TAX MANAGEMENT

MEMORANDUM

The Proposed Cost Sharing Regulations and Their Impact on Current Issues Related to Buy-In Transactions

by Rocco V. Femia, Esq.
and Megan McLaughlin Kirmil, Esq.[*]
Miller & Chevalier Chartered
Washington, D.C.

Major References:

REG-144615-05, 70 Fed. Reg. 51116 (8/29/05).

INTRODUCTION

The IRS and the Treasury Department (Treasury) in recent years have devoted considerable attention to the transfer pricing issues raised by cost sharing arrangements between related parties for the development of intangible property. On August 29, 2005, the IRS and Treasury issued proposed regulations (Proposed Regulations) related to the transfer pricing issues raised by cost sharing.[1] Several weeks earlier, on August 10, 2005, the IRS and Treasury released an audit checklist (Audit Checklist) for use by International Examiners and Field Specialists in examining cost sharing issues.[2]

Although both documents are comprehensive and therefore address a variety of issues raised by cost sharing arrangements, the primary focus of the Proposed Regulations and the Audit Checklist is on the issues raised by so-called "buy-in" transactions – that is, transactions by which a participant that makes pre-existing intangible property available for use in the cost sharing arrangement is compensated by the other participants.[3] These issues are high stakes and conceptually difficult, and the reso-

[*] Rocco V. Femia is a partner at Miller & Chevalier Chartered, and is a former Associate International Tax Counsel at the U.S. Department of Treasury. Megan McLaughlin Kirmil is an associate at Miller & Chevalier Chartered.

[1] REG-144615-05, 70 Fed. Reg. 51116 (8/29/05).

[2] IRS, "LMSB Division Prepares Audit Checklist for Cost-Sharing Arrangements," 2005 *Tax Notes Today* 153-8, (8/10/05) (Audit Checklist).

[3] Among the many changes of the Proposed Regulations is the introduction of an entirely new nomenclature and an abandonment of existing terms, in particular the term "buy-in." This memorandum in general utilizes the terms "buy-in payment" and "buy-in transaction" except where discussing the specific terms of the Proposed Regu-

lution of these issues could have a significant impact on the transfer pricing principles applicable to transfers of intangible property and similar transactions. The Proposed Regulations particularly are relevant to existing arrangements and disputes because the IRS indicated in the Audit Checklist and other recent guidance that it intends to interpret the current regulations on the basis of principles articulated in the Proposed Regulations, much as it has (unsuccessfully, to date) in the context of the stock option issue that was the focus of 2003 regulations.[4] Further, the Tax Court's recent decision in *Xilinx*,[5] in particular its disregard of conceptual economic arguments put forward by the IRS, could provide some insight into the manner in which courts may resolve issues raised by buy-in transactions in the years before the Proposed Regulations are effective.

This memorandum is divided into six parts. The first three parts provide a general discussion of cost sharing in the transfer pricing context, examining in turn the general context, historical development of guidance, and the current regulations.

The fourth part provides an overview of the changes proposed in the Proposed Regulations. The Proposed Regulations introduce significant changes to the current regulations, particularly with respect to issues raised by the buy-in transaction. The Proposed Regulations introduce new generally applicable principles against which the buy-in payment must be evaluated, and introduce three new transfer pricing methods (and refine an existing method) applicable to buy-in transactions. The Proposed Regulations also set out the application of periodic adjustment rules in the buy-in context that differ from those applicable to other transfers of intangibles. Outside of the buy-in context, the Proposed Regulations restrict the controlled participants' interests in developed intangibles on an exclusive territorial basis and introduce significant new filing and reporting requirements. Each of these changes appears intended to address the concern of the IRS and Treasury that the current regulations allow insufficient buy-in payments to U.S. entities contributing pre-existing intangibles in cost sharing arrangements.

The fifth part examines the following four key issues related to the analysis of buy-in transactions:

- When is a buy-in payment necessary?
- What is the subject matter of the buy-in transaction?
- How may the amount of the buy-in payment be determined?
- Are there constraints on the form of the buy-in payment?

Although this analysis will be based on current law, including the broader implications of the Tax Court's recent decision in *Xilinx*, due regard will be given to the principles of the Proposed Regulations given that the IRS has indicated that it will attempt to apply these principles in administering the current regulations.

The final part of the memorandum offers concluding observations on the Proposed Regulations.

OVERVIEW OF COST SHARING IN THE TRANSFER PRICING CONTEXT

Under §482,[6] the IRS may distribute, apportion, or allocate gross income, deductions, credits, or other items between or among taxpayers under common control where necessary to prevent tax evasion or to reflect income clearly. In the case of any transfer or license of intangible property, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible.

There are extensive regulations under §482 that provide guidance on the circumstances under which the IRS will exercise its authority to reallocate income and the methods by which the IRS will do so.[7] These regulations also provide taxpayers with guidance on how to structure and price controlled transactions to minimize the risk of an adjustment by the IRS and to minimize the possibility of penalties in the case of an adjustment. These regulations adopt the principle that transactions between controlled taxpayers should be priced at arm's length — that is, that transactions should be priced consistent with the price that would have been negotiated between two parties with respect to similar transactions in similar circumstances.[8] In general, data based on the results of transactions between unrelated parties provides the most reliable basis for determining whether the results of a related

lations.

[4] T.D. 9088, 68 Fed. Reg. 51171 (8/26/03). For a comprehensive discussion of the 2003 regulations see Lewis & Kockman, "The Final Word on Stock Options in Cost Sharing Arrangements??," 32 *Tax Mgmt Int'l J.* 651 (12/12/03).

[5] *Xilinx Inc. v. Comr.*, 125 T.C. No. 4 (2005).

[6] Unless otherwise notes, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[7] *See* Regs. §§1.482-1 through -8.

[8] Regs. §1.482-1(b)(1).

Tax Management Memorandum

ISSN 0148-8295

party transaction are consistent with this arm's length standard.[9]

Historically, the most contentious issues in the transfer pricing context have involved the allocation of income generated by intangible property.[10] The reasons for this are two-fold. First, the stakes can be very high. Because intangible property may allow businesses to earn above-normal returns on investment, the income potentially subject to reallocation can be very significant.[11] Second, the issues can be very difficult. Determining a conceptually appropriate allocation of income from intangible property can be very difficult because of the elusive nature of intangible property itself. Estimating the value of an item of intangible property, such as a patent, a trade name, or know-how, can be much more difficult and involve much more speculation than estimating the value of an item of tangible property, such as business equipment or goods, or services.[12]

A controlled group that is developing intangible property has several alternatives from a transfer pricing perspective. It can choose, for example, to have one taxpayer fund the development of the intangible. That taxpayer may or may not be the taxpayer that actually performs the research and development, marketing, or other relevant intangible development function. Because that taxpayer incurs all of the intangible development costs and therefore undertakes the risk that the project will fail, in general it will be considered the economic owner of the intangible property developed. If one or more controlled taxpayers use that intangible property, they likely will need to make an arm's length payment to the owner. Although the arm's length amount can be paid in any form, in practice the amount generally is paid as a contingent royalty based on sales or some other key.[13]

As an alternative to this royalty arrangement, two or more controlled taxpayers may enter into a cost sharing arrangement. A cost sharing arrangement is an agreement between two or more controlled participants to share the costs of developing one or more intangibles in proportion to their respective shares of reasonably anticipated benefit from these intangibles. Because the participants share the costs and the risks of intangible development, they also are considered to have joint economic ownership of the intangibles. Thus, each participant can exploit the intangible in its business without paying a royalty to the other participants or to another controlled taxpayer. Importantly, to ensure that cost sharing participants share in all of the costs and risks of intangible development, a cost sharing arrangement also entails buy-in payments for pre-existing or acquired intangibles made available by a controlled participant in the cost sharing arrangement.

REGULATORY AND LEGISLATIVE HISTORY

Early Guidance — the 1968 Regulations

The IRS and Treasury first issued regulations addressing "bona fide" cost sharing arrangements in 1968.[14] These regulations contained only one paragraph of guidance and did not address directly the buy-in issue. In particular, the regulations provided:

> [W]here a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the [IRS] shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. . . .[15]

The regulations defined a "bona fide cost sharing arrangement" as an "agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced."[16] They also provided that the arrangement must reflect "an effort in good faith by the participating members to bear their respective shares of all the

---

[9] *See, e.g.*, Regs. §1.482-1(b)(1), (c)(2).

[10] *See, e.g.*, *Eli Lilly & Co. v. Comr.*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comr.*, 88 T.C. 252 (1987); Staff of Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, 1015 (Comm. Print 1987) ("the Bluebook").

[11] *See, e.g.*, *GlaxoSmithKline Holdings (Americas) Inc. & Subs. v. Comr.*, Tax Court Petition Nos. 005750-04 (filed Apr. 2, 2004) and 006959-05 (filed Apr. 12, 2005) (collectively featuring asserted deficiencies of over $13 billion over 12 years).

[12] *Cf.* H.R. Rep. No. 426, 99th Cong., 1st Sess. 424 (1985) (observing that industry norms for transfers of less profitable intangibles frequently are not realistic comparables for transfers of so-called "high profit" intangibles for which arm's length comparables often do not exist).

[13] *See generally* Regs. §1.482-4.

[14] 1968 Regs. §1.482-2(d)(4), 33 Fed. Reg. 5848 (4/16/68). In issuing the 1968 final regulations, the IRS and Treasury withdrew the more detailed and prescriptive proposed regulations it had issued in 1966 (1966 Prop. Regs. §1.482-2(d)(4) (8/2/66)).

[15] 1968 Regs. §1.482-2(d)(4).

[16] *Id.*

ISSN 0148-8295

costs and risks of development on an arm's-length basis.''[17]

The Tax Reform Act of 1986 and the 1988 Treasury White Paper

Congress, as well as the IRS and Treasury, weighed in on cost sharing arrangements generally, and the buy-in requirement in particular, in the context of the Tax Reform Act of 1986.[18] That 1986 TRA revised §482 by adding a second sentence dealing specifically with transfers of intangible property and introducing the ''commensurate with income'' standard. This standard was based on a perception by Congress that the courts inappropriately had allowed the use of rules of thumb or industry norms regarding the pricing of licenses of routine intangibles to serve as a basis for determining the value of a transfer of a ''high profit'' intangible.[19] Because high profit intangibles rarely are transferred at arm's length and in any event are somewhat unique, the commensurate with income standard was introduced to allow the determination of the value of an intangible on the basis of the income generated by that intangible over time.[20]

In response to taxpayer concerns about the breadth of the statutory change, the legislative history clarified that this change was not intended to affect certain cost sharing arrangements:

> In revising section 482, Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each.

The legislative history also articulated a view of the economic underpinnings of the buy-in payment requirement:

> [T]o the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment.

Pursuant to a request from Congress to study transfer pricing issues further, the IRS and Treasury issued a White Paper in 1988 that contained, among other things, an extensive discussion of cost sharing arrangements and the conditions under which such arrangements would satisfy both the arm's length standard and the new ''commensurate with income'' standard.[21] The White Paper suggested that only cost sharing arrangements that contained certain fairly narrowly prescribed terms could meet these standards.[22] For example, the White Paper suggested that cost sharing arrangements should be fairly limited in scope (e.g., covering the development of productions within three-digit SIC codes), that participants should be able to use the developed intangibles directly in their active businesses, that participants should be assigned exclusive geographic rights, and that marketing intangibles should be excluded from cost sharing arrangements.

