

USA COST SHARING REGULATIONS - 2009 UPDATE

The new temporary regulations issued by the Treasury Department and the IRS on December 31, 2008 maintain the same general principles, with respect to cost sharing, as the proposed regulations from August 2005. As expected, the temporary regulations place a much greater focus on platform contribution transactions (PCTs), previously referred to as buy-in transactions. The modifications made to the 2005 proposed regulations are expected to result in increased compensation in PCTs, and in greater ability of CSAs enacted prior to January 5, 2009 to avoid application of the new regulations.

The temporary regulations aim to curb insufficient compensation in cost sharing arrangements by emphasizing the *investor model* framework, which becomes a critical element to determine a best method for transactional analyses. The investor model concept implies that in a cost sharing arrangement, each participant's aggregate net investment should earn a return that reflects the risk associated with their respective activities under the agreement – that is, the rate of return should equal the appropriate discount rate for each participant's activities and risks over the period of the CSA. The period of a CSA is extended by the temporary regulations to include time when new intangibles may be developed by exploiting the existing cost share intangibles. This implies that even for patented products, the life of the CSA may continue beyond the patent's expiration. The concepts of a *realistic alternative* and the *best realistic alternative* also become focal points in the selection of a best method, purporting uncontrolled taxpayers would not enter into an arm's-length transaction unless no preferable alternative existed. The best realistic alternative expands upon this by suggesting that the preferable alternative for a payor in a PCT would be to license the rights to make and sell IP from a third party; and the preferable alternative for a payee would be to invest in developing the intangible themselves and subsequently license to a third party. This concept intends to cap the profit a payor may reap from a PCT at the level it would earn were it to license from a third party instead.

METHODS FOR DETERMINING PCT PAYMENTS

Building off of the proposed regulations, the temporary regulations offer five specified analytical methods for determining an appropriate arm's-length payment in a cost sharing arrangement.

Income Method

More specific guidelines are provided by the temporary regulations than previously regarding the application of the income method. This method is intended for situations in which only one controlled party to the CSA offers non-routine contributions, and it focuses more on the payor than the payee. This method is most likely to be applied by the IRS in CSAs where unreasonably high returns are being earned by a participant or participants offering no material non-routine contributions.

The income method calculates the PCT payment as the net present value (NPV) of residual income, which is defined as the payor's operating income less routine returns, including returns to routine operating intangibles. Such calculation parallels with the principle that the PCT payment should be equivalent to the payee's potential earnings from their best realistic alternative of licensing their own developed intangible to an uncontrolled party. The temporary regulations require projections in this and all other methods to be based on probability-weighted averages of possible outcomes rather than the most likely outcome, and to employ cash flows rather than projected income in analyses.

Generally, the regulations prescribe that the present value of cost sharing and the licensing alternative must be evaluated using post-tax discount rates applied to post-tax income, with adjustment to reflect the pre-tax PCT payment. However, the text provides that in some circumstances, the post-tax discount rate can be applied to a pre-tax income to determine the payment. In these cases, the regulations add a factor of one minus the tax rate to the equation, except in cases where the tax rate faced by the participant is not dependent on participation in a cost sharing arrangement versus a licensing arrangement.

Comparable Uncontrolled Transaction (CUT) Method / Comparable Uncontrolled Services Price (CUSP) Method

Following the same general structure for this method as in the proposed regulations, the temporary regulations specify stricter criteria for an agreement's qualification as a CUT or CUSP. Similarity of contractual terms, similarity of the degree to which risk allocation is proportional to reasonably anticipated benefit (RAB) shares, similarity of the period, and similarity of scope, uncertainty, and potential for profit are all requirements for use of the CUT /CUSP method.

Acquisition Price Method

This method is essentially a CUT for acquisitions. Primarily intended for PCTs resulting from acquisitions taking place after the formation of a CSA (post formation acquisitions, or PFAs), this method uses the acquisition price or relevant portion thereof in an equivalent, uncontrolled transaction to determine the arm's-length nature of the amount charged in the PCT. The reliability of this method depends on substantially all of the acquired company's non-routine intangibles being contributed to a CSA by a PCT. In these situations, the regulations now permit participants to select the form of PCT payment rather than dictating that the PCT payment must be made in the same form as the consideration paid for the acquisition.

Market Capitalization Method

Similar to the Acquisition Price Method, the Market Capitalization Method employs stock prices rather than acquisition prices to determine the value of the relevant business enterprise. As opposed to the proposed regulations, the temporary regulations prescribe the use of average stock price for the 60 days preceding a PCT, adjusted for dividends, stock splits and other occurrences as necessary. Calculated values are further subject to adjustments for liabilities, tangible assets, and the allocation of values among intangible assets not covered in the PCT.

