IRS Issues Temporary Cost Sharing Regulations Effective Immediately

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On December 31, 2008, the IRS and the Treasury Department issued temporary and proposed regulations concerning the application of section 482 and the arm’s length method to cost sharing arrangements. The regulations are generally effective for cost sharing arrangements entered into after January 5, 2009. Comments on the regulations are due April 6, 2009, and a public hearing is scheduled for April 21, 2009.

The temporary regulations make modest changes to the proposed cost sharing regulations that were issued on August 29, 2005. See Rocco V. Femia and Megan McLaughlin Kirmil, “The Proposed Cost Sharing Regulations and Their Impact on Current Issues Related to Buy-In Transactions” (2005). As such, the temporary regulations are a significant departure from the 1995 regulations that they replace. As with the 2005 proposed regulations, the temporary regulations focus on providing guidance regarding so-called buy-in payments and retain as a core concept the controversial investor model.

The practical impact of the regulations on any particular taxpayer will depend on whether the taxpayer has an existing cost sharing arrangement or is contemplating a new or expanded arrangement, and the extent to which each participant to the arrangement contributes intangible property or similar resources at the start of the arrangement. As described below, in general existing cost sharing arrangements are grandfathered and therefore appear not to be directly affected by the temporary regulations, although that conclusion is not entirely clear from a close reading of the regulations. Similarly, where each participant in a cost sharing arrangement contributes intangible property or similar resources to the arrangement, the practical operation of the temporary regulations is unlikely to differ in material ways from the operation of the 1995 regulations.

However, for new cost sharing arrangements in which all or most of the intangibles and similar resources are contributed to the arrangement by one participant, the temporary regulations are much more restrictive than the 1995 regulations. Indeed, the combination of the investor model and the periodic adjustment rules ensures that the participant making the contribution of platform intangibles will be entitled to the lion’s share of the expected returns from the arrangement, as well as the actual returns from the arrangement to the extent they materially exceed the expected returns. Taxpayers considering a new or expanded cost sharing arrangement should consider other alternatives for structuring their intangible development arrangements or, alternatively, should consider an advance pricing agreement that covers the cost sharing agreement.

Cost Sharing Arrangements in General

A cost sharing arrangement is an agreement between related persons to share the costs of developing intangible property in proportion to the participants’ respective anticipated benefits from the developed intangible property. As a consequence of the arrangement, each of the participants will be considered to have an ownership interest in the developed intangible and will be able to exploit it independently without paying a royalty to any other participant or related person. As such, cost sharing is an alternative from the typical intangible development model, in which one person funds the development of intangible property and then licenses the developed intangible property to others in exchange for a royalty. The participants in a cost sharing arrangement must make a “buy in” payment to any participant that makes preexisting intangible property available for use in the cost sharing arrangement.

Scope of Cost Sharing Arrangements

The temporary regulations clarify that a taxpayer may rely on the benefits of the cost sharing rules only for an arrangement that
(1) the taxpayer reasonably concludes complies with the substantive requirements in the regulations, and (2) complies with the administrative requirements (i.e., contractual, documentation, accounting, and reporting requirements) in the regulations. Notwithstanding the taxpayer’s treatment, the IRS may treat an arrangement as a cost sharing arrangement if it concludes that the arrangement complies with the administrative requirements in the regulations and that, notwithstanding the failure of the arrangement to meet the substantive requirements in the regulations, the application of the cost sharing arrangement rules to such nonconforming arrangement will provide the most reliable measure of an arm’s length result.

The temporary regulations provide that non-conforming intangible development arrangements are governed by generally applicable section 482 principles. However, in evaluating non-conforming arrangements under these general principles, the transfer pricing methods and best method considerations of the cost sharing rules may be relevant. By extension, these methods may be relevant to the pricing of transfers of intangible property more generally.

**Divisional Interests**

The IRS reintroduced some flexibility with respect to the division of developed intangibles. The 2005 proposed regulations restricted the division of interests in cost-shared intangibles to divisions made on a territorial basis. Each controlled participant was required to receive exclusive and perpetual rights to exploit the cost shared intangibles in at least one non-overlapping geographic territory, and the rights of all participants, in the aggregate, had to cover all geographic territories. In addition to territorial divisions, the temporary regulations allow controlled participants to divide developed intangibles based on field of use or, if certain conditions are met, other non-overlapping bases. Where other non-overlapping bases are used, however, a transfer of intangible property is deemed to occur if the proportion of intangible development costs borne by a participant is materially greater than the proportion of benefits from the developed intangible property. In light of this rule, the use of divisions other than territorial or field of use should be carefully considered. It is not clear how this rule, which is somewhat similar to a rule in the 1995 regulations that applied at the IRS’s discretion only, will be administered in practice.