The White Paper also addressed buy-in payments, or payments reflecting the contribution of pre-existing intangibles to a cost sharing arrangement. It explained that these payments must be made with respect to ''three basic types of intangibles'':

> A participant may own preexisting intangibles at various stages of development that will become subject to the arrangement. A company may also conduct basic research not associated with any product. Finally, there may be a going concern value associated with a participant's research facilities and capabilities that will be utilized.[23]

The White Paper noted that ''fully developed intangibles'' are not subject to this type of payment, but rather are subject to the general rules of the commensurate with income standard.[24] With respect to valuing the buy-in payment, the payment ''should reflect the full fair market value of all intangibles utilized in the arrangement and not merely costs incurred to date'' and may be made in the form of a lump sum or periodic payments.[25] The White Paper provided for similar ''buy-out'' payments when a participant withdraws from a cost sharing arrangement, as well as ''secondary buy-in'' payments when new members are admitted after a cost sharing agreement is in place.[26]

[17] *Id.*

[18] Tax Reform Act of 1986, P.L. 99-514.

[19] H.R. Rep. 426, 99th Cong., 1st Sess. 424-25 (1985).

[20] *Id.*

[21] Notice 88-123, 1988-2 C.B. 458 (Chapters 12-13).

[22] *Id.* at 498-499.

[23] *Id.* at 497.

[24] *Id.*

[25] *Id.*

[26] *Id.*

ISSN 0148-8295

1992 Proposed and 1993 Temporary Regulations

As suggested in the White Paper, proposed regulations issued in 1992 were quite prescriptive. For example, they limited participants to taxpayers that could use the developed intangibles in their active business, and included a rule that provided a cost-to-operating income ratio as a check to determine whether cost shares were proportionate to actual benefit shares.[27] Temporary regulations that resembled the 1968 final regulations went into effect in 1993 as the government considered reactions to the 1992 proposed regulations.[28]

Current Guidance

Final regulations were issued on December 20, 1995, and are described in detail below.[29] The regulations did not include many of the restrictions from the 1992 proposed regulations that were suggested by the White Paper. In part, this reflected comments from taxpayers and practitioners regarding the necessity of flexibility to accommodate the great variety of actual arrangements that taxpayers had entered into under the 1968 regulations and also to ensure appropriate treatment under the transfer pricing rules of other countries. For example, the 1995 regulations replaced the cost-to-operating income ratio of the 1992 proposed regulations with a more amorphous provision that allowed the IRS to allocate income in the case of a cost sharing arrangement the terms of which were not consistent with economic substance. Further, the IRS and Treasury amended the 1995 regulations shortly after their issuance to remove the requirement that participants must be able to use the developed intangible in their active businesses.[30] In 2003, the regulations were further amended to provide guidance on the treatment of costs attributable to stock based compensation.[31]

The Organisation for Economic Co-operation and Development (OECD) also has issued guidelines dealing with ''cost contribution arrangements.''[32] The OECD Guidelines in general are not as detailed or prescriptive as the 1995 regulations. The OECD Guidelines provide fairly limited guidance on buy-in transactions. They note, for example, that that the value of each participant's contribution to a cost contribution arrangement, including presumably a contribution of pre-existing intangibles, should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances.[33] The OECD guidelines generally reserve the term ''buy-in payment'' for payments by a new entrant to a pre-existing cost contribution arrangement, although they acknowledge that some jurisdictions apply that term to any payment in recognition of a transfer of pre-existing property or rights.[34] In the context of a new entrant to a cost contribution arrangement, the OECD Guidelines provide that the new participant may obtain an interest in work in progress and knowledge obtained from past cost contribution arrangement activities, and that the amount of the buy-in payment should be determined based on the arm's length value of such rights.[35] The OECD Guidelines also note that it is possible that the results of prior activity may have no value, in which case there would be no buy-in payment.[36]

OVERVIEW OF THE 1995 REGULATIONS

Qualified Cost Sharing Arrangements — In General

Under the 1995 regulations, a cost sharing arrangement is an agreement between two or more parties to share the costs of developing one or more intangibles in proportion to their respective shares of reasonably anticipated benefits derived from these intangibles.[37] A taxpayer is entitled to the benefits of the cost sharing regulations only if it participates in a ''qualified'' cost sharing agreement (QCSA) that meets the administrative and other requirements provided by the regulations.[38] By contrast, the IRS may apply the cost sharing regulations as long as the arrangement is ''in substance'' a cost sharing arrangement.[39]

To constitute a QCSA, a cost sharing arrangement must include two or more controlled participants;[40] provide a method to calculate, and adjust as appropri-

[27] 1992 Prop. Regs. §1.482-2(g), 57 Fed. Reg. 3571 (1/30/92).

[28] 1993 Regs. §1.482-7T, 58 Fed. Reg. 5263 (1/21/93).

[29] 61 Fed. Reg. 7157 (12/20/95).

[30] T.D. 8670, 61 Fed. Reg. 21955 (5/13/96).

[31] T.D. 9088, 68 Fed. Reg. 51171 (8/26/03).

[32] Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter VII (Aug. 1997).

[33] *Id.* at Chapter VIII, ¶8.14.

[34] *Id.* at Chapter VIII, ¶8.31.

[35] *Id.*

[36] *Id.* at Chapter VIII, ¶8.32.

[37] Regs. §1.482-7(a)(1).

[38] *Id.*

[39] *Id.*

[40] Although under Regs. §1.482-7(c)(1), a QCSA may include both controlled and uncontrolled participants, in practice, most QCSAs involve controlled participants only. For purposes of this memorandum, only the term ''controlled participant'' is used. A ''controlled taxpayer'' is ''any one of two or more taxpayers

ISSN 0148-8295

ate, each controlled participant's share of intangible development costs; and be recorded in a written document that is contemporaneous with the formation or revision of the cost sharing arrangement and that includes certain specified terms.[41]

A controlled taxpayer may be a participant only if it reasonably anticipates that it will benefit from the exploitation of the covered intangibles[42] and substantially complies with the accounting and administrative requirements of Regs. §1.482-7(i) and (j).[43] In practice, this rule does not limit which taxpayers can be controlled participants because a controlled taxpayer that plans to license the covered intangibles to another controlled taxpayer is considered to reasonably anticipate that it will benefit from the QCSA. If a controlled taxpayer assists in the development of the covered intangibles, but is not a participant in the QCSA, it is treated as a service provider and must receive arm's length consideration from the controlled participants pursuant to the rules applicable to service providers.[44]

There are no significant limits on the scope of research and development or other intangible development activities that may be conducted through a QCSA, or on the scope of intangibles to be covered by the agreement. Taxpayers can (and often do) have ''umbrella'' arrangements by which all of their intangible development is folded into a QCSA.[45]

The QCSA will not be treated as a partnership, and a foreign participant in a QCSA will not be treated as having a U.S. trade or business or permanent establishment due to its participation in the QCSA.[46] These rules greatly increase the certainty of using QCSAs by foreclosing the issue of whether the income of a foreign controlled participant in a QCSA from its exploitation of the covered intangibles can be taxable by the United States as effectively connected to a U.S. trade or business or attributable to a U.S. permanent establishment.

owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers.'' Regs. §1.482-1(i)(5). An ''uncontrolled taxpayer'' is ''any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.'' *Id.*

[41] Regs. §1.482-7(b)(1)-(4).

[42] A ''covered intangible'' is any intangible property that is developed as a result of research and development undertaken under the cost sharing arrangement. Regs. §1.482-7(b)(4)(iv).

[43] Regs. §1.482-7(c)(1)(i)-(iii).

[44] Regs. §1.482-7(c)(2)(i). For the rules applicable to service providers, see Regs. §1.482-2(b). *See also* Regs. §1.482-4(f)(3)(iii).

[45] *See also* Audit Checklist, Doc. Set Two, C.3 (indicating that marketing intangibles may be developed under QCSA).

[46] Regs. §1.482-7(a)(1).

Intangible Development Costs and Reasonably Anticipated Benefit Share

Intangible development costs include operating expenses, excluding depreciation and amortization, plus an arm's length charge for the use of any tangible property made available to the QCSA (to the extent this is not included in operating expenses).[47] Since 2004 the regulations also have specified that operating expenses include costs attributable to compensation, including stock-based compensation (e.g., stock options), provided by a controlled participant to an employee or an independent contractor.[48]

Controlled participants must share intangible development costs in proportion with their shares of reasonably anticipated benefits under the QCSA.[49] Thus, each controlled participant must reimburse the other controlled participants for costs actually incurred until each controlled participant has incurred costs proportionate to its benefit share.[50]

The regulations define ''reasonably anticipated benefits'' as ''the aggregate benefits that [the controlled taxpayer] reasonably anticipates that it will derive from covered intangibles.''[51] Benefits are ''additional income generated or costs saved by the use of covered intangibles.''[52]

A controlled participant's ''share of the reasonably anticipated benefits'' equals its reasonably anticipated benefits, divided by the sum of all of the controlled participants' reasonably anticipated benefits.[53] A controlled participant's share of anticipated benefits is determined using ''the most reliable estimate of reasonably anticipated benefits.''[54] In effect, the regulations for determining benefit shares provide a standard similar to the guidance on determining and applying the appropriate transfer pricing method in the context of a transfer of tangible or intangible property.[55]

Anticipated benefits may be measured on either a direct basis by estimating additional income or saved costs attributable to the use of the covered intangibles, or an indirect basis by reference to certain measurements that can reasonably be assumed to relate to income generated or costs saved, such as (1) units used,

[47] Regs. §1.482-7(d)(2). Regs. §1.482-2(c) provides guidelines on the determination of an arm's length charge for the use of tangible property.

[48] Regs. §1.482-7(d)(2)(i).

[49] Regs. §1.482-7(f)(1), (d)(1).

[50] Regs. §1.482-(d)(1).

[51] Regs. §1.482-7(e)(2).

[52] Regs. §1.482-7(e)(1).

[53] Regs. §1.482-7(f)(3)(i). Note that the anticipated benefits of an uncontrolled participant are not included in this calculation. *Id.*

[54] Regs. §1.482-7(f)(3)(i).

[55] *See* Regs. §1.482-1(c), (d) (setting forth best method and comparability standards).

ISSN 0148-8295

produced, or sold, (2) sales, and (3) operating profit.[56] If the benefit shares are not expected to change significantly over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares.[57] If the projected benefit shares and actual benefit shares diverge significantly, the IRS may use actual benefits as the most reliable measure of anticipated benefits.[58] However, if the amount of divergence for each controlled participant is less than or equal to 20% of the participant's projected benefit share or if the divergence is attributable to an extraordinary event beyond the participants' control that could not reasonably have been anticipated at the time the costs were shared, the projections will not be considered unreliable.[59]

In practice, most taxpayers use an indirect base, such as actual or anticipated sales, to determine reasonably anticipated benefit shares. In addition, many taxpayers use actual rather than anticipated results.[60]

Treatment of Equalizing Payments

A payment (other than a buy-in payment) by one controlled participant to another controlled participant pursuant to a QCSA is considered a cost of developing intangibles of the payor and a reimbursement of the same type of cost of developing intangibles of the payee.[61] As a result, reimbursements generally are not income and therefore, for example, there generally is no withholding tax due with respect to the payment.[62] Reimbursement payments received by a controlled participant are applied pro rata against deductions in connection with the QCSA.[63]

Buy-In Payment Requirement

Where a controlled participant makes intangible property in which it owns an interest available to the QCSA, the other participants are required to make a buy-in payment to the contributor of the intangible property. The mechanism by which the 1995 regulations require such a payment is by treating the contributing participant as having transferred an interest in the intangible property to the other controlled participants.[64] Thus, the regulations provide that "[a] controlled participant that makes intangible property available to a QCSA will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it."[65] As a result, the other controlled participants must make a buy-in payment to the contributor of the intangible property.[66] If a controlled participant fails to make this buy-in payment, the IRS may make reallocations to reflect an arm's length consideration for the transfer.[67] Therefore, unlike contributions of services by participants in a QCSA, contributions by participants of intangible property are compensated based on *value*, not cost.