The regulations caution that the reliability of this method is diminished in the following situations:

- A significant portion of the PCT payee's non-routine contributions to its own business activities is not covered by the PCT or group thereof, and cannot be valued reliably;
- A significant portion of the PCT payee's assets are comprised by tangible assets that cannot be valued reliably;
or
- A substantial divergence is likely between the PCT payee's average market capitalization and the value of its resources, capabilities, and rights, and such divergence cannot be corrected for.

Residual Profit Split Method (RPSM)

Intended for application only in situations where more than one CSA participant makes non-routine contributions, this method falls into a grey area of best method selection due to questions regarding at what point a participant makes a non-routine contribution. However, in this methodology, the regulations make the determination and documentation of appropriate discount rates particularly important. The temporary regulations prove more flexible than the proposed regulations, recognizing that different discount rates may apply in CSAs than in licensing transactions for two reasons: 1) CSAs may cover projects with different risk profiles than that of the unified company; and 2) the form of the PCT payment may partially dictate the appropriate discount rate.

The regulations recognize that while the reliability of this method is enhanced by the fact that it is applied to all participants under a CSA, it is also dependent on the separate reliability of data and assumptions for each participant. Therefore, the temporary regulations allow for the use of a method that depends on the results of the party for which data and assumptions are most reliable, in place of the RPSM.

Unspecified Methods

Use of methods unspecified in the temporary regulations is permitted as in the proposed regulations, provided that the method employed analyzes the benefits that would have accrued to the controlled participant had they chosen a realistic alternative to the CSA.

Aggregation of Transactions

If multiple transactions related to a single CSA and involving platform, operating, or other contributions of resources, capabilities or rights are reasonably anticipated to be interrelated, the arm's-length charge for the relevant PCTs and other transactions may be determined on an aggregate basis.

However, the regulations note that when analyzing a payment by aggregating transactions, the reliability of the result may be diminished by the inclusion of transactions where expected benefits differ from participants' RAB shares. Since a payment calculated by aggregating transactions is usually derived by allocating the aggregate value of the relevant contributions based on RAB shares, care must be taken when any transaction involving non-cost share intangibles is included.

FORMS OF PCT PAYMENTS

According to the newly-issued regulations, PCT payments may be made as a fixed amount, paid in lump sum or installments, or as a contingent payment. However, any provision for a PCT payment to be contingent upon the exploitation of a cost shared intangible will only be considered valid by the Service if the following items are clearly specified: 1) the event(s) that precipitate a PCT payment obligation; 2) the royalty base for such payment; and 3) the formula by which the PCT payment is to be calculated. Moreover, the royalty base must be one which is verifiable by records kept in the normal course of the controlled participant's business.

A fixed present value payment may be converted to a stream of contingent payments using a level royalty rate.

DIVISION OF INTERESTS AND REASONABLY ANTICIPATED BENEFITS

Previously, the regulations recognized only one basis for the division of interests among participants to a CSA: territorial or geographical bases. The new regulations provide that interests may also be divided based on field of use or on other, unspecified bases, provided that:

- The basis clearly and unambiguously divides all interests in cost shared intangibles among all the controlled participants;
- Records maintained by the participants may be used to verify the consistent use of such basis to allocate interests in the cost shared intangible;
- The rights of each participant to the cost shared intangibles are non-overlapping, exclusive, and perpetual; and
- The resulting benefits for each participant's interest in the cost shared intangibles may be predicted with reasonable reliability

Furthermore, the regulations allow for review and modification of RAB shares as apportioned above to account for changes in economic conditions, the operations of the CSA participants, and the development of the cost shared intangibles.

INTERQUARTILE RANGES AND VARIABLE INPUT PARAMETERS

Under the newly-issued regulations, interquartile ranges are still applicable for determining routine returns as part of a CPM or RPSM analysis; however, the use of variable parameters are no longer limited to these situations.

Variable input parameters are defined as those market-based variables that are, or may be adjusted to be, similar in reliability and comparability to non-variable inputs. These parameters may be used to determine the value assigned to a PCT payment. When two or more are used concomitantly to reach a PCT payment, the range of arm's-length payments is calculated by assessing the PCT payment given each possible combination of input parameters. This differs from situations where input parameters are non-variable, in which case the arm's-length PCT payment is determined using the single, most reliable value for each parameter.

This portion of the regulations becomes particularly important in situations where, for example, the arm's-length range for a PCT payment is being determined using both a comparable uncontrolled licensing royalty rate and a comparable uncontrolled discount rate to convert the lump sum PCT payment to a royalty basis. In this situation, the arm's-length range of payments would be determined as the interquartile range of a set of all payments resulting from each possible combination of comparable royalty rates and discount rates.

