US Department of Treasury issues final cost sharing regulations

Global Tax News

25 Jan 2012
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The US Department of Treasury has issued final cost sharing regulations under Treas. Reg. §1.482-7.

These Final Regulations issued in December, update the Temporary Regulations issued in 2008 and contain no major departures from the earlier regulations. Rather, the Final Regulations sharpen and clarify the Internal Revenue Service positions in light of recent court cases, taxpayer comments and IRS experience with this often discussed tax planning structure.

Cost sharing agreements (CSAs) are arrangements in which one or more related parties fund the development of intangible assets jointly. Each party to a CSA bears the financial risk for the commercial success or failure of the developed intangible asset commensurate with its level of expected benefit. CSAs have come under intense scrutiny by the IRS as a potential vehicle for improper transfer of taxable income associated with intangible assets. Moreover, the cost sharing regulations are not just for taxpayers with CSAs: the IRS has made known that principles developed in these cost sharing regulations may be used to value the transfer of intangible assets or related services, whether there is a qualified CSA in place or not.

The Final Regulations, which have an effective date of January 9, 2009 based on the Temporary Regulations, generally reflect technical modifications to the Temporary Regulations.

The most material modifications include closing so-called backdoor CSAs. The IRS is concerned that taxpayers might set up an arrangement with the economic risk-sharing properties of cost sharing, but without meeting all of the administrative requirements required by the Final Regulations. This would allow a taxpayer to not qualify as a CSA under Treas. Reg. §1.482-7 and thereby avoid some of the valuation and pricing methods required therein. The Final Regulations empower the IRS to employ economic and valuation principles in the cost sharing regulations for all related party transactions that have economic dynamics similar to cost sharing. Therefore, there is the possibility that the arm’s length nature of a transfer of an intangible asset may be assessed under the cost sharing provisions rather than under the specified methods contained in the intangible asset provisions of the regulations.

Under a qualified CSA, the intangible asset development costs are shared among the participants with respect to each party’s reasonably anticipated benefit (RAB) share. Under the Final Regulations, the selection of the RAB share may only be changed prospectively, not retroactively after the year has concluded. Although typical RAB share measurements include sales, units or profits, it is acceptable to base the RAB share on a formula.
The majority of the Final Regulations address the difficult issue of how to value economic contributions to a CSA, known as a platform contribution transaction (PCT). It is important to recognize that the presumptive CSA addressed in the Final Regulations is one in which one participant contributes all economic contributions and performs all of the intangible development activity while the other participant is a passive investor.

The Final Regulations maintain and expand the three dominant themes of the 2008 Temporary Regulations with respect to the valuation of PCTs:

- **Investor model**: the economic principle that each participant in a CSA should earn an expected return consistent with its level of financial risk incurred
- **Realistic alternatives**: the concept that, under the arm’s length standard, a party would enter into a CSA as long as there is no realistic alternative that is unambiguously better and
- **Income method**: the principle that the value of a contribution to a CSA should be based on its anticipated income

Under the Final Regulations, a PCT is determined as the difference between the net present value of the CSA to the “investor-like” participant less the net present value of a hypothetical licensing arrangement between the two parties.

Along with the Final Regulations, Treasury also issued **two proposed regulations on specific issues concerning valuation of PCTs**. Combined, these regulations make two important points:

1) The financial forecast of revenues and expenses of the license and cost sharing alternatives should be identical, except for the replacement of the cost sharing payments with licensing payments (i.e., revenues and operating expenses should be the same) and

2) The discount rates used under both scenarios should differ only to the extent the replacement of cost sharing payments with licensing fees itself creates a different risk profile.

The IRS is concerned that some taxpayers may be using discount rates with too wide of a difference between the licensing and cost sharing scenarios. These regulations request taxpayers to be more analytically rigorous in defending the use of differing discount rates and, at a minimum, request that the difference in rates be compared to the discount rates used in any comparable uncontrolled intangible development activities.

The Final Regulations also contain several additional clarifying examples, provide responses to taxpayer comments and note a few minor corrections. The Final Regulations also leave many issues open, especially guidance on specific valuation issues, such as stock options and the use of projected cash flows rather than income.

Related to the issuance of the Final Regulations, Treasury has also announced that it will rescind the controversial 2007 Coordinated Issue Paper (CIP) on cost share buy-ins. With the general principles of the income method enshrined in the Final Regulations, Treasury no longer feels the need to support the highly formulaic method expressed in the CIP, thus removing a source of controversy with taxpayers.

Although the Final Regulations have provided some clarity for CSAs, the outbound transfer of intangibles will continue to be a source of discussion between the IRS and taxpayers for the foreseeable future.

For more information about the Final Regulations, please contact **Paul Flignor**.

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