Cost sharing arrangements: the sensitivity of the income method to discount rates

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The US Department of Treasury has issued final cost sharing regulations under Treas. Reg. §1.482-7 demonstrating its continued focus on the income method. Both the final regulations and the accompanying temporary and proposed regulations, which were issued on December 19, 2011, come at a time of continued IRS scrutiny of cost sharing arrangements and platform contributions.

The income method is one of five specified methods for valuing the Platform Contribution Transaction (PCT) payment and is typically applied when only one participant makes non-routine contributions. The income method determines whether a PCT payment conforms to the arm's length standard by reference to the participant's best realistic alternative to entering into the cost sharing arrangement. The final regulations provide that, in general, the best realistic alternative for a cost sharing participant would be to in-license the cost shared intangibles from an unrelated licensor. Under this framework, the application of the income method boils down to separately valuing the costing sharing alternative and the licensing alternative and then determining the PCT value as the difference in the values of the two alternatives.

Valuation under the two alternatives requires taxpayers to discount the profit streams under both alternatives. The regulations recognize the difference in risk profiles under the two alternatives and allows for the usage of two different discount rates in valuing each of the alternatives. Consequently, the choice of discount rates has become a critical input to the valuation of the PCT payment.

Sensitivity of the PCT payment to the choice of discount rates

The discount rate is among the most important determinants of the value of an asset, and small changes to the discount rate produce large changes in asset value.

What makes the income method so sensitive to the discount rate is the fact that two different discount rates are required to compute the PCT payment. The mechanics of the income method are such that a combination of a high discount rate for the cost sharing alternative and a low discount rate for the licensing alternative produces a low PCT payment. This makes sense because a high cost sharing discount rate decreases the value of the cost sharing alternative and a low discount rate increases the value of the licensing alternative, and the net result is a low PCT payment. It follows that even small changes to either of the two discount rates will produce large swings in the PCT payment. This has even prompted some practitioners to question whether the results of the income method can be considered reliable due to the sensitivity of the results to the inputs.

Limited guidance from regulations on developing discount rates
The Final Regulations provide very limited guidance on developing discount rates for valuing the cost sharing and licensing alternatives, even though it is clear that these are the most important inputs into the calculation of a PCT payment. Examples provided in the regulations recognize that the licensing alternative is considered less risky and use a lower discount rate to value the licensing alternative.

The Final Regulations suggest using an analysis of the “differential income stream” to determine the reasonableness of results achieved. Specifically, these regulations state that the PCT payment, based on two different discount rates for the cost sharing and the licensing alternatives, implies a certain discount rate for the “differential income stream,” which is the difference between the licensing payments to be made under the licensing alternative minus the PCT payor’s cost contributions to be made under the cost sharing alternative. The differential income stream conceptually corresponds to the development value of the cost shared intangibles and, to that extent, the implied discount rate of the differential income stream should be consistent with the discount rates of comparable independent parties performing similar intangible development activities. In effect, this suggests that there is limited room for the cost sharing discount rate to deviate from the licensing alternative discount rate.

A new example in the Final Regulations illustrates a determination that the discount rate required to produce a zero net present value for the differential income-stream (34.4 percent) is greater than the rate of return for the uncontrolled comparables (16 percent), which indicates that the taxpayer used too high a discount rate to evaluate the incremental income stream under the cost sharing alternative. In other words, it seems the IRS position is that the cost sharing discount rate can be slightly higher than the discount rate for the licensing alternative, but not excessively higher.

This poses a challenge for taxpayers, however, because it is difficult to identify comparable independent firms performing similar intangible development activities. There are only a handful of industries in which independent parties solely performing similar intangible development activities can be identified. Given the lack of independent comparable parties, it will be difficult for the taxpayers to apply this guidance in practice.

In addition, there is no case law on which taxpayers can rely. The only legal precedent that can be pointed to in this regard is the Veritas’ case, where the court determined that a discount rate of approximately 21 percent was appropriate for valuing the intangibles contributed to the cost sharing arrangement. However, this was for a specific industry and a specific asset class, which may not be directly applicable for another taxpayer’s situation.

**Uncertainty for taxpayers**

The regulations provide very little guidance for developing the discount rates, and the valuation results are highly sensitive to the choice of discount rates, meaning the regulations are a source of considerable uncertainty in both the taxpayer and practitioner communities. This is particularly the case with taxpayers who plan to migrate intangibles offshore for cost sharing purposes. The decision to migrate or not clearly depends on the quantification of the PCT payment, which drives the benefit achieved from the migration of intangibles. The uncertainty around the choice of discount rates makes it difficult to quantify the PCT payment and the sustainability of tax positions with any degree of certainty.

This also leaves taxpayers who have migrated intangibles under the new regime using the income method in an uncertain position regarding their choice of discount rates and the need for a corresponding financial statement reserve.

In the absence of clear regulatory guidance, taxpayers and practitioners are left to rely on finance theory and interpretations thereof. What compounds the problem is the inherent subjectivity involved in developing discount rates. While a number of models exist for calculating discount rates, none of the models for developing discount rates is considered accurate, and practitioners routinely make adjustments to account for any additional risks that may not be fully captured. For example, the CAPM is routinely augmented by a “size premium” to capture the effect of a firm’s size. Similarly, some practitioners make industry-specific or firm-specific adjustments. These adjustments in many instances introduce a substantial element of subjectivity into the discount rate calculations. Consequently, there is no clear consensus on what models and adjustments may be considered appropriate or defensible under audit.

In addition, these models require identification of publicly traded comparable companies to benchmark the discount rates. This again poses a problem for taxpayers because it may be difficult to identify comparable independent companies for the two alternatives. The implication is both practitioners and taxpayers are left to rely on their experience and judgment.
to ensure their positions are defensible under audit.

Additional guidance is still necessary

The final regulations and the accompanying temporary regulations from the IRS provide more technical guidance for quantitative analysis under the income method and reflect a tightening of rules. However, additional guidance is still necessary when it comes to choice of discount rates, which impacts the computation of PCT payments. Until more definitive guidelines are made available by the IRS, taxpayers and practitioners will have to rely on their experience and judgment in applying the income method. The transfer pricing community can expect some significant litigation in this area.

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§1.482-7T(g)(4)(viii), Example 8 of the temporary regulations
ii Veritas Software Corp. and Subs. v. Commissioner