**Retention of the Investor Model for Pricing Buy-In Transaction**

The temporary regulations have retained the controversial “investor model” as a fundamental concept for determining the results that would have been realized under an arm’s length cost sharing arrangement and addressing the relationships and contributions of controlled participants in a cost sharing arrangement. Under the investor model, each controlled participant is viewed as making an aggregate investment, through contributions of intangibles and other resources as well as through cost sharing and buy-in payments, for the purpose of achieving an anticipated return appropriate to the risks of the cost sharing arrangement over the term of the development and exploitation of the intangibles resulting from the arrangement.

The Preamble to the temporary regulations emphasizes that the investor model is key to ensuring consistency of the results of a cost sharing arrangement with the arm’s length standard. The Preamble makes an effort to address concerns from commentators that the investor model strips away risky returns from the buy-in transaction payor. Although the Preamble cites the ability of a payor to achieve results commensurate with its assumption of risks, its illustration of where a payor would attain such results is limited to where the payor contributes its own intangibles (other than intangibles developed in the cost sharing arrangement) to the arrangement. The Preamble fails to address that, absent such a contribution, the payor’s expected returns generally are limited to a financing return. Thus, there remains a bias under the investor model towards allocating all expected above normal returns to the buy-in payee.

**Methods for Pricing Buy-In Transaction**

Like the 2005 proposed regulations, the temporary regulations recognize the following methods for determining the appropriate arm’s length charge in buy-in transactions: comparable uncontrolled transaction, income, acquisition price, market capitalization, and residual profit split. For cost sharing arrangements in which only one participant contributes intangibles, the income method...
and acquisition price method effectively remain the default methods.

The temporary regulations clarify that in applying the comparable uncontrolled transaction method, comparability and reliability are particularly dependent on similarity of contractual terms, degree to which allocation of risks is proportional to reasonably anticipated benefits, similar period of commitment as to the sharing of intangible development risks, and similar scope, uncertainty, and profit potential of the subject intangible development.

The IRS has also made numerous technical modifications to the income method in response to taxpayer comments. The most significant among these appears to be additional guidance on discount rates. Unlike the 2005 proposed regulations, the temporary regulations equate the cost sharing and licensing alternatives of the buy-in transaction payor using discount rates appropriate to those alternatives.

Subject of the Buy-In Transaction - Platform Contributions

The temporary regulations modify the scope of so-called “platform contribution transactions” for which buy-in payments are due from other controlled participants. The 1995 regulations required buy-in payments for the contribution of intangible property. The temporary regulations require buy-in payments for any “platform contribution”, which includes any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity that is reasonably anticipated to contribute to developing cost shared intangibles. As with the 2005 proposed regulations, the temporary regulations do not limit contributions that must be compensated in buy-in transactions to the transfer of intangible property as defined in section 936(h)(3)(B), thereby sidestepping the issue of whether resources and capabilities such as workforce in place or business opportunities are intangible property so defined. Certain make-sell rights (i.e., any right to exploit an existing intangible without further development) are excluded from the scope of platform contributions. Further, the temporary regulations adopt the rebuttable presumption that a controlled participant provides any resource, capability, or right to the intangible development activity pursuant to the cost sharing arrangement on an exclusive basis. Although the language in the temporary regulations is different from the language of the 2005 proposed regulations, it is not clear that the differences will have a practical impact. Importantly, the temporary regulations for the first time apply rules historically limited to the pricing of transfers of intangible property, such as the periodic adjustment regime discussed below, to resources and capabilities that do not constitute intangible property.

Form of Payment

As with the 2005 proposed regulations, taxpayers may structure buy-in transactions with consideration in the form of fixed payments (lump sums or installment payments with arm’s length interest) or contingent payments. The temporary regulations provide greater flexibility, however, with respect to post formation acquisitions. The 2005 proposed regulations required that consideration for a post formation acquisition (i.e., in the parlance of the 2005 proposed regulations, an external contribution that is acquired by a controlled participant in an uncontrolled transaction that takes place after the formation of the cost sharing arrangement and that, as of the date of acquisition, is reasonably anticipated to contribute to developing cost-shared intangibles) be paid in the same form as the uncontrolled transaction in which the post formation acquisition was acquired. The temporary regulations have removed these restrictions and, as a result, taxpayers may choose the form of payment for buy-in transactions, regardless of whether the transaction occurs at the outset of the cost sharing arrangement or later.