The amount of each other controlled participant's buy-in payment is equal to "the arm's length charge for the use of the intangible under the rules of Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits."[68] Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6 govern the determination of an arm's length charge in connection with the transfer of intangible property. A controlled participant's buy-in payment is "reduced to the extent of any payments owed to it . . . from other controlled participants."[69] A buy-in payment may take the form of (1) lump sum payments, (2) installment payments, or (3) royalties.[70] The periodic adjustment rules of Regs. §1.482-4(f)(2) presumably apply to allow the IRS in certain cases to adjust the buy-in payment based on the profitability of the arrangement in future years, although the manner in which these rules apply in the cost sharing context is not clear.[71]

If a controlled participant "bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the [IRS] may conclude that the economic substance of the arrangement. . . is inconsistent with the terms of the cost shar-

[56] Regs. §1.482-7(f)(3)(ii), (iii).

[57] *Id.*

[58] Regs. §1.482-7(f)(3)(iv)(B).

[59] *Id.* For purposes of the 20% test, all controlled participants that are not U.S. persons are treated as a single controlled participant.

[60] *See* Audit Checklist, Doc. Set Four, B.2 (directing IRS examiners to test reasonably anticipated benefit shares against actual results).

[61] Regs. §1.482-7(h).

[62] *See also* OECD Guidelines Chapter VIII, ¶8.25. Payments received in excess of such deductions attributable to the QCSA are treated as rent. Regs. §1.482-7(h).

[63] Regs. §1.482-7(h).

[64] Regs. §1.482-7(g)(1).

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] Regs. §1.482-7(g)(2).

[69] *Id.*

[70] Regs. §1.482-7(g)(7)(i)-(iii). *See also* Regs. §1.482-4 (containing similar flexibility with respect to form of transaction).

[71] *See* Audit Checklist, Doc. Set Six, C.11 ("Buy-in valuations, like other intangible valuations, are subject to periodic adjustments over time . . . . Periodic adjustments are the prerogative of the Service, although taxpayers may achieve somewhat similar results through an appropriately valued contingent royalty extending over the entire life of the intangible.").

ISSN 0148-8295

ing arrangement.''[72] In such a case, the IRS may ''disregard such terms and impute an agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles.''[73] This rule is the successor of the provision in the 1992 proposed regulations that used a cost-to-operating profit ratio to determine whether the cost shares are proportional to the actual benefits received by the participants.

A buy-in payment also is required when a new controlled participant enters a QCSA and acquires any interest in the covered intangibles.[74] In this situation, the new participant must pay an arm's length consideration under the rules of Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6 to each controlled participant from whom it acquired this interest.[75] Likewise, if a controlled participant transfers, abandons, or otherwise relinquishes an interest in one or more covered intangibles to another controlled participant, the acquiring participant must pay an arm's length consideration under the rules of Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6 to the relinquishing participant.[76]

Regulatory Benefits of a QCSA

The primary benefit to a controlled group of entering into a QCSA is that the regulations impose significant limitations on the allocations that the IRS may make. For example, the IRS generally may not impose a royalty payment between participants in a QSCA or otherwise reallocate the income from the intangible property developed by the QCSA.[77] Nonetheless, the IRS may make adjustments in three contexts. First, it can redetermine benefit shares and allocate costs on a going forward basis. Second, it can redetermine costs to be shared. Third, it can adjust (or impose) buy-in payments.

In addition to the limitations on the transfer pricing allocations the IRS can make, there are other incidental benefits of entering into a QCSA, including for example an elimination of withholding tax and certainty with regard to whether activities of arrangement constitute a U.S. trade or business or permanent establishment of a foreign participant. Also, Regs. §1.482-7(h)(1) provides that research performed under a QCSA is treated as an intragroup transaction under Regs. §1.41-6(e); thus, even if a U.S. controlled participant is reimbursed for its research activities by a foreign controlled participant, it will nonetheless be entitled to the research credit.

OVERVIEW OF CHANGES PROPOSED BY THE PROPOSED REGULATIONS

The Proposed Regulations present the same basic framework as the 1995 regulations: controlled participants in a cost sharing arrangement must share the costs of developing intangibles in proportion to their respective shares of reasonably anticipated benefits derived from these intangibles.[78] In addition, as in the 1995 regulations, a buy-in payment is necessary where a controlled participant contributes pre-existing intangibles to the arrangement. This payment must equal an arm's length charge that is consistent with the other §482 regulations.[79] The Proposed Regulations, like the 1995 regulations, generally preclude adjustments by the IRS except in the context of redetermining benefit shares and allocating costs on a going forward basis, redetermining costs to be shared, or adjusting (or imposing) buy-in payments.

The Proposed Regulations, however, introduce significant new guidance, in particular with respect to issues raised by buy-in transactions. Also, the Proposed Regulations introduce a new nomenclature into the cost sharing context, replacing existing terms with new terms and creating new terms to articulate new concepts. Consistent with the substantive changes, most of the changes in terminology are related to the new rules dealing with buy-in transactions (or, in the terminology of the Proposed Regulations, ''preliminary or contemporaneous transactions'').

The Proposed Regulations will be effective as of the date on which the final regulations are published.[80] Arrangements that are in existence prior to the date on which the final regulations are published will be considered cost sharing arrangements if, prior to that date, they were QCSAs, but only if the written agreement is amended to conform with the finalized regulations by the close of the 120th day after that date.[81] Transactions, including buy-in transactions, occurring prior to the date on which the final regulations are published are subject to the 1995 regulations,

[72] Regs. §1.482-7(g)(5).

[73] *Id.* The scope of this provision is unclear, and the authors are not aware of the IRS ever exercising this authority.

[74] Regs. §1.482-7(g)(3).

[75] *Id.*

[76] Regs. §1.482-7(g)(4).

[77] Regs. §1.482-7(a)(2).

[78] Prop. Regs. §1.482-7(a)(1). Note that, as in the case of the 1995 regulations as amended in 2003, a cost sharing arrangement produces results that are consistent with an arm's length result under §482 if, and only if, each controlled participant's share of intangible development costs equals its share of reasonably anticipated benefits. Prop. Regs. §1.482-7(h).

[79] Prop. Regs. §1.482-7(a)(2).

[80] Prop. Regs. §1.482-7(l).

[81] Prop. Regs. §1.482-7(m)(1).

ISSN 0148-8295

except in the case of buy-in transactions that become subject to the rules on periodic adjustments.[82] Transactions that occur on or after that date, however, generally must comply with the substantive requirements of the Proposed Regulations as finalized.[83]

Cost Sharing Arrangements — In General

The Proposed Regulations present a different set of administrative and procedural requirements than the 1995 regulations. A cost sharing arrangement (CSA), no longer a "QCSA," is a contractual agreement to share the costs of developing one or more intangibles pursuant to which the controlled participants:

(1) At the outset of the CSA, divide among themselves all interests in cost shared intangibles on an exclusive territorial basis;

(2) Enter into and effect cost sharing transactions (i.e., equalization payments) covering all intangible development costs and preliminary or contemporaneous transactions (i.e., buy-in transactions) covering all external contributions;

(3) Individually own and exploit their respective interests in the cost shared intangibles without any further obligation to compensate one another for such interests; and

(4) Substantially comply with certain contractual, documentation, accounting, and reporting requirements.[84]

The first three requirements above are considered substantive requirements. As with the 1995 regulations, a taxpayer may benefit from the cost sharing regulations only if it participates in a CSA that meets the administrative and other requirements provided by the regulations, whereas the IRS may apply the cost sharing regulations as long as the arrangement is "in substance" a CSA.[85] An arrangement is in substance a CSA if it meets the three substantive requirements set out above.

Perhaps the most significant change to the definition of a CSA is the explicit requirement that all buy-in transactions be entered into and effectuated. The effect of this rule is not clear. For example, if a controlled participant does not receive any buy-in payment with respect to a cost sharing arrangement and the IRS later determines that a buy-in payment was appropriate, can the IRS choose to treat the arrangement as something other than a CSA rather than simply make an allocation based on the buy-in transaction? What if a buy-in payment is made, but later determined to be too low? Conversely, to what extent could the taxpayer argue against an IRS adjustment to a buy-in payment by asserting that its arrangement did not meet the substantive requirements of a CSA and therefore is not governed by the cost sharing regulations?

Like the 1995 regulations, the Proposed Regulations provide that a controlled taxpayer may be a participant only if it reasonably anticipates that it will benefit from the CSA.[86] In addition, if a controlled taxpayer assists in the development of the covered intangibles, but is not a participant in the CSA, it is treated as a service provider and must receive appropriate arm's length consideration.[87] As with the 1995 regulations, the Proposed Regulations impose no significant limits on the scope of research and development or other intangible development activities that may be conducted through a CSA, or on the scope of intangibles to be covered by the agreement.[88]

The Proposed Regulations retain the rules that the CSA will not be treated as a partnership,[89] and a foreign participant in a CSA will not be treated as having a U.S. trade or business or permanent establishment due to its participation in the CSA.[90]

Unlike the 1995 regulations, the Proposed Regulations restrict the controlled participants' interests in cost shared intangibles on an exclusive territorial basis.[91] Thus, each controlled participant must receive exclusive and perpetual rights to exploit the cost shared intangibles in at least one non-overlapping geographic territories, and in the aggregate all of the participants must receive rights with respect all such territories. This is a significant change, and would prevent controlled participants from dividing the interests in the cost shared intangibles on the basis of field of use or other bases even though unrelated parties to joint development agreements may divide rights in such a manner. This rule raises many issues, including the manner in which the IRS will treat an arrange-

---

[82] Prop. Regs. §1.482-7(m)(3).

[83] Preamble to Proposed Regulations, 70 Fed. Reg. 51115, 51132 (8/29/05).

[84] Prop. Regs. §1.482-7(b)(1).

[85] Prop. Regs. §1.482-7(b)(1), (5)(i). Where a taxpayer satisfies the administrative and other requirements, the IRS *must* apply the rules under Prop. Regs. §1.482-7. Prop. Regs. §1.482-7(b)(5)(ii).

[86] Prop. Regs. §1.482-7(j)(1)(i). The Proposed Regulations define participation in CSAs only with respect to controlled participants, unlike the 1995 regulations, which also allowed participation by uncontrolled participants. Prop. Regs. §1.482-7(b)(1).

[87] Prop. Regs. §1.482-7(a)(3)(i).

[88] Prop. Regs. §1.482-7(j)(1)(ii).

[89] Prop. Regs. §1.482-7(j)(2)(iii).

[90] Prop. Regs. §1.482-7(j)(2)(ii).

[91] Prop. Regs. §1.482-7(b)(4)(i).

ISSN 0148-8295

ment in which interests were divided in some other way but met all other CSA requirements. Could such an arrangement, for example, be treated as a partnership given that it does not meet all of the substantive definitional requirements for a CSA? Importantly, this rule does not apply to existing QCSAs that meet certain requirements.

