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Final cost-sharing regulations provide additional guidance on significant issues

The IRS on December 16 issued final cost-sharing regulations (the Final Regulations) under section 482, providing guidance on the determination of and compensation for the economic contributions made by controlled participants in connection with a cost-sharing agreement (CSA) under the arm's-length standard. The 202-page Final Regulations largely continue the guidance set forth in the temporary regulations issues December 31, 2008 (the 2008 Temporary Regulations).

Subsequently, on December 19, the IRS issued additional cost-sharing rules in the form of temporary regulations (the 2011 Temporary Regulations), addressing the evaluation of discount rates in applying the income method. At the same time, the IRS also issued proposed regulations (the 2011 Proposed Regulations), which propose to include a new specified application of the income method based on the use of the "differential income stream."

Some of the more significant changes reflected in the Final Regulations include:

- More specific guidance on the need to use consistent financial projections in applying the income method;
- More specific guidance on the evaluation of the discount rates used in applying the income method, designed to restrict what the IRS considers to be inappropriate use of differential discount rates to lower platform contribution transaction (PCT) values;
- More specific guidance on the potential need to adjust an income method value to reflect a pre-tax value, and new guidance on the tax rate to be used in making this adjustment;
- A prohibition on making retroactive adjustments to reasonably anticipated benefit (RAB) shares for prior years; and

- New guidance permitting the IRS to ignore contingent price adjustment clauses that are deemed too vague or indeterminate, a principle that may be broadly applicable beyond solely CSAs.

The Final Regulations are generally applicable to all CSAs, with a continuation of the transition rules in the 2008 Temporary Regulations that apply to CSAs in existence on January 5, 2009. Written comments on the 2011 Proposed Regulations are requested by March 21, 2012.

Overview

As expected, the Final Regulations generally adopt the principles and transfer pricing methods described in the 2008 Temporary Regulations. In particular, the Final Regulations continue the basic "investor model" approach reflected in the prior regulations and re-affirmed in the Action on Decision issued by the IRS on the Tax Court's *Veritas Software* decision. That approach generally requires platform contributions to be valued based on aggregate valuation approaches that consider the entire period over which intangibles developed under the CSA are expected to generate returns. (For prior discussion, see WNTS Insight, "IRS will not appeal Tax Court decision in Veritas cost-sharing case," November 18, 2010.)

In this context, the preamble to the Final Regulations specifically states that the period to be considered under the investor model approach may not correspond to "the conventional concept of useful life." Similarly, the "periodic trigger" rules basically are unchanged.

The principles adopted in the Final Regulations, the 2011 Temporary Regulations, and the 2011 Proposed Regulations can be traced to the basic tenets of the proposed cost sharing regulations issued in 2005 (the 2005 Proposed Regulations) and the 2008 Temporary Regulations. In particular, the Final Regulations continue to leave the PCT payor with the same net present value of expected income under a licensing alternative as under the cost sharing alternative. ***Observation:*** This approach continues to leave unanswered the question as to why an independent party would enter into a CSA when doing so increases its risks but does not increase its present value of expected profits relative to being a licensee.

The Final Regulations also include some changes and clarifications, including several new examples, in response to comments received on the 2008 Temporary Regulations, and based on the IRS's further experience in applying the income method. ***Observation:*** The clarifications and new guidance in the regulations are mostly at the margins.

Observations: The changes to the Final Regulations on the selection of discount rates are linked to the guidance included in the 2011 Temporary Regulations and 2011 Proposed Regulations. Read together, these changes seek to address what the IRS perceives as unreasonable positions taken by taxpayers, relying on relatively low licensing discount rates and relatively high cost sharing discount rates without consideration of the interrelationship of the discount rates and financial projections. The IRS has proposed an alternative income method application that would apply a single discount rate to value the “differential income stream” representing the difference between projected results under the cost sharing and licensing alternatives. However, as a practical matter, it is unclear how an appropriate discount rate would be developed to determine the present value of the differential income stream.

Analysis

The following sections provide more detailed analysis of the Final Regulations, the 2011 Temporary Regulations, and the 2011 Proposed Regulations.

Methods applicable to PCTs

While the Final Regulations generally adopt the principles and transfer pricing methods described in the 2008 Temporary Regulations to value a platform contribution, and in particular the reliance on the investor model, the Final Regulations provide further clarification on the standards used in the application of the specified methods, such as tax rates and discount rates. The Final Regulations clarify that the "tax rate" for purposes of determining amounts on a pre-tax basis refers to the "reasonably anticipated effective rate with respect to the pre-tax income to which the tax rate is being applied (PCT Payor or PCT Payee)." Discussion of the discount rates is provided under the income method section below.

Income method

The income method values the PCT payment by comparing the present value of the income earned by a PCT payor or payee to its best realistic alternative to entering into a CSA, namely the licensing alternative. The Final Regulations provide a number of clarifications and further discussions related to the application of the income method, including the following:

- *Financial projections.* The Final Regulations require the underlying financial projections used to value the licensing alternative to be the same as the financial projections used to value the cost sharing alternative. This point is clearly illustrated in the examples provided under Reg. sec. 1.482-7(g)(4)(viii).