Periodic Adjustments

Although the temporary regulations liberalize some aspects of the 2005 proposed regulations, the periodic adjustment regime has been tightened substantially. Both the 2005 proposed regulations and the temporary regulations permit the IRS (but not the taxpayer) to make periodic adjustments to buy-in payments in certain circumstances where the actual outcomes of a cost sharing arrangement differ significantly from the expectations or projections at the time of the transaction. Under the 2005 proposed
regulations, periodic adjustments were permitted when the ratio of a taxpayer’s actual profits over the present value of its investments was outside the range of 0.5 and 2 (i.e., the actual return was less than half or more than twice the anticipated return), and none of the exceptions (extraordinary events beyond the participant’s control that could not have reasonably been anticipated) applied. The temporary regulations have narrowed the periodic return ratio range to between 0.667 and 1.5 (or between 0.8 and 1.25 if the taxpayer has not substantially complied with certain documentation requirements). Thus, unless a taxpayer’s actual results are very close to its projections, the commensurate with income standard may be applied by the IRS at audit to make adjustments with the benefits of hindsight.

The IRS also announced in the Preamble to the temporary regulations its intent to issue a separate revenue procedure that will except a buy-in transaction from the periodic adjustment rules where the transaction is covered under an advance pricing (APA) agreement. Taxpayers considering new or expanded cost sharing arrangements should weigh the benefits of certainty that would come with the successful negotiation of an APA against the costs of obtaining an APA.

**Transition Rules**

The temporary regulations apply to cost sharing arrangements commencing on or after January 5, 2009. With respect to preexisting cost sharing arrangements, the temporary regulations provide that the 1995 cost sharing regulations generally will continue to apply so long as the cost sharing agreement is amended to conform with certain administrative requirements before July 6, 2009. This transition relief does not apply to buy-in transactions that occur on or after the date of a material change in the scope of a pre-existing cost sharing arrangement as of January 5, 2009. Thus, the 1995 cost sharing regulations arguably will continue to apply to taxpayers that historically have maintained so-called “umbrella” cost sharing arrangements covering all intangible development activities. These transition rules appropriately are less restrictive than that of the 2005 proposed regulations.

Note that the practical effect of the transition relief is unclear for two reasons. First, the procedural requirements could be interpreted as introducing substantive requirements consistent with the substantive rules of the regulations. For example, existing cost sharing arrangements must be amended to require participants to make buy-in payments for any future platform contributions, presumably consistent with the substantive regulations.

Second, the IRS already has adopted the positions in the temporary regulations for pre-existing arrangements. The IRS’s Coordinated Issue Paper (“CIP”) on cost sharing buy-in payments includes references to the investor model, an expansive view of the nature of the buy-in transaction, and the application of the income, acquisition price, and market capitalization methods. See Rocco V. Femia and David Blair, “Hazards Ahead: The IRS’s Coordinated Issue Paper on Cost Sharing Buy-In Payments” (2008).

**Conclusion**

The temporary regulations make modest changes to the 2005 proposed regulations, and therefore represent a dramatic departure from the 1995 cost sharing regulations. The changes will be most evident in cost sharing arrangements in which all or most of the intangibles and similar resources contributed to the arrangement are contributed by one participant. The combination of the investor model and the periodic adjustment rules ensures that the participant making the contribution of platform intangibles is entitled to the lion’s share of the expected and (to the extent materially greater) actual returns from the arrangement. Taxpayers considering a new or expanded cost sharing arrangement should consider other alternatives for structuring their intangible development arrangements or, alternatively, should consider an APA that covers the buy in transactions to preclude the application of the periodic adjustment regime.

Existing cost sharing arrangements are grandfathered and therefore appear not to be directly affected by the temporary regulations, so long as the underlying agreements conform to certain administrative requirements. Whether these administrative requirements introduce substantive requirements is unclear. Similarly, where each participant in a cost sharing arrangement
contributes intangible property or similar resources to the arrangement, the practical operation of the temporary regulations is unlikely to differ in material ways from the operation of the 1995 regulations.

More broadly, the temporary regulations provide additional evidence of the aggressive administrative approach taken by the IRS to transactions or arrangements that are perceived to facilitate the migration of intangible property outside the U.S. taxing net. Although comments have been solicited, it is unlikely that the IRS will reconsider its basic approach given the similarities between the 2005 proposed regulations and the new temporary regulations and given the pressure on the IRS to step-up enforcement in this area. The temporary regulations, coupled with the enforcement resources directed at cost sharing arrangements under pre-existing law, constitute a show of resolve on the part of the IRS. It is not clear whether the IRS will be successful in applying the theories of the temporary regulations to cases under preexisting law, or whether its efforts to do so ultimately will undermine the temporary regulations themselves. Further, it is not clear the extent to which aspects of these rules will be applied to arrangements outside of the cost sharing context, for example to other intangible development arrangements or to transfers governed by sections 482 or 367(d) more generally.

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