Intangible Development Costs and Reasonably Anticipated Benefit Share

The Proposed Regulations do not substantially change the definition of ''intangible development costs'' or ''reasonably anticipated benefit share.''[92] Further, as in the 1995 regulations, the Proposed Regulations provide that controlled participants must share the intangible development costs of the cost shared intangibles in proportion to their shares of reasonably anticipated benefits.[93] The Proposed Regulations do not substantially change the manner in which the controlled participants' reasonably anticipated benefit shares may be determined.[94]

Treatment of Equalizing Payments (CST Payments)

Although the Proposed Regulations do not substantially change the treatment of equalizing payments, they do introduce a new term to describe the transactions pursuant to which such payments are made. The Proposed Regulations thus define ''cost sharing transactions'' as controlled transactions in which the controlled participants share the intangible development costs of one or more cost shared intangibles in proportion to their respective reasonably anticipated benefit shares.[95]

Buy-In Payment Requirement (PCT Payments)

While the Proposed Regulations retain the basic concept of buy-in transactions, they introduce significant changes and additional guidance with respect to these concepts. The Proposed Regulations introduce a host of new definitional terms to articulate this guidance, including notably a term to replace buy-in transactions: ''preliminary or contemporaneous transactions,'' or PCTs. The Proposed Regulations also introduce new generally applicable principles, the investor model and the realistic alternatives principle, against which the buy-in payment must be evaluated. In addition, three new transfer pricing methods applicable to buy-in transactions are provided, and a fourth, the residual profit split method (RPSM), is substantially refined. The Proposed Regulations also set out periodic adjustment rules applicable to PCT payments that differ from those applicable to other transfers of intangibles. Each of these changes appears intended to address the concern of the IRS and Treasury that the current regulations allow insufficient buy-in payments to U.S. entities contributing pre-existing intangibles in cost sharing arrangements. If finalized, these rules will change fundamentally the manner in which buy-in payments are determined.

New Definitional Terms and Concepts

Of the new terms introduced by the Proposed Regulations, perhaps the most significant is a term replacing buy-in transactions: ''preliminary or contemporaneous transactions,'' or PCTs. A PCT is a controlled transaction by which a controlled participant (the ''PCT Payee'') is compensated for an ''external contribution'' to a CSA.[96] An ''external contribution'' consists of specified rights in any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles and that a controlled participant has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA.[97] Examples of items that could be the subject of PCTs include the contribution of traditional intangible assets such in-process technology as well as other ''resources or capabilities,'' such as an experienced research team.[98] Thus, the scope of PCTs appears to be significantly broader than that of buy-in transactions under the current regulations, and more akin to the broad description of buy-in transactions in the White Paper.

The Proposed Regulations introduce an additional concept, that of a ''reference transaction,'' to specify the rights that must be evaluated to determine a PCT Payment. A reference transaction is a hypothetical transaction that would provide the benefits of all rights (except make-sell rights, as noted below), exclusively and perpetually, in the resource or capability

[92] Prop. Regs. §1.482-7(d)(1). One change of note is that the Proposed Regulations include a self-contained definition of operating costs rather than cross reference the definition in Regs. §1.482-5.

[93] Prop. Regs. §1.482-7(a)(1).

[94] Prop. Regs. §1.482-7(e).

[95] Prop. Regs. §1.482-7(b)(2)(i).

[96] Prop. Regs. §1.482-7(b)(3)(i).

[97] Prop Regs. §1.482-7(b)(3)(ii). For purposes of this section, external contributions do not include rights in depreciable tangible property or land, and do not include rights in other resources acquired by intangible development costs.

[98] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51119-20 (8/29/05). According to the Preamble, the term ''resources and capabilities'' stops short of including a business opportunity. *Id.* at 51120.

ISSN 0148-8295

that is the subject of the external contribution.[99] A reference transaction may consist of or be structured as the provision of services, as well as the transfer of intangible property.[100] The arm's length compensation under a PCT and the applicable method used to determine such compensation must reflect the transaction and contractual terms of the reference transaction.[101]

The Proposed Regulations clarify that make-sell rights (i.e., any right to exploit an existing intangible without further development) do not constitute external contributions to CSAs. Accordingly, an arm's length compensation for these rights does not satisfy the compensation obligation under a PCT.[102] A taxpayer may, however, aggregate make-sell rights and PCT Payments where this provides a more reliable result than separate payments.[103]

General Principles: Investor Model and Realistic Alternatives Principle

The Proposed Regulations establish general guidance with respect to the application of valuation methods. Most significant is the emphasis on the 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."[104] In explaining the investor model, the Preamble to the Proposed Regulations states:

> Under the investor model, the amount charged in a PCT must be consistent with the assumption that each controlled participant is making a net aggregate investment, as of the date of the PCT, attributable to both external contributions and cost contributions, for purposes of achieving an anticipated return appropriate to the risks of the CSA over the entire term of development and exploitation of the intangibles resulting from the CSA.[105]

The Proposed Regulations note further that each controlled participant's investment in developing cost sharing intangibles under the CSA must be reasonably anticipated to earn a rate of return equal to the appropriate discount rate.[106] This return is measured over the entire period of developing and exploiting the cost shared intangibles.[107] As a consequence, the taxpayer apparently is required to allocate to the PCT Payee a return on its external contribution over the life of the cost shared intangibles, rather than the life of the intangibles that are the subject of the PCT.[108]

The determination of an appropriate discount rate is a critical element to applying the investor model. The Proposed Regulations indicate that the discount rate should "most reliably reflects the risk of the activities and the transactions based on all the information potentially available at the time for which the present value calculation is to be performed."[109] The Proposed Regulations suggest as a guide the weighted average cost of capital of publicly traded entities that carry out similar development and exploitation activities, or the taxpayer's own weighted average cost of capital if it would provide a reliable basis.[110]

Consistent with the investor model, the Proposed Regulations introduce the principle that the valuation of the PCT Payment must be based on an upfront assessment of contractual terms and risk allocations.[111] In accordance with this principle, taxpayers generally must compute the PCT Payment at the time of the PCT, and the method for determining PCT Payments in subsequent years must be consistent with the method utilized at the start. Further, the Proposed Regulations require taxpayers to document their determination of the present value of anticipated PCT Payments at the time of the PCT, and maintain such documentation for production to the IRS upon request.

The Proposed Regulations also stress that when determining the arm's length charge, taxpayers should take into account the general principle that uncontrolled taxpayers dealing at arm's length would evaluate the terms of a transaction, and would enter into the transaction only if there was no preferable alternative

---

[99] Prop. Regs. §1.482-7(b)(3)(iv). The parties to a PCT are not required to actually enter into the reference transaction that is referenced for purposes of determining the magnitude of the compensation obligation under the PCT. *Id.*

[100] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51120 (8/29/05).

[101] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51119 (8/29/05).

[102] Prop. Regs. §1.482-7(c).

[103] Prop. Regs. §1.482-7(c)(2), *Ex. 2*.

[104] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51117 (8/29/05). The Preamble describes the investor model as follows: "Under this model, each controlled participant may be viewed as making an aggregate investment, attributable to both cost contributions (ongoing share of intangible development costs) and external contributions (the preexisting advantages which the parties bring into the arrangement), for purposes 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." *Id.*

[105] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51124 (8/29/05).

[106] Prop. Regs. §1.482-7(g)(2)(viii)(A).

[107] *Id.*

[108] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51125 (8/29/05). *See also* Prop. Regs. §1.482-7(g)(2)(viii)(B), *Ex.*

[109] Prop. Regs. §1.482-7(g)(2)(vi)(A).

[110] *Id.*

[111] Prop. Regs. §1.482-7(g)(2)(ii).

ISSN 0148-8295

(i.e., the realistic alternatives principle).[112] Thus, if the total anticipated value of the PCT for any controlled participant, as of the date of the PCT, is less than the total anticipated value that could have been achieved through a realistically available alternative investment, the PCT valuations do not satisfy this principle because a rational investor would not have entered into this investment when a better alternative investment was available.[113] The realistic alternatives principle articulated by the Proposed Regulations is similar to, but more prescriptive than, the principles in the transfer pricing regulations that provide generally that the IRS may consider alternatives available to the taxpayer in determining the appropriate transfer price.[114] It is not clear whether the realistic alternatives principle of the Proposed Regulations is intended to reiterate existing law or have independent significance.

Transfer Pricing Methods for Determining PCT Payments

The Proposed Regulations set forth three new specified methods for purposes of determining the arm's length charge of PCTs: the income method, the acquisition price method, and the market capitalization method. The Proposed Regulations also provide rules for applying the RPSM, provide that the CUT method is a specified method, and allow for unspecified methods, provided they are consistent with specified principles including in the investor model and the realistic alternatives principle. This guidance represents a significant change from the 1995 regulations, which simply referred to the rules for determining an arm's length charge for the use of an intangible under Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6.

Income Method

The income method follows from the realistic alternatives principle by determining the PCT Payment to equal the present value of the PCT Payee's best realistic alternative as of the date of the PCT.[115] The Proposed Regulations provide two examples of the income method, one based on the comparable uncontrolled transaction (CUT) method and the other based on the comparable profits method (CPM), but state that the application of this method not limited to these applications.[116] The income method typically is applied in cases where only one controlled participant furnishes nonroutine contributions.[117]

Under the CUT approach, the present value of the PCT Payment is determined on the basis of the present value of the income the PCT Payee would receive under its best realistic alternative to a CSA, such as developing and exploiting the cost shared intangibles itself.[118] Under the CPM approach, the focus is on the payor of the PCT (the "PCT Payor"), rather than the PCT Payee. Under this approach, a PCT Payment is determined on a basis that allows the PCT Payor to earn a return on its anticipated cost sharing payments that would equal the market return from its activities.[119]

The CPM based income method will be applicable in most CSAs where only one controlled participant is making external contributions. This method in combination with, and as reinforced by, the investor model appears to limit the anticipated return of a PCT Payor that does not make external contributions to a normal return on its cost sharing payments. If the intangible development income from the project exceeds what is anticipated, however, the PCT Payor presumably will have a claim to a share of that income unless the periodic adjustment rules described below apply.

Acquisition Price Method

The acquisition price method is set out as a type of CUT method.[120] Under the acquisition price method, the PCT Payment is the product of the adjusted acquisition price and the PCT Payor's reasonably anticipated benefit share.[121] This method is applicable where the subject of the PCT is acquired from an unrelated party at or following the start of a CSA. The adjusted acquisition price equals the acquisition price of the assets or company acquired, plus relevant liabilities, minus the value of tangible property and any other resources and capabilities not covered by PCTs.[122]

The acquisition price method generally applies only when substantially all of the nonroutine resources and capabilities of a recently acquired target's business constitute external contributions relevant to the CSA. Thus, this method is less reliable where a substantial portion of the target's nonroutine contributions is not covered by a PCT, and that portion cannot reliably be valued, or when a substantial portion of the target's

[112] Prop. Regs. §1.482-7(g)(2)(iv).

[113] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51124 (8/29/05).

[114] *See, e.g.*, Regs. §1.482-1(f)(2)(ii).

[115] Prop. Regs. §1.482-7(g)(4).

[116] Prop. Regs. §1.482-7(g)(4)(ii)(A), (iii), (iv).

[117] Prop. Regs. §1.482-7(g)(4)(iii)(A), (iv)(A).

[118] Prop. Regs. §1.482-7(g)(4)(iii).

[119] Prop. Regs. §1.482-7(g)(4)(iv).

