions) must consider its best alternative, e.g. develop the intangible itself and then license the resulting intangible to related parties. The 2008 Regulations suggest that this self-development alternative is the "best realistic alternative" unless the company can demonstrate that another alternative is reasonable. Therefore, the analysis required under the income method is a theoretical licensing alternative where the licensor bears the entire risk of the development of the intangible. This means that present values of both expected revenues and costs must be computed, and the discount rates must account for differences in risk.

The 2008 Regulations suggest that cost sharing participants that do not make a platform contribution should earn the same present value of expected profits that they would have earned had they been granted a long-term licence after the intangible was fully developed. This is a very interesting position, i.e. cost sharing participants share the costs and, more importantly, the risks of developing intangibles. In other words, cost sharing participants run the risk that they will commit significant amounts of money to an R&D activity that will fail. Licensees face no such risk because the intangible property is developed at the time a licence is agreed. Of course, the licensee has the risk that the market will not accept the product that incorporates the intangible, but the cost sharing participants have the same risk. Cost sharing participants, as a result, earn no return on the risk they bear during the intangible development process, and are compensated as though they had entered into a long-term licence agreement. This is inconsistent with the arm's length standard.

The problem identified in the previous paragraph is addressed in the 2008 Regulations by allowing different types of costs and revenues to have different discount rates, i.e. the participant that makes the platform contribution should have a higher discount rate because entering into a cost sharing arrangement is riskier than using a licence agreement, and that participant should receive the full benefit of that extra risk. The economic analysis needed to properly determine all relevant discount rates will be tedious and fraught with potential disagreements between taxpayers and tax authorities.

The acquisition price method applies primarily to post-cost sharing acquisitions of intangibles. In other words, participants enter into a cost sharing arrangement and subsequently, one of the participants acquires intangibles through acquisition of an unrelated third party. This method uses the CUT method or CUSP (comparable uncontrolled services price) method to determine the arm's length PCT payment by reference to the acquisition price for the stock or asset purchase of an organization (the target) that is contributed to the cost sharing arrangement. Adjustments are required to account for the target's liabilities and tangible property so that the price accurately reflects the value of the platform contribution. The adjusted acquisition price is divided by the RAB shares of each participant to determine the arm's length PCT payment due from each participant.

The reliability of this method is reduced if the entire target intangible is not contributed to the cost sharing arrangement; the tangible property cannot be reliably valued; the purpose of the acquisition reflects other benefits to the purchaser that affected the price; or the acquisition date and PCT are not contemporaneous. If a company is acquired solely for the purpose and use of its resources, capabilities or rights in the IDA, the entire acquisition price may be used. However, if the acquisition was for the benefit of activities other than the cost sharing arrangement, the reliability is reduced because of the difficulty in valuing the activities or assets that are not contributed. The problem with this method, as when it was included in the 2005 Regulations, is that it suggests that the entire purchase price of the target is attributable to the intangibles acquired. It does not recognize, for example, that companies frequently overpay for acquired companies, and as a result, significant goodwill is included in the balance sheet of the target.

The market capitalization method uses the CUT method or CUSP method to compute the arm's length PCT payment by reference to the average market capitalization of a controlled participant the stock of which is regularly traded and for which substantially all of that participant's non-routine contributions are covered by a PCT. In other words, if all of the resources of a subsidiary are contributed to the PCT, and that subsidiary has a market-derived market capitalization, this market capitalization can be used to value the contribution. Once again, adjustments are made for any liabilities and tangible property not covered in the PCT. Many economic criticisms can, and have been, levelled against this

method. Indeed, the authors are not convinced that it produces arm's length values for intangible property.

The RPSM method, which is retained in a limited form from the 2005 Regulations, allocates the operating profit or loss attributable to one or more platform contributions. Under the 2008 Regulations, the RPSM method may not be used if only one controlled participant makes significant non-routine contributions, and the most narrowly identifiable business activity must be used as the basis for defining the contributions. The profit allocated to any controlled participant under this method is not limited to the total group operating profit, such that one or more participants may earn profits while others incur a loss.

The 2008 Regulations allow unspecified methods to be used if the specified methods cannot reliably generate an arm's length outcome. The 2008 Regulations suggest that an unspecified method should consider alternatives realistically available to cost sharing as the primary consideration, and should be entered into only if no alternative is preferable. Preference is given to methods that rely on uncontrolled comparables rather than internal data.

4.4. Types of payments

The form of cost sharing payments is limited to fixed payments, either a lump sum or instalments with interest, or contingent payments based on the exploitation of the intangibles. The details of the payment form must be determined no later than the due date of the applicable tax return in the year the cost sharing arrangement begins, and the events that give rise to the PCT payment obligations must be specified in the contract. Some of the specified pricing methods require certain payment forms. For example, the acquisition price and market capitalization methods require a fixed payment rather than a contingent royalty, whereas the income method allows for any of these payment forms. In all cases, the payment form is expected to provide the most reliable measure of an arm's length result.