- *Post-tax vs. pre-tax projections.* The Final Regulations continue to require the PCT payment to be calculated on a pre-tax basis under the income method. The actual calculation of the PCT payment could be performed using post-tax projections (by subtracting the present value of the post-tax income associated with the licensing alternative from the present value of the post-tax income associated with the cost sharing alternative, exclusive of the PCT payment). However, should such an approach be adopted, the Final Regulations require that this difference in present values must be grossed-up to derive the pre-tax PCT payment (because it reflects the post-tax value of the PCT payment). New examples (examples 4 to 6 in Reg. sec. 1.482-7(g)(4)(viii)) have been added to illustrate the calculation of the pre-tax PCT payment derived from post-tax information, assuming the tax rate applicable to both alternatives is the same.

- *Discount rates.* The Final Regulations, the 2011 Temporary Regulations, and the 2011 Proposed Regulations dedicate a large amount of discussion and clarification to the use of discount rates under the application of the income method. ***Observations:*** This indicates that the IRS intends to scrutinize closely the discount rates used by taxpayers in the application of the income method. These rules will put additional burdens on taxpayers to defend their selection of the discount rates used in the income method, and are designed to ensure consistency between the different discount rates used in the different alternatives.

Use of discount rates

As discussed further below, the Final Regulations provide more specific guidance on the selection of different discount rates to prevent what the IRS perceives as the inappropriate application of discount rate differentials to produce understated PCT values. The 2011 Temporary Regulations supplement this guidance by suggesting that the discount rate implied by an income method analysis can be checked against market evidence of discount rates as a way of evaluating the reliability of the income method analysis. The 2011 Proposed Regulations carry the concept further by proposing to use this market evidence of discount rates directly in a newly specified application of the income method.

The Final Regulations include an added section specifically dedicated to the use of discount rates under the different alternatives. The regulations state that if different discount rates are warranted for the two alternatives (the cost-sharing and licensing alternatives, respectively), those rates must be closely related, given that the financial projections underlying the two alternatives are the same. Consequently, differences between the discount rates must reflect only the differences between the obligations undertaken by the PCT payor under the two alternatives -- the licensing payments under the licensing alternative versus the cost contribution payments and PCT payments under the cost-sharing alternative.

In connection with this issue, the 2011 Temporary Regulations also include provisions that complement the Final Regulations with regard to the interrelationship between the different discount rates used under the income method. The 2011 Temporary Regulations discuss an evaluation of the reasonableness of the "implied discount rate" of the "differential income stream" -- defined as the difference between undiscounted income streams under the cost sharing and licensing alternative, respectively.

Specifically, the 2011 Temporary Regulations suggest that the "implied discount rate" for the "differential income stream" that yields an equivalent value for the PCT as determined under the income method using different discount rates for the cost sharing and licensing alternatives be consistent with *reliable direct evidence* on discount rates applicable for activities that can be expected to generate income streams with similar characteristics. The weighted average cost of capital (WACC) for uncontrolled companies whose activities consist primarily of developing intangibles similar to the cost-shared intangibles is suggested as a basis to determine a discount rate appropriate for the "differential income stream." The addition of an example (Example 8) is intended to illustrate these principles.

Lastly, a provision in the 2011 Proposed Regulations would provide a new specified application of the income method. This application would determine the PCT obligation as the present discounted value of the "differential income stream" using an appropriate discount rate. Again, the WACC of uncontrolled companies whose activities consist primarily of developing intangibles similar to the cost-shared intangibles is suggested as a basis to determine a discount rate appropriate for the "differential income stream." Example 9 is added to illustrate the newly proposed specified application of the income method.

Acquisition price method (APM) and market capitalization method (MCM)

The APM and MCM remain the same except that the Final Regulations omit the language in the 2008 Temporary Regulations that references the potential adjustment that may be needed to capture the fact that PCT payee's tax liability

attributable to the purchase may differ from the tax liability attributable to the PCT payments.

This language had referred to the potential for a "tax gross-up" of the relevant acquisition price or market capitalization value to convert if necessary from a post-tax to a pre-tax value. The preamble to the Final Regulations explains that the determination of whether a gross-up for tax is needed is a facts and circumstances determination and is best addressed under the general comparability guidance in Reg. sec. 1.482-1(d) (Comparability).

Residual profit split method (RPSM)

The RPSM also remains largely unchanged from the 2008 Temporary Regulations. The Final Regulations clarify that in the calculation of residual profit, routine profit should exclude market returns to cost contributions (shared intangible development costs) because cost contributions benefit the development of cost-shared intangibles and are therefore compensated through the income that the cost-sharing participant retains from exploitation of those intangibles.