PERIODIC ADJUSTMENTS

The periodic adjustment trigger rules in the temporary regulations are stricter than in the 2005 proposed regulations. The regulations allow for the Service to make a periodic adjustment to the PCT payment for any open taxable year and all subsequent taxable years during the CSA in the event that a periodic adjustment trigger occurs. Under the temporary regulations, a periodic trigger occurs if, over the period from the earliest date of an intangible development cost through the end of an adjustment year, the payor realizes an actual return ratio of PV divisional operating profits to PV investments (the sum of cost contributions plus the PCT payments) that is outside the range of 0.667 to 1.5. For participants not in compliance with documentation requirements, this range is narrowed to 0.8 to 1.25. For purposes of determining present value, the applicable discount rate (ADR) is the PCT Payor's WACC, unless the Commissioner rules, or the controlled participants establish to the Commissioner's satisfaction, that another discount rate more accurately reflects the risk of the CSA activity.

Also included in the temporary regulations is a list of exceptions for the periodic adjustment rule. These include the following situations:

- A CUT exists where the same platform contributions are made to a third party on the same terms and circumstances as the PCT in question;
- Results of the return ratio reflect unanticipated and extraordinary results;
- The substitution of residual profits for divisional operating profits in the ratio calculation does not result in a trigger;
- Inclusion of years beyond Adjustment Years in the trigger analysis does not result in a trigger;
- In any year subsequent to the 10-year CSA period, the actual return falls within the period return ratio for each year of the CSA; or
- In any year subsequent to the 5-year CSA period, the actual return falls below the lower boundary of the periodic return ratio (0.667).

The Service has expressed intent to modify the regulations further to shelter from periodic adjustments trigger PCTs covered under an advanced pricing agreement (APA). However, this additional guidance has not yet been issued.

CSA DOCUMENTATION REQUIREMENTS

With respect to filings, the temporary regulations require any CSA in existence on January 5, 2009 to be amended to conform to the new requirements for such agreements. These revisions are due by July 6, 2009.

For arrangements created after January 5, 2009, each controlled participant is required to submit a "CSA Statement" no later than 90 days after the incursion of the first intangible development cost (IDC) related to the CSA, or no later than 90 days after the taxpayer becomes a controlled participant (in the case of acquisitions). A copy of the original CSA Statement must then be attached to income tax filings for each taxable year for the remainder of the CSA period, as well as annual filings of any changes made to the CSA terms. Controlled participants not required to file US income tax returns are still required to file the CSA Statement and any annual changes to schedule M of Form 5471 or 5472, or to Form 8865.

PRE-EXISTING CSAs AND GRANDFATHER RULES

The temporary cost sharing regulations enable prior-existing CSAs to avoid application of the new regulations with more ease than under the proposed regulations from August 2005. Qualified CSAs in existence as of January 5, 2009 are considered valid CSAs under the new regulations provided that the activities of the controlled participants comply with, and the written agreement is amended to comply with, the temporary regulations. To qualify for grandfathered status, pre-existing CSAs must be amended to include the following elements, many of which may have already been included despite the absence of such requirements:

- Address of each domestic entity participating in CSA or as a member of controlled group and reasonably anticipated to benefit from the use of the cost shared intangibles;
- Country of incorporation of each foreign participant to CSA or member of controlled group as described above;
- Specification of the functions and risks undertaken by each controlled participant to the CSA;
- Specification that controlled participants must use consistent accounting methods to determine IDCs and RAB shares, including foreign exchange conversions;
- Specification of date of entry into CSA;
- Specification of consequences of change in participation under CSA due to controlled transfer of interest or capability variation;

- Specification of method for calculating each participant's share of IDCs based on factors reasonably expected to reflect RAB and required updates; and
- Specification of form of payment under each PCT (or group thereof) in existence at formation and any subsequent revision of the CSA, including information and explanations reasonably supporting the analysis of applicable provisions under the new form of payment rules.

The newly-issued regulations eliminate the provision that denies grandfathering to pre-existing CSAs if the participants experienced a 50 percent change in ownership, a periodic trigger event, or a material change in scope. Furthermore, termination of a CSA is not required in the event of a material change in scope; however, periodic adjustment rules apply to any PCT occurring on or after the date of such material change. For such PCTs in connection with a CSA with grandfathered status, the periodic adjustment rules from the August 2005 regulations apply.

For IP acquired on or after January 5, 2009 and available to participants in a grandfathered CSA, PCTs are subject to valuation and transfer pricing methods of the newly-issued temporary regulations; but, except in the case of a material change in scope, the periodic adjustment rules of the proposed regulations apply here, as well.

To be eligible under grandfathering rules, pre-existing CSAs must be amended as previously described by July 6, 2009; and all controlled participants to the CSA must file a related CSA Statement by September 2, 2009.

About TPA Global

The TPA Global group is an independent and specialist provider of expert transfer pricing, tax valuation, customs and supply chain services. With our global headquarters in Amsterdam and an extensive network of our own offices and alliance partners, we cover more than 25 countries around the world. We pride ourselves in being able to provide high quality advice and assistance to multinationals of all sizes around the world, wherever they are located.

For more details of our innovative services, please visit our website at

www.tpa-global.com