[120] Prop. Regs. §1.482-7(g)(5)(i).

[121] Prop. Regs. §1.482-7(g)(5)(ii).

[122] Prop. Regs. §1.482-7(g)(5)(iii).

ISSN 0148-8295

assets consists of tangible property that cannot reliably valued.[123]

The form of the PCT Payment under this method must be the same as that of the acquisition, generally a one-time lump sum payment. A lump sum cash payment is mandated under this method even where the acquisition is funded in stock, and presumably even when the acquisition is leveraged.

Market Capitalization Method

The market capitalization method is similar to the acquisition price method, with the market capitalization of the PCT Payee substituted for the acquisition price.[124] Under the market capitalization method, the PCT Payment is determined on the basis of the PCT Payee's adjusted market capitalization (daily average over the 60-day period preceding the PCT), multiplied by the PCT Payor's reasonably anticipated benefit share. The adjusted market capitalization equals the market capitalization of the PCT Payee plus the value of liabilities on the date of the PCT, minus tangible and other assets that are not covered by the PCT.[125]

The use of the market capitalization method ordinarily is limited to cases where substantially all of a PCT Payee's nonroutine contributions are covered by a PCT.[126] The reliability of this method is reduced where a substantial portion of the target's nonroutine contributions is not covered by a PCT, and that portion cannot reliably be valued, where a substantial portion of the contributing controlled participant's assets consists of tangible property that cannot reliably be valued, or where facts and circumstance suggest a material divergence between the average market capitalization and the value of the controlled participant's resources capabilities for which reliable adjustments cannot be made.[127] The market capitalization method as applied by the IRS under the current regulations has been the subject of significant criticism by taxpayers and commentators. Given the significant limitations in the Proposed Regulations, this method is unlikely to be applicable in many cases.

Residual Profit Split Method

The Proposed Regulations provide guidance on the application of the RPSM to buy-in transactions.[128] Importantly, the Proposed Regulations limit the application of the RPSM to cases in which more than one controlled participant makes significant contributions of nonroutine capabilities and resources.[129] This represents a substantial departure from the manner in which the RPSM currently is applied to cost sharing arrangements. Under current applications of the method, participants share the residual profits from the developed intangible both on the basis of preexisting intangibles and on the basis of intangibles that are developed in the cost sharing arrangement.

Where the application of the RPSM is not precluded, a three-step version of the RPSM may be applied. The first two steps allocate to the controlled participants an amount of income to provide them with a market return for their routine external contributions and their cost sharing contributions. The residual profit is allocated among controlled participants on the basis of the relative value of their nonroutine external contributions. Where only one controlled participant makes nonroutine external contributions, an application of this method would lead to the same result as the CPM approach to the income method.

The preamble cautions that any application of the RPSM not in accordance with the Proposed Regulations would constitute an unspecified method.[130] Thus, a taxpayer that wishes to apply such a method will have the burden of justifying why that method is more reliable than each of the specified methods and will face the enhanced documentation standards applicable to unspecified methods for purposes of avoiding penalties in the case of an adjustment.[131]

Form of PCT Payments

The consideration under a PCT for an external contribution generally may take one or a combination of both of the following forms — (1) fixed payments, either paid in lump sums or installments, with interest; or (2) payments contingent on the exploitation of cost shared intangibles by the payor controlled participants.[132] Consideration under a PCT for a post formation acquisition, however, must be paid in the same form as the uncontrolled transaction in which the post formation acquisition was acquired.[133] A post formation acquisition is an external contribution that is acquired by a controlled participant in an uncontrolled transaction that takes place after the formation of the CSA and that, as of the date of acquisition, is reasonably anticipated to contribute to developing cost shared intangibles (i.e., in the parlance of the 1995 regulations, an acquired intangible, as opposed to a

[123] Prop. Regs. §1.482-7(g)(5)(iv).

[124] Prop. Regs. §1.482-7(g)(6).

[125] Prop. Regs. §1.482-7(g)(6)(ii)-(iv).

[126] Prop. Regs. §1.482-7(g)(6)(i).

[127] Prop. Regs. §1.482-7(g)(6)(v).

[128] Prop. Regs. §1.482-7(g)(7).

[129] Prop. Regs. §1.482-7(g)(7)(i).

[130] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51127 (8/29/05).

[131] *Compare* §6662(e)(3)(B)(i) *with* §6662(e)(3)(B)(ii).

[132] Prop. Regs. §1.482-7(b)(3)(vi).

[133] Prop. Regs. §1.482-7(b)(3)(vi)(B).

ISSN 0148-8295

pre-existing intangible).[134] PCT Payments may not be paid in shares of stock in the payor controlled participants.[135] The form of payment selected for any PCT must be specified no later than the date of that PCT.[136]

Periodic Adjustments to PCT Payments

Significantly, the Proposed Regulations permit the IRS (but not the taxpayer) to make periodic adjustments with respect to PCTs in certain circumstances where the expectations of a cost sharing arrangement differ significantly from the outcomes. The preamble defends this position by noting the absence of comparables and the asymmetry of information between the taxpayer and the IRS.[137] The IRS may make periodic adjustments where the ratio of a controlled participant's actual profits over the present value of its investments is outside a specified range (generally twice or half of the return anticipated, with a narrower range applicable where there is inadequate documentation), and none of the exceptions (e.g., extraordinary events beyond its control and that could not reasonably have been anticipated) apply. Taxpayers may nevertheless defend an arrangement as arm's length and avoid an adjustment under the periodic adjustment rules. The ability of taxpayers to argue that the results of their arrangement is arm's length as a defense to a periodic adjustment is critical given the Tax Court's recent discussion of the commensurate with income standard in *Xilinx*, which confirmed that the commensurate with income standard is a supplement to, and not a replacement of, the arm's length standard.

The Proposed Regulations also introduce detailed, mechanical rules pursuant to which the IRS may make periodic adjustments where appropriate. Such adjustments would be made on a going forward basis, consistent with the periodic adjustment rules applicable to transfers of intangibles generally, and would be based on a modified version of the RPSM in which residual profits anticipated as of the date of the first periodic adjustment generally are allocated to controlled participants on the basis of their original external contributions.[138]

Observations on PCT Guidance

The investor model, in combination with the CPM approach to the income method, the modifications to the application of the RPSM, and the periodic adjustment rules, will limit significantly the returns of controlled participants that do not make external contributions to the CSA. In theory, the combination of these provisions will limit the expected return on cost sharing contributions to a normal return equal to a CPM return on relatively routine functions, and generally will limit the actual return to twice the CPM return in cases where the overall returns from the intangible development project greatly exceed expectations. Undoubtedly there will be questions regarding whether such a result is conceptually defensible under the arm's length standard and advisable as a matter of the exercise of the IRS and Treasury's regulatory authority. Practically, however, if finalized, the new guidance will put tremendous pressure on the accuracy of projections and the determination of variables such as the appropriate discount rate.

Allocations by the IRS

As in the 1995 regulations, the IRS may make certain allocations in connection with CSAs to ensure that the results are consistent with an arm's length result.[139] For example, the IRS may make adjustments to make intangible development cost shares align with reasonably anticipated benefit shares.[140] Such adjustments may include (1) adding or removing costs from intangible development costs, (2) allocating costs between the activity under the CSA of developing or attempting to develop intangibles and other business activities, (3) improving the reliability of the benefits measurement basis used or the projections used to estimate reasonably anticipated benefit shares, or (4) allocating any unallocated territorial interests among the controlled participants.[141] The IRS also may make adjustments to PCTs to ensure that the results are consistent with an arm's length result.[142] In addition, where CSTs are consistently and materially greater or lesser than its reasonably anticipated benefit shares, the IRS may conclude that the arrangement lacks economic substance and impute an agreement that is consistent with the controlled participants' conduct.[143]

Administrative Requirements

The Proposed Regulations also would introduce new (and modify existing) contractual, documentation, accounting, and reporting requirements.[144] Similar to the 1995 regulations, the Proposed Regulations

[134] Prop. Regs. §1.482-7(b)(3)(v).

[135] Prop. Regs. §1.482-7(b)(3)(vi)(C).

[136] Prop. Regs. §1.482-7(b)(3)(vi)(A).

[137] The audit checklist indicates that this is the position of the IRS under current law as well. *See* Audit Checklist, Doc. Set Six, C.11.

[138] Prop. Regs. §1.482-7(i)(6)(v).

[139] Prop. Regs. §1.482-7(i)(1).

[140] Prop. Regs. §1.482-7(i)(2)(i).

[141] Prop. Regs. §1.482-7(i)(2)(i)-(ii).

[142] Prop. Regs. §1.482-7(i)(3).

[143] Prop. Regs. §1.482-7(i)(5).

[144] Prop. Regs. §1.482-7(k).

ISSN 0148-8295

require that the controlled participants record a CSA in writing in a contract that is contemporaneous with the formation of the CSA and includes certain provisions.[145] A document is contemporaneous if it is signed and dated no later than 60 days after the first occurrence of any intangible development costs.[146] The controlled participants must also update and maintain certain documentation relating to the CSA[147] and establish a consistent method of accounting.[148] Finally, each controlled participant must file with the IRS a CSA Statement, which includes the identification of participants and dates of relevant activities and agreements.[149] This CSA Statement must be filed within 90 days of first incurring costs under the arrangement, and updated and filed annually with the IRS.[150]

Effective Date and Transition Rule

The Proposed Regulations will be effective as of the date on which the final regulations are published.[151] All CSAs that commence on or after that date will be subject to the Proposed Regulations, as finally revised.[152] Arrangements that are in existence prior to the date on which the final regulations are published will be considered CSAs if, prior to that date, they were QCSAs, but only if the written contract is amended to conform to the finalized regulations by the close of the 120th day after that date.[153]

CSTs and PCTs occurring prior to the date on which the final regulations are published are subject to the 1995 regulations, unless the PCT Payments become subject to periodic adjustments.[154] CSTs and PCTs that occur on or after that date, however, must comply with the substantive requirements of the Proposed Regulations as finalized (with the exception of the exclusive territorial interest requirement), as well as modified or delayed documentation requirements.[155]

Under certain circumstances, the ''grandfathered'' status of arrangements in existence prior to the date on which the final regulations are published will be revoked.[156] These include the failure to comply with the finalized regulations, as modified, a material change in the scope of the arrangement, and a 50% change in the beneficial ownership of the interests in cost shared intangibles.[157]

ISSUES RAISED UNDER CURRENT LAW BUY-IN PAYMENT REQUIREMENT

In recent years, there has been considerable controversy regarding several fundamental aspects of the buy-in payment requirement. Recent IRS guidance has helped to clarify the IRS position under current law in some of these areas, which is consistent in many respects to the principles underlying the Proposed Regulations described above. In addition, the IRS has just issued the Audit Checklist[158] and is in the process of developing settlement guidelines to address ongoing cases under current law. The Tax Court's decision in *Xilinx* also may have implications on the resolution of these issues.

This part examines the following four key issues related to the analysis of buy-in transactions based on current law, including the broader implications of the Tax Court's recent decision in *Xilinx*, with due regard to the principles of the Proposed Regulations:

- When is a buy-in payment necessary?
- What is the subject matter of the buy-in transaction?
- How may the amount of the buy-in payment be determined?
- Are there constraints on the form of the buy-in payment?

When Is a Buy-In Payment Necessary?