5. Comments and Conclusions

After the release of the 2005 Regulations, the IRS received advice and comments from taxpayers, much of it critical of the investor model. However, the 2008 Regulations do not back away from the model. The IRS kept the investor model with only a few relatively minor changes, and this leaves several important concerns about the future of cost sharing.

The key to understanding the 2008 Regulations (and their predecessors) is the IRS assumption that all, or almost all, valuable intangibles are created in the United States and are shared with non-US companies at prices that are disadvantageous to the US tax base. In today's world this assumption is simply wrong. Multinational companies do not have all of their research facilities and intellectual capital in the United States. Instead, significant research is conducted throughout the world. As competition increases and the costs associated with

research increase, many companies are turning to joint development arrangements with unrelated partners to pool their resources to stay at the cutting edge of technology. The IRS explicitly ignores these real-world transactions, but more importantly, has established punitive treatment of R&D conducted in the United States for the benefit of the world. Many believe, including the authors, that these regulations will have the effect of:

- causing multinationals to locate research outside the United States when tax becomes the deciding factor, i.e. differing tax treatment is the deciding factor when all other factors balance out;
- providing opportunities for foreign-owned companies to exploit these rules to the disadvantage of the US tax base; and
- substantially increasing the complexity of supporting a cost sharing arrangement, and substantially adding to the tax risk of such arrangements. In these days of aggressive FIN 48 analysis by the public accounting firms, it is reasonable to assume that new cost sharing arrangements are unlikely to be established by US companies.

In short, the 2008 Regulations have replaced the arm's length standard with a purely theoretical model of what a transaction might look like if it were based fully on the commensurate-with-income standard (as opposed to the arm's length standard). The investor model directly ties all returns to the initial contributions of the participants, and mandates that these outside contributions receive returns based on their alternative value had they been used outside of the cost sharing arrangement. This shift away from the arm's length standard is unsettling because it brings uncertainty to taxpayers, and it seems to contradict the OECD Transfer Pricing Guidelines. Although the OECD Guidelines have continued to assert that all transactions, including cost sharing arrangements, must be based on real-world transactions, it is worth noting that the OECD's recent draft regarding business restructuring goes at least part of the way toward the US view of intangibles.

The 2008 Regulations are inconsistent with an important recent Tax Court case that upheld the arm's length standard as the primary transfer pricing standard. In *Xilinx*,⁵ the Court specifically rejected the conceptual arguments of the IRS that parties to a development agreement would share stock option costs, choosing instead to rely on concrete, real-world transactions provided by the taxpayer. The Court found that the IRS broke with the arm's length standard by putting theoretical arguments ahead of factual evidence, and affirmed the principle that commensurate with income should be viewed only as an extension of the arm's length principle, not as the primary standard. The 2008 Regulations are likewise based on a theoretical supposition and will cause more controversies that will likely need to be litigated.

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5. In *Xilinx*, the IRS argued that "commensurate with income" is a standard that replaced the arm's length standard. The Tax Court disagreed. As stated above, this issue has been appealed.

The investor model causes significant concern that it does not reflect the economic reasoning behind cost sharing. The model puts the emphasis on, and provides the residual return on, the external contributions (pre-existing intangibles and other contributions to the cost sharing arrangement). This follows from the IRS belief that independent parties do not participate in cost sharing agreements and therefore the only business reason for such an agreement is the movement, not the development, of intangible and entrenched value out of the United States. There is little acknowledgement of cost and risk sharing advantages in the development process.

In technology-driven industries, the pooling of risks, costs and technical abilities among a group of participants makes sound business sense. This, combined with the fact that far more countries have developed strong research and technical abilities and development has become a worldwide field that is no longer centred in the United States, makes international collaboration a natural business practice. A cost sharing agreement should be focused on the benefits of the development process itself, which means rewarding the participants for taking on the risks, costs and development obligation, and not just the external contributions.

With the emphasis on the external contributions, the open-ended use of the discount rate to value the contributions and returns earned by the participants places too much importance on the imprecise sciences of revenue projection and the assignment of risk. The computation of the discount rate, which is the measure of risk over time and is used to determine the current value of a future or historic stream of cash flows, is open to interpretation. While commonly used measures such as a company's WACC are based on formulas and may be thought to be precise, they are based on a company's full portfolio of risks and not specifically on any specific cost sharing project. The current project may have significantly more or significantly less risk, which would make the WACC a poor choice for a measurement tool.