Helpful details were added to the two examples included under the RPSM, which now show in tables how the RPSM is applied. The examples illustrate cost-plus mark-ups for the computation of the routine returns (using exploitation costs and operating cost contributions as cost base); a reference points back to the methods in Reg. secs.1.482-3 through 1.482-5 and sec.1.482-9(c) to estimate the routine returns, and to the definitions in Reg. sec.1.482-7((j) for the definition of the cost bases.

The illustrations in the two examples are also insightful from two perspectives. First, the two examples use a negative growth rate in the terminal value presumably to reflect the notion that the value of platform contributions declines over time. Second, the RPSM in Example 1 confirms that the initial years of the CSA can produce residual losses which are included in the computation of the cumulative residual profit subject to split.

Scope of platform contributions

The scope of compensable contributions under the 2008 Temporary Regulations generally was broader than only intangibles (as defined in Code section 936(h)(3)(B) or otherwise). Instead, the 2008 Temporary Regulations introduced the concept that any "resource, right or capability" -- including resources contributed in the form of services, for example -- must be compensated. The Final Regulations ensure that this concept is consistently reflected throughout in the regulatory language by changing a few references to "intangibles" in the Temporary Regulations to "resource, capability or right."

In response to comments on the 2008 Temporary Regulations, the Final Regulations provide that the contributions of a research team to a CSA may be compensated through a PCT payment that is structured as a markup on the research team's costs, reflecting the value of its services. The preamble to the Final Regulations expresses the IRS's expectation, however, that the market value of the research team ordinarily will be evaluated most reliably in the aggregate together with other platform contributions.

Reasonably anticipated benefit (RAB) share

The Final Regulations include new language that explicitly prohibits any retroactive change to RAB shares for prior years based on updated information regarding

relative benefits that was not available in the prior year. In certain circumstances, this prohibition could produce a significant misalignment between the share of research and development (R&D) costs incurred by a cost-sharing participant and the benefit that a participant will actually receive. ***Observation:*** Given the general policy of the regulations to match each party's R&D cost and benefit shares, it might have been worthwhile for the IRS to consider allowing taxpayers to provide for cost sharing true-ups in their CSAs so that costs and benefits could be aligned over the life of a CSA.

Contingent price adjustment terms

The Final Regulations add a new sentence to Reg. sec.1.482-7(h)(2)(i)(B) clarifying the ability of taxpayers to structure PCT payments in any manner or form provided that such form and period of payment are consistent with an arm's-length charge as of the date of the PCT. The preamble to the Final Regulations notes that while taxpayers have flexibility in agreeing to contingent payment terms, the IRS is aware that some taxpayers fail to provide for arm's-length compensation for the resulting allocation of risk or failing to provide sufficiently clear upfront allocation of risk in these payment structures.

As a result, four new examples were added in Reg. sec.1.482-7(h)(2)(iii)(C). The examples, especially Example 6, clarify that the regulations are meant to be consistent with the guidance offered by GLAM 2007-007 (allowing CSA participants flexibility in the manner they determine buy-in payments). The examples demonstrate situations in which the IRS will or will not accept contingent pricing buy-ins for a CSA based on the economic substance of the transaction.

As illustrated by the examples included in the Final Regulations, a number of issues appear to be critical in arranging contingent payment structures:

- The contingencies in payment must be sufficiently specified such that their occurrence or nonoccurrence is unambiguous and determinable;
- The allocation of risk must be compensated in a clear and determinable manner and on an arm's-length basis;
- The contingent payment must be agreed upon at the inception of the CSA and must be compulsory (the party cannot elect whether to make payment on ex-post basis) upon the occurrence or nonoccurrence of the contingency; and
- The compensating adjustment must be a predetermined amount (or established by a predetermined formula) as of the inception of the CSA.

Example 6 is notable because it offers guidance on the forms of payment that will not meet economic substance under Reg. secs. 1.482-1(d)(iii)(B) and 1.482-7(h)(2)(iii)(B). The example identifies the contingent forms of payment the IRS is trying to prevent: arrangements that allow the taxpayer to choose when it will make compensating adjustments. The example clarifies that an agreement in which one party may elect to adjust is akin to an illusory contract (that is, an agreement in which one party will act if it so chooses and therefore is not a contract) and may be disregarded, allowing the IRS to impute other contractual terms in its place consistent with the economic substance of the CSA.

Observations: While this guidance on contingent price adjustment terms applies only to CSAs, the principle of these rules may be broadly applicable to other types of related-party contracts that contain contingent price adjustment clauses. Many related-party license agreements, for example, contain provisions that are tied to the

commensurate-with-income safe harbor in Reg. sec. 1.482-4(f), allowing the parties to adjust the contractual royalty rate if profits fall outside the 80-percent-to-120-percent band in the regulatory safe harbor. Some other related-party licenses provide more generally that the parties will periodically review and adjust the royalty rate as necessary to be consistent with the arm's length standard. The new guidance in the Final Regulations may affect whether and how the IRS takes such contractual clauses into account when evaluating the arm's-length results of these license arrangements.

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