The regulations provide that a buy-in payment is required where ''[a] controlled participant . . . makes intangible property available to a qualified cost sharing arrangement.''[159] More specifically, the regulations state that a QCSA participant must make a buy-in payment when another participant ''makes preexisting intangible property in which it owns an interest available to other controlled participants for pur-

[145] Prop. Regs. §1.482-7(k)(1).
[146] Prop. Regs. §1.482-7(k)(1)(iii).
[147] Prop. Regs. §1.482-7(k)(2).
[148] Prop. Regs. §1.482-7(k)(3).
[149] Prop. Regs. §1.482-7(k)(4).
[150] *Id.*
[151] Prop. Regs. §1.482-7(l).
[152] Prop. Regs. §1.482-7(m)(1).
[153] *Id.*
[154] Prop. Regs. §1.482-7(m)(3).
[155] Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51132 (8/29/05).
[156] Prop. Regs. §1.482-7(m)(2).
[157] *Id.*
[158] Audit Checklist.
[159] Regs. §1.482-7(g)(1).

ISSN 0148-8295

poses of research in the intangible development area under the qualified cost sharing arrangement.''[160]

In TAM 200444022, the National Office determined whether a buy-in payment was necessary on the basis of the investor model subsequently articulated in the Proposed Regulations. Under this model, a buy-in payment is required to provide a return to a controlled participant for expenses incurred or risks assumed by performing research and development activities outside of the arrangement. As with respect to the Proposed Regulations, the IRS referenced the legislative history to the 1986 Tax Reform Act and the 1988 White Paper in support of this model.

It is unclear whether the IRS believes under current law that the investor model would *always* require a buy-in payment in cases where a participant had incurred research and development costs outside of the QCSA. For example, what if the participant's efforts had not yet resulted in the development of a commercially transferable right in an intangible? Regs. §1.482-7(a)(2) provides that ''[a]n interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation.'' Arguably, unless the transferor actually made a transfer of some valuable right to the transferee, no buy-in payment would be warranted because there is no transfer and no rights.[161] On the other hand, there may be some benefit to the transferee of the transferor's having already taken risks and performed preliminary research and development activities, and even if no commercially transferable right has resulted, perhaps the transferor should be compensated for these activities. In such a case, there may be some tension between the result under the investor model, which arguably is consistent with what parties might agree at arm's length, and the technical words of the current regulation. The Proposed Regulations address this issue on a prospective basis by explicitly providing for the investor model and specifying that resources and capabilities such as an experienced research team may be the subject of a buy-in transaction.[162]

While the investor model may have a basis both in the legislative history of the Tax Reform Act of 1986 and in economic theory, it is not clear whether the IRS could persuade a court to apply the model to buy-in transactions in the absence of clear regulatory guidance or evidence that unrelated parties incorporate such a model in similar transactions. The Tax Court's recent decision in *Xilinx* may provide some insight in this regard. In *Xilinx*, which involved the issue of whether stock option costs must be shared in the context of QCSAs, the Tax Court placed considerable weight on the taxpayer's evidence about the behavior of unrelated parties in actual transactions even though there were differences between those transactions and the related-party transactions at issue. In contrast, the court gave relatively little weight to the IRS's conceptual arguments about what independent parties considering similar transactions would have done, and noted pointedly that the IRS was unable to uncover any similar unrelated party transaction that supported its position.

Indeed, the parallels between the stock option issue considered in *Xilinx* and the buy-in issues being considered currently are enough to give government litigators pause. As noted above, in 2003 the IRS and Treasury finalized regulations providing that stock option costs must be taken into account for purposes of determining the costs that must be shared in a cost sharing arrangement, and the IRS directed the field to attempt to settle cases concerning prior tax years under the principles of the new regulations. This position resulted in litigation, and the Tax Court held against the IRS. Time will tell whether a similar fate awaits the IRS on the buy-in issue with respect to tax years before the finalization of the Proposed Regulations.

Another issue relevant to determining when a buy-in payment is necessary is whether the intangible must be ''used'' by the transferee controlled participant. In TAM 200444022, the National Office concluded that a buy-in payment is required regardless whether the ''payor'' participant ''uses'' the intangible. The taxpayer cited the technical language of Regs. §1.482-7(g)(2) (''The buy-in payment by each such other controlled participant is the arm's length charge for the *use* of the intangible . . . .'') (emphasis added) for the proposition that, because the employees of the transferee foreign subsidiary did not use the transferor U.S. parent corporation's software intangibles in its research and development activities under the QCSA, no buy-in payment was required.[163] The National Office concluded that ''actual, 'hands on' exploitation of the intangible in R&E'' is not required.[164] A participant need only make available pre-existing intangibles to the QCSA for there to be a

[160] Regs. §1.482-7(g)(2).

[161] *Cf.* Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter VIII, ¶8.32.

[162] It is the position of the IRS that resources and capabilities as defined in the Proposed Regulations constitute intangible property under current law. *See* Preamble to Proposed Regs, 70 Fed. Reg. 51115, 51120 (8/29/05) (''The Treasury Department and the IRS believe that a contribution of . . . an experienced team in place would result in the contribution of intangible property within the meaning of §1.482-4(b) and section 936(h)(3)(B)'').

[163] TAM 200444022.

[164] *Id.*

ISSN 0148-8295

deemed transfer, and as a result, for a buy-in to be required. The IRS further explained that the reference to "use" in Regs. §1.482-7(g)(2) does not indicate an actual use requirement, but rather, "indicates that the arm's length charge for 'use in R&E activities' is the benchmark for the buy-in calculation."[165] This issue does not arise under the Proposed Regulations because of the expansive definition of external contribution and the utilization of the reference transaction concept.

Although this result seems noncontroversial, one related open question is the extent to which the "use" of the pre-existing intangible by the QCSA plays a role in determining whether a buy-in payment is necessary.[166] Regs. §1.482-7(g)(2) states that "[t]he buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible." What is the result when a controlled participant makes available to a QCSA a pre-existing intangible that has significant, demonstrable value, but the QCSA determines after a careful review of the technology that it will go in another direction and incorporate another technology? Is a buy-in payment required under this scenario? Was the fact that the intangible was made available to the QCSA sufficient to require a buy-in payment even if the QCSA is considered not to have used the intangible? Further, in light of the *Xilinx* decision, what would be the result under current law if a taxpayer did not pay for the right to assess the usefulness of pre-existing intangibles on the basis of actual transactions in which unrelated parties appeared to agree to this result? Similarly, what if the IRS could not provide evidence of any actual transactions in which unrelated parties agreed to a payment in consideration for the right to assess the usefulness of intangibles? A variant of this issue also could arise under the Proposed Regulations, which provide in determining the buy-in payment that a portion of the value of intangibles that are made available to the arrangement may be allocated depending on the degree to which the intangibles are used in non-CSA related activities.[167]

What Is the Subject Matter of the Buy-In Payment?

Assuming a buy-in payment is required, the next issue to consider concerns the subject matter of the buy-in payment (i.e. the scope of "intangible property" for which a buy-in payment is required under Regs. §1.482-7(g)). For purposes of §482, an "intangible" is defined as:

> [A]n asset that comprises any of the following items and has substantial value independent of the services of any individual —
>
> (1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
>
> (2) Copyrights and literacy, musical, or artistic compositions;
>
> (3) Trademarks, trade names, or brand names;
>
> (4) Franchises, licenses, or contracts;
>
> (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
>
> (6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.[168]

Regarding buy-in payments, an "interest in an intangible" "includes any commercially transferable interest, the benefits of which are susceptible of valuation."[169] The 1988 White Paper specified:

> There are three basic types of intangibles subject to the buy-in requirement. A participant may own preexisting intangibles at various stages of development that will become subject to the arrangement. A company may also conduct basic research not associated with any product. Finally, there may be a going concern value associated with a participant's research facilities and capabilities that will be utilized.[170]

The language of the White Paper appears to be broader than that of the regulations, and therefore may be of limited utility in interpreting the regulations. For example, it may be difficult to argue that going concern value is a commercially transferable interest. This broader approach appears to have been adopted under the Proposed Regulations, particularly under an application of the acquisition price or market capitalization methods.

---

[165] *Id.*

[166] A similar issue — whether the subject matter of the buy-in includes only the intangibles that are ultimately incorporated into the developed intangibles — is discussed at some length in the following section.

[167] Prop. Regs. §1.482-7(g)(2)(xi).

[168] Regs. §1.482-4(b). Section 482 states that the term "intangible property" has the same meaning as provided in §936(h). Accordingly, the intangibles identified under Regs. §1.482-4(b) are the same as those under §936(h). Note that §936 has been eliminated for tax years beginning after Dec. 31, 2005.

[169] Regs. §1.482-7(a)(2).

[170] Notice 88-123, 1988-2 C.B. 458, 497.

ISSN 0148-8295

In TAM 200444022, the National Office took the position that a buy-in analysis applies only to "platform" rights associated with intangibles, and not "make-sell" rights, which are valued under Regs. §1.482-4.[171] "Make-sell" rights relate to the use of the pre-existing intangible to manufacture product using an existing generation technology, whereas "platform" rights relate to the use of the pre-existing intangible to develop subsequent generations of the technology under the QCSA.[172] Under the facts of TAM 200444022, the taxpayer argued that no buy-in payment for platform rights was due in addition to the royalty payments being made for the use of the make-sell rights.[173]

The taxpayer argued that Regs. §1.482-7(g)(1) requires buy-in payments for "interests" in intangible property made available to a QCSA and that Regs. §1.482-7(a)(2) defines intangible interests as "commercially transferable interests," therefore including make-sell rights.[174] The National Office agreed that make-sell rights are "commercially transferable;" however, it clarified that Regs. §1.482-7(g)(1) concerns intangible property that is made available to a cost sharing arrangement that governs the sharing of research and development costs.[175] Make-sell rights are "irrelevant" to research and development costs. As a result, the buy-in regulations "do not apply to the manufacturing, marketing, or distribution of copyrighted articles."[176] The National Office concluded that make-sell rights are properly analyzed under Regs. §1.482-4, and not Regs. §1.482-7, and that therefore an amount in addition to the royalty with respect to the make-sell rights may be due for the deemed transfer of the platform rights.[177] The Proposed Regulations reflect the position of the IRS that make-sell rights cannot be part of the buy-in transaction and that therefore, buy-in payments must be in addition to any consideration for make-sell rights.

One question that arises from this distinction between make-sell rights and platform rights is whether a buy-in payment in addition to a royalty for make-sell rights results in "double-counting." Under intellectual property law, the provision of make-sell rights may entitle the licensee to utilize the intangibles for other purposes as well, including the carrying out of further research and development. It would be incongruous to require controlled participants in a QCSA to make an additional payment for the use of platform rights when such payment is not typical or necessary in comparable commercial transactions. On the other hand, the controlled participant is entitled through its participation in the QCSA to exploit rights in addition to the rights typically granted to or used by a mere licensee of the make-sell rights. Further, in light of the *Xilinx* decision, what would be the result under current law if a taxpayer did not pay an amount in excess of the consideration for make-sell rights on the basis of actual transactions in which unrelated parties appeared to agree to this result? Similarly, what if the IRS could not provide evidence of any actual transactions in which unrelated parties agreed to a payment in excess of the consideration for make-sell rights for the right to utilize intangible assets in the development of new intangible assets?