Other methods of determining the discount rates may be subject to dispute in cases where the taxpayer and the IRS determine contrasting rates, which would lead to sharply different returns. Along with the uncertainty of the discount rate, the use of long-term projections as the basis of revenue shares is troubling. The requirement that the entire term of the development and use of the developed intangible be considered in determining the shares earned by the participant forces companies to determine, at the outset, projections that may be for 15 or 20 years in the future. Forecasts this far ahead are inherently unreliable, especially when forecasting the outcomes of development that has not yet taken place, i.e. if the intangible is not developed, there is no way to know what product will result and what its profitability is likely to be.

The 2008 Regulations make it clear that the discount rate, and all other analyses are to be applied to income statement figures, not cash flows. Ordinarily, the type of analysis described by the investor model is applied to

cash flows. Care needs to be taken to ensure that the analysis can be applied to income flows. Nothing in the 2008 Regulations suggests that this evaluation has taken place.

Finally, as mentioned, the definition of intangibles is broadening significantly. This began many years ago when the IRS, followed by other tax authorities, began to audit in-bound distributor arrangements. Many governments have attempted to identify "marketing intangibles" that are separate from trademarks that can be used to increase the taxable income of distribution subsidiaries. This trend continued when the IRS became concerned about transfers of intangibles "masked as services". The temporary services regulations (previously mentioned) provide the IRS response to this issue, and contain many situations where it is suggested that services constitute intangible transfers. Then, the 2008 Regulations broaden the definition of intangibles contained in platform contributions. While it can be argued that some of the concerns are valid, governments have been very creative in defining intangibles with the result that the arm's length standard is in serious jeopardy.

Given this uncertainty, and subsequent room for abuse, the periodic re-evaluation that allows the IRS to look back at the outcome of a cost sharing arrangement and reassign shares is especially troubling. This violates one of the basic tenets of the arm's length standard, i.e. that transfer prices are set at the outset of a transaction by the taxpayer and should not be changed based on outcomes. The IRS includes a safe harbour that provides protection against periodic adjustments as long as the ratio of the present value of discounted returns earned by participants is within a ratio of 0.67 to 1.25 of the discounted value of their contribution.⁶ This is not really a safe harbour, however, because the calculation is highly dependent on the discount rates that are used to provide these values, and these discount rates are subject to significant differences of opinion. For example, the IRS may assert, with hindsight, that a participant took on greater risk than it initially stated, and thus provide a higher discount rate. This change could therefore move the participant outside of the safe harbour range and allow the IRS to make adjustments.

To summarize, two significant results apply to all companies that are active in industries where intangible property is developed. First, with the stringent administrative requirements, the lack of benefits available to participants that do not provide the platform contributions, as well as the ability of the IRS to make changes – years after the inception of the agreement – that substantially remake the cost sharing arrangement, the 2008 Regulations have dismantled the incentive to participate in cost sharing. Instead, multinationals may find other ways to transfer intangibles to related parties when business needs dictate that such transfers must occur.

6. The 2008 Regulations narrowed the range that was included in the 2005 Regulations, and suggests that participants can earn no more than 1.25 times their investment.

A larger concern, however, is the effect that these regulations may have on other types of intangible transfers and on service fees. IRS spokesmen have publicly stated that the principles and methods included in the 2008 Regulations may apply outside cost sharing, specifically to long-term licences and long-term, risky service arrangements. These spokesmen have also stated that such arrangements cannot be compared to third-party transactions. Thus, the IRS seems to believe that multinationals transfer intangibles and provide services that have no market counterpart in relationships between unrelated parties. To continue with statements made by IRS spokesmen, the belief is that these “nonconforming arrangements are unsatisfactory because they do not involve the same scope, term, or level of coverage of intangible inputs”.⁷ As a result, the IRS may change the intangibles and the services sections of the transfer pricing rules to diminish the use of third-party comparable transactions to benchmark intercompany royalties and service fees. If this happens, the arm’s length standard may well become a thing of the past and taxpayers will experience a significant increase in uncertainty.

The IRS is reacting to its experience with a relatively small number of aggressive taxpayers to formulate regulations that apply to all taxpayers. By applying such aggressive tactics, the IRS is, figuratively speaking, using a Sherman tank when a water pistol may be all that is needed. At the least, this aggressive approach is likely to prevent multinationals based in the United States from undertaking cost sharing arrangements. More likely, it will lead to the continued movement of high-paid, high value research jobs outside the United States. And, it provides an opportunity for non-US companies to exploit the cost sharing regulations to the detriment of the US tax base. Finally, these regulations may well lead to the abandonment of the arm’s length standard in favour of a more formulary approach that will, inevitably, bring with it a whole host of fairness problems.

7. “Musher speaks to Narrowed Periodic Trigger, Other Changes in New Temporary Cost Sharing Rules,” *Transfer Pricing Report*, Vol. 17, No 19, February 5, 2009, p. 726.

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