Another issue related to the subject matter of a buy-in payment is the application of the regulations to intangibles acquired by one of the controlled participants after the formation of the QCSA. Recent IRS guidance indicates that the buy-in payment regulations apply not only to pre-existing intangibles, but also to acquired intangibles.[178] The uncertainty in this area stems from Regs. §1.482-7(g)(2), which provides that buy-in payments are required with respect to "pre-existing intangibles." This language would appear to exclude "acquired intangibles," or intangibles that a controlled participant develops or acquires independently of the QCSA and transfers to the QCSA after its formation. By contrast, Regs. §1.482-7(g)(1) speaks in more general terms, stating only that a participant must make a buy-in payment where another controlled participant makes "intangible property" available to a QCSA. The Proposed Regulations definitively resolve this issue on a prospective basis and, moreover, introduce significant limitations on taxpayers in this context by generally requiring a lump sum buy-in payment at the time of the acquisition.

In FSA 200001018 and FSA 200225009, the Chief Counsel's Office confirmed that the buy-in analysis applies to both pre-existing and acquired intangibles. In FSA 200001018,[179] the U.S. parent corporation formed a foreign subsidiary, and the two parties entered into a license agreement and a cost sharing agreement related to a product known as "Shared

[171] TAM 200444022.

[172] *Id.*

[173] *See also* Audit Checklist, Doc. Set Six, C.2 ("Licenses to unrelated third parties of limited rights to make and sell products incorporating current generation intangibles generally will not provide a comparable basis for valuing the buy-in for intangibles made available to the CSA").

[174] TAM 200444022.

[175] *Id.*

[176] *Id.*

[177] *Id.*

[178] *See* FSAs 200225009, 200001018. *See also* Audit Checklist, Doc. Set Six, C.5 ("The buy-in payment should reflect the valuation of all preexisting or acquired intangibles made available to the CSA").

[179] Note that the IRS's analysis under FSA 200001018 was governed by the 1993 temporary regulations.

ISSN 0148-8295

Systems.'' At the time the parties entered into these agreements, the U.S. parent conducted research and development primarily with respect to Technologies B, C, and D, whereas USTechCorp, an unrelated corporation, conducted research and development with respect to Technology A. The U.S. parent purchased Technology A-based components from one of USTechCorp's subsidiaries for use in its Shared Systems. After the U.S. parent and its foreign subsidiary entered into the license and cost sharing agreements, the U.S. parent purchased USTechCorp, thereby acquiring Technology A. The U.S. parent and its foreign subsidiary did not arrange for a buy-in payment related to Technology A. The IRS determined that a buy-in payment equal to the foreign subsidiary's share of the value of the intangible property related to Technology A was required because the U.S. parent had acquired Technology A ''for the purpose of maintaining leadership in the field of Shared Systems.''[180] In FSA 200225009, the Chief Counsel's Office similarly determined that the buy-in payment regulations applied equally to pre-existing and acquired intangibles. It cited Regs. §1.482-7(g)(1) as the general buy-in rule and explained that the use of the term ''pre-existing intangibles'' in Regs. §1.482-7(g)(2) does not exclude acquired intangibles.

Also in FSA 200225009, the Chief Counsel's Office determined that a buy-in payment must reflect all intangibles that a participant makes available to a QCSA, and not just the intangibles that ultimately are incorporated into the manufactured product. In this FSA, a U.S. parent corporation and its wholly-owned foreign subsidiary executed a cost sharing agreement and a license agreement related to ''Product.'' Under the license agreement, the U.S. parent transferred to the all pre-existing intangible property developed (whether fully-developed or in-process) or acquired by the U.S. parent as of the date the agreement was executed, in exchange for a royalty. The Chief Counsel's Office considered whether the value of the buy-in payment should reflect the value of all pre-existing intangible property made available to the QCSA, or whether it should reflect only the value of the pre-existing intangibles that ultimately were embedded in the manufactured product.

The Chief Counsel's Office concluded that buy-in payments should be ''valued based on the intangible property that is made available, and as a result, deemed to be transferred to the cost sharing arrangement'' and added that the determination of whether pre-existing intangible property was made available to a QCSA is a factual one.[181] The Chief Counsel's Office further elaborated:

> A buy-in payment cannot be valued based only on whether pre-existing intangible property made available to the cost sharing arrangement ultimately is incorporated into a manufactured product, since there may be value associated with the right to use other pre-existing intangible property made available to the cost sharing arrangement.[182]

In applying this analysis to the facts, the Chief Counsel's Office determined that because all of the U.S. parent's pre-existing intangible property was made available to the QCSA, the buy-in payment must reflect the entirety of this property, and not just the portion that was incorporated into the manufactured product.[183] The Proposed Regulations are consistent with the position taken by the IRS. Indeed, under the Proposed Regulations, the buy-in payment is determined on the basis of the life of the covered intangibles and not on the basis of the life or utilization of the contributed intangibles.

Several questions remain, however, with respect to this issue under current law. One question is whether the analysis of the IRS can be reconciled with the technical language of the regulations. The regulations could be interpreted to provide that a buy-in payment is required where an intangible is made available to the QCSA, but that the contributed intangible is considered for purposes of determining the buy-in payment only to the extent it is used by the QCSA. A second question is whether the result depends on, and therefore can be altered, by a careful description of the intangibles made available to the QCSA. Could a controlled participant, for example, agree to make available to a QCSA only those rights that are ultimately incorporated into the developed intangible? The Proposed Regulations appear to preclude this type of planning on a prospective basis through the utilization of the reference transaction concept.

How May the Amount of the Buy-In Payment Be Determined?

Assuming that a buy-in payment is appropriate and the proper subject matter of the buy-in payment has

---

[180] FSA 200001018.

[181] FSA 200225009.

[182] *Id.*

[183] *See also* Audit Checklist, Doc. Set Six, C.5 (''the buy-in valuation must reflect the value of all preexisting intangible property . . . made available to a CSA, and is not limited to the value of only those preexisting intangibles that ultimately are embedded in a manufactured product'').

ISSN 0148-8295

been identified, it is necessary to determine the value of that subject matter. According to the 1988 White Paper, ''The buy-in payment should reflect the full fair market value of all intangibles utilized in the arrangement and not merely costs to date.''[184] The regulations indicate that the value of a buy-in payment equals ''the arm's length charge for the use of the intangible under the rules of Regs. §1.482-1 and Regs. §§1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits.''[185] Regs. §1.482-4 provides that the arm's length charge for the transfer of intangible property may be determined under the CUT method, the CPM, the RPSM, or under an unspecified method.

There has been a considerable amount of controversy between taxpayers and the IRS on the question of which method or methods are most appropriate in the buy-in payment context. One difficulty with applying the methods specified by Regs. §1.482-4 to buy-in payments is that this regulation for the most part appears designed to address the determination of an arm's length charge for the transfer of an intangible that is currently or soon will be exploitable. This raises the question of whether the reference to these rules is reasonable and, even if so, whether taxpayers or the IRS can usefully apply the existing rules in the buy-in context. Such concerns may have contributed to the adoption by the Proposed Regulations of three specified methods in the buy-in context, and the substantial revision of a fourth method.

In FSA 200023014, the Chief Counsel's Office concluded that the so-called ''market capitalization'' approach may be considered a type of CUT in the context of an umbrella QCSA covering all of the controlled group's research and development activities. The Examination Team recommended this method as an alternative to the taxpayer's RPSM. Under the market capitalization approach, the value of a buy-in payment is based on a controlled participant's market capitalization value. This value is determined by starting with the transferor controlled participant's publicly traded stock price at the time it entered into the QCSA, then adding liabilities, and finally subtracting tangible assets and intangible assets not made available to the QCSA.[186] The theory behind the market capitalization approach is that the remaining value reflects the value of the future profitability of the transferred intangibles. This amount, multiplied by a controlled participant's benefit share, would constitute the buy-in payment.

Taxpayers and practitioners have heavily criticized this approach because of its conceptual shortcomings and because of the perception that the IRS employed such an approach with respect to tax years in the late 1990s to capitalize on the high market capitalizations of the period. The residual value determined under this approach may reflect not only the value of the future profitability of the transferred intangibles but also the value of other unidentifiable intangibles or even speculation regarding economic trends and developments that have little if anything to do with an assessment of the value of specific intangible assets. It is noteworthy that although the Proposed Regulations provide that the market capitalization method is a specified method, the Proposed Regulations include significant limitations on its application.

As highlighted by FSA 200023014, in general taxpayers have utilized variations on the RPSM, which is specified in Regs. §1.482-4 and described in Regs. §1.482-6, to determine the buy-in payment. Under the RPSM, the arm's length charge is determined in two steps. The first step ''allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity.''[187] Under the second step, ''the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution.''[188]

In FSA 200023014, the taxpayer applied a rudimentary form of the RPSM for purposes of calculating the buy-in payment with respect to intangibles transferred from the U.S. parent to its foreign subsidiary. Although the description of the taxpayer's methodology in FSA 200023014 is not clear, it appears that the taxpayer methodology essentially allocated the residual profit from cost shared intangibles to the foreign controlled participant up to the absolute amount of cost savings received by the foreign participant, thus resulting in little or no buy-in payment to the contributor of the pre-existing intangibles. In its analysis of the taxpayer's proposed transfer pricing methods, the Chief Counsel's Office faulted the taxpayer's application of the RPSM.[189] Specifically, the Chief Counsel's Office noted that the second step of the RPSM analysis requires a *two-sided* analysis of both routine and nonroutine contributions by the controlled participants.[190]

The description in FSA 200023014 of the manner in which the Examination Team considered applying the RPSM, which generally was viewed favorably by

[184] Notice 88-123, 1988-2 C.B. 458.

[185] Regs. §1.482-7(g)(2).

[186] Weissler, ''APA Program Training on Cost Sharing Buy-In Payments'' (Aug. 14, 2002).

[187] Regs. §1.482-6(c)(3)(i)(A).

[188] Regs. §1.482-6(c)(3)(i)(B).

[189] FSA 200023014.

[190] *Id.*

ISSN 0148-8295

the Chief Counsel's Office, is much more fully developed and, in fact, is consistent with the RPSM applied in the buy-in context by many taxpayers. The Examination Team started from the proposition that the proper application of the RPSM requires measuring both parties' intangible contributions and then comparing their relative values to determine the proper allocation of residual profit. In determining the relative values of the intangibles contributed by each party, the Examination Team considered agreeing that:

> FSub contributes intangibles to the extent of its past level of direct R&D as well as, after the CSA commences, to the extent of its share of the R&D under the CSA, as capitalized and amortized on an appropriate basis. USGroup would be viewed as contributing intangibles to the extent of its past and ongoing level of R&D, less cost sharing payments from FSub under the CSA after that commences, as capitalized and amortized on an appropriate basis. Importantly, under the approach presently being considered, Examination would estimate the relative value of FSub's and USGroup's respective intangible contributions with regard to their respective shares of such R&D.[191]

In general, consistent with this description, taxpayers have utilized the RPSM to measure the relative value of the pre-existing intangibles and the intangibles being developed and funded by the controlled participant to which the pre-existing intangibles were deemed to be transferred. The relative value of the pre-existing intangibles declines over time based on assumptions or observations regarding useful life or amortization/decay rate, while the relative value of the developed intangible increases over time based on the continuing funding of the costs of research and development. As applied to the determination of the buy-in payment, this method in practice can produce sharply declining royalties.

The RPSM has been criticized by some commentators as being applied to lead to results that consistently and materially understate the amount of the buy-in payment.[192] The assumptions regarding useful life and decay rate are subject to manipulation, and the application of the method does not seem to compensate the transferor for undertaking costs earlier in the process, when there may have been more risk of failure. Further, this application of the RPSM seems inconsistent with the positions taken in more recent guidance by the IRS, in particular the adoption by the IRS of the investor model and the disapproval expressed for methods of analysis that rely on a determination of the extent to which the pre-existing intangibles are incorporated into the developed intangibles. As with the market capitalization method, the Proposed Regulations significantly limit the applicability of the RPSM. Under the Proposed Regulations, the RPSM cannot be applied unless more than one controlled participant contributes nonroutine intangibles. Further, cost sharing payments are considered routine contributions under the second step of the modified three-step RPSM, resulting in an allocation of residual profits to the controlled participants that contribute nonroutine intangibles.

Commentators critical of the application of the RPSM under current law have instead suggested the use of a discounted cash flow analysis in the context of determining the buy-in payment. Under the discounted cash flow analysis, the value of a transferred intangible is determined by calculating the present value of the cash flow the intangible is expected to generate in the hands of the transferor participant in the absence of the QCSA, net of the costs of development that the will be funded by the transferee participant. The discount rate would be estimated based on the risk that the estimated cash flows will be substantially higher or lower than anticipated. Thus, higher discount rates translate to lower buy-in payments, and lower discount rates translate to higher buy-in payments. Although this approach is consistent with established economic principles, in practice it relies heavily on assumptions, including assumptions regarding estimated future cash flow and discount rate, that are difficult to estimate and subject to manipulation. The Proposed Regulations introduce a new specified method, the income method, which allows a discounted cash flow analysis. Indeed, this method appears to be the preferred method in the most common type of cost sharing arrangement — a cost sharing arrangement where only one controlled participant contributes significant intangibles.

Other commentators, however, have criticized this discounted cash flow approach as conceptually flawed because it arguably would sweep in expected profits that are not associated with transferable rights. Such commentators argue that the application of a discounted cash flow analysis could lead inappropriately to a buy-in payment based on the "transfer" of a business opportunity from one controlled taxpayer to another in a manner that would be inconsistent with cur-

---

[191] *Id.*

[192] The IRS indicated in the Audit Guidelines that it also views this method of applying the RPSM as less reliable due to its reliance on the historical costs of developing the intangibles contributed to the QCSA. *See* Audit Checklist, Doc. Set Six, C.9 ("An RPSM split with respect to relative values of contributed intangibles will . . . be less reliable to the extent it uses relative costs for purposes of the split by a comparison based on historical intangible costs to ongoing [intangible development costs]").

ISSN 0148-8295

rent case law. Finally, because the discounted cash flow method is not a method specified by the regulations, controlled groups that adopt such a method would have to meet the more stringent requirements applicable to unspecified methods for purposes of ensuring that transfer pricing penalties would not apply in the case of an adjustment.[193]

Thus, under current law, there are significant open issues relevant to the valuation of a buy-in payment. The regulations provide little useful guidance in this area. Methods asserted or applied by the IRS and taxpayers, including the market capitalization method and variations on the RPSM, have been criticized on conceptual and practical grounds. Although commentators have offered the discounted cash flow method as an alternative method, this method is not specified by the current regulations and might be difficult to apply in practice. The Proposed Regulations address these issues by providing three new specified methods and by revising a fourth method.

What Should the Form of Payment Be?

Assuming a buy-in payment is required, the form of the buy-in payment must be considered. The regulations provide that the consideration for a buy-in transaction "may take any of the following forms":

(1) Lump sum payments;

(2) Installment payments spread over the period of use of the intangible; and

(3) Royalties contingent on the use of the intangible.[194]

With respect to determining the arm's length charge for the buy-in payment, Regs. §1.482-4(f)(1) provides that where no or nominal consideration is paid and the transferor retains a substantial interest in the intangible property, the arm's length consideration "shall be in the form of a royalty, unless a different form is demonstrably more appropriate." In addition, the 1988 White Paper states:

> The buy-in payment could take the form of lump sum or periodic payments spread over the average life expectancy of contributed intangibles — perhaps on a declining basis since intangibles generally have greater value in the earlier stages of their life cycle. Obviously, periodic payments should reflect the time value benefit of not making a lump sum payment at the inception of the agreement.[195]

FSA 200001018 advises that where a taxpayer fails to provide for a form of payment, the IRS may propose a royalty. Recall that in this FSA, the U.S. parent acquired Technology A after entering into a QCSA with its foreign subsidiary, but did not arrange for a buy-in payment related to Technology A. The Examination Team proposed a royalty payable over five years, with periodic payments based on declining percentages of the foreign subsidiary's sales of Shared Systems.[196] In analyzing the propriety of this royalty, the Chief Counsel's Office stated: "Where a taxpayer fails to provide for a form of payment, the standard to be applied by the Service in making an adjustment is what unrelated parties would do in similar circumstances."[197] The Chief Counsel's Office cited 1993 Regs. §1.482-4T(e)(1) (now Regs. §1.482-4(f)(1)), and explained that a determination of form "will depend on the facts, including the economic life of the existing intangibles and their continuing value over time."[198] The Chief Counsel's Office observed that under the facts at hand, the royalty form "may gain support" from the fact that the U.S. parent and its foreign subsidiary used the royalty form when they provided for the transfer of existing technology upon entering into the cost sharing agreement.[199]

In FSA 200023014, the Chief Counsel's Office indicated that where a buy-in is structured as a royalty, this form of consideration generally will be respected.[200] The Chief Counsel's Office also suggested that where buy-in payments are structured as royalties, they should take the form of stream of commensurate-with-income royalties, extending over the useful life of the transferred intangibles.[201] As described above, under the facts of this FSA, a U.S. parent and its foreign subsidiary entered into a license agreement and a cost sharing agreement, pursuant to which the foreign subsidiary paid a royalty to the U.S. parent in exchange for specified intangible property rights.

In analyzing whether the buy-in payment must be computed as a lump sum or as a royalty, the Chief

[193] *See* §6662(e)(3)(ii).

[194] Regs. §1.482-7(g)(7).

[195] Notice 88-123, 1988-2 C.B. 458, 497.

[196] FSA 200001018.

[197] *Id.*

[198] *Id.*

[199] *Id.*

[200] FSA 200023014 applies the 1994 final §482 regulations, which did not include cost sharing regulations, but rather, stated that the 1993 temporary cost sharing regulations applied. For purposes of the IRS's analysis, these regulations do not differ from the 1995 final regulations.

[201] FSA 200023014.

ISSN 0148-8295

Counsel's Office cited Regs. §1.482-1(f)(2)(ii)(A), which provides that the IRS ''will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance.'' It also cited Regs. §1.482-1(d)(3)(ii)(B), which similarly states that contractual terms will be respected where the terms are consistent with the transaction's underlying economic substance, and Regs. §1.482-4(f)(1). The Chief Counsel's Office concluded that these regulations provide that a royalty form will be respected unless it ''does not reflect the economic substance of the buy-in transaction'' or ''a different form is otherwise demonstrably more appropriate.''[202] The Chief Counsel's Office added that the amount of the royalty remains subject to adjustment for consistency with the arm's length standard.[203]

Next, the Chief Counsel's Office considered the time period over which a royalty should extend. The Chief Counsel's Office referenced the commensurate with income standard of §482, as well as 1994 Regs. §1.482-4(f)(2), which provides that if an intangible is transferred under a multi-year arrangement, the IRS may consider all relevant facts and circumstances ''throughout the period the intangible is used.'' Based on these provisions, the Chief Counsel's Office concluded:

> [W]here a buy-in payment for a taxable year must be computed in the form of a royalty, it should generally be set at the amount of the royalty for such year in a stream of commensurate with income royalties, determined as of such taxable year, extending over the remaining useful life of the transferred intangibles.[204]

The Chief Counsel's Office also referenced Regs. §1.482-4(f)(5)(i), which provides that where intangible property is transferred in the form of a lump sum payment, the amount of the payment must equal the amount of an equivalent royalty for a taxable year. An ''equivalent royalty for a taxable year'' is defined as ''the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible.'' The Chief Counsel's Office regarded this language as further supporting its conclusion that a royalty should take the form of stream of commensurate-with-income royalties, extending over the useful life of the transferred intangibles. Note that the Proposed Regulations appear to require consideration of the life of the cost shared intangibles, rather than the contributed intangibles, in determining the buy-in payment.

FSA 200001018 and FSA 200023014 confirm that the royalty form generally will be respected; however, they leave open the question of whether there are there circumstances in which the taxpayer's chosen form of payment will not be respected. For example, what is the scope of the IRS's caveats regarding economic substance and demonstrably more appropriate forms? Furthermore, does the approval of contingent royalties mean that controlled groups may always structure the buy-in payment so that it is payable only if the research is successful? May controlled groups structure the buy-in payments so that it is payable only if the pre-existing intangible is actually incorporated into the developed intangible? The Proposed Regulations introduce a significant new limitation in this regard in the case of newly acquired intangibles (or companies). In such a case, the form of the buy-in payment must be consistent with the form of the acquisition, generally a lump sum.

Finally, FSA 200001018 indicates that the IRS may assert a buy-in payment for open taxable years even though it did not assert this requirement during prior taxable years that are now closed. In FSA 200001018, a U.S. parent and its foreign subsidiary entered into a license agreement and a cost sharing agreement, pursuant to which the U.S. parent transferred rights to pre-existing intangible property to the foreign subsidiary in Taxable Year 1. The Examination Team had reviewed and closed the taxpayer's Taxable Years 1 and 2 without asserting a buy-in payment. In its review of Taxable Years 3 and 4, however, it determined that such a payment was necessary. In concluding that the IRS may assert a buy-in payment with respect to the open taxable years, the Chief Counsel's Office explained: ''There is no equitable doctrine that precludes the Service from correcting in an open taxable year a mistake of law made in a closed taxable year. The Service may correct an error even where a taxpayer has relied to its detriment on the mistake.''[205] The Chief Counsel's Office also cited favorably the fact that there had been no assertion that the IRS had misrepresented its position during Taxable Years 1 and 2 to the taxpayer.[206]

CONCLUSION

The IRS and Treasury are devoting considerable attention to the transfer pricing issues raised by cost sharing arrangements, in particular issues raised by buy-in transactions. These issues are high stakes and conceptually difficult, and the resolution of these issues could have a significant impact on the transfer pricing principles applicable to transfers of intangible

[202] *Id.*
[203] *Id.*
[204] *Id.*
[205] FSA 200001018 (citation omitted).
[206] *Id.*

ISSN 0148-8295

property and similar transactions. The IRS and Treasury recently have articulated positions on several of these issues based in part on principles underlying recently issued Proposed Regulations. It remains to be seen whether the IRS will be more successful in applying these principles to buy-in transactions in the absence of clear regulatory guidance covering the years at issue than it has been to date in the context of the stock option issue addressed by the Tax Court in *Xilinx*. The IRS has indicated that its next step is the issuance of settlement guidelines in an attempt to resolve ongoing buy-in cases under current law short of litigation.

More broadly, it is worthwhile noting that there is no conceptual bar to the application of many of the innovations in the Proposed Regulations to the transfer pricing rules concerning transfers of intangibles more generally. Such innovations include the introduction of the investor model, the articulation of the realistic alternatives principle, and the introduction of the income method and the detailed periodic adjustment rules. Indeed, there is no conceptual reason why such guidance should not be so extended if it is determined after the regulatory comment period to be advisable in the cost sharing context. Thus, it is imperative that taxpayers and other commentators review the Proposed Regulations and provide input into the process even if they have not utilized, and do not plan to utilize, cost sharing arrangements.

ISSN 0148-8295