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The New Temporary Cost Sharing Regulations: What Needs to be Done?

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Introduction

The newly issued Cost Sharing Regulations (§ 1.482-7T, new Regs.) replace the 1995 cost sharing regulations for determining taxable income in connection with Cost Sharing Arrangements (CSAs). The new Regs. include specific instructions regarding the calculation of buy-in payments, or "Platform Contribution Transactions" (PCTs). The new Regs. also define how Intangible Development Cost (IDC) shares related to ongoing development activities should be determined. There are new documentation and accounting requirements that are more stringent than before and require taxpayers with ongoing CSAs to act soon in conforming their CSAs to the new guidance.

A CSA in existence on 5 January 2009 may be grandfathered, in part, if, prior to this date, it was a qualified CSA under § 1.482-7 (the old regulations), but only if the written contract is amended, as necessary, to conform with, and only if the activities of the controlled participants substantially comply with, the provisions of the new regulations as modified by certain transition rules.

The New Cost Sharing Regulations (§ 1.482-7T)

A CSA is "an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of Reasonably Anticipated Benefits (RAB) from their individual exploitation of the interests in the intangibles assigned to them under the arrangement." The arm's length principle applies in determining the RAB shares of the controlled participants. In general, a CSA must provide a method to calculate each controlled participant's share of the IDCs, based on factors that can reasonably be expected to reflect each participant's share of anticipated benefits. The CSA must be recorded in a document that is contemporaneous with the formation and any revision of the arrangement.

To determine whether the allocation of IDCs is arm's length, a controlled participant's share of IDCs for the taxable year is compared with its RAB share. IDCs include all of the costs incurred by that participant related to the intangible development area, plus all cost sharing payments it makes to other participants, less all cost sharing payments it receives. RABs are benefits that a controlled participant anticipates it will derive from covered intangibles. A CSA is arm's length if each controlled participant's IDC share is approximately proportionate to its RAB share.

Platform Contribution Transactions (Buy-in Payments). A controlled participant that makes intangible property available to a qualified CSA will be treated as having transferred interests in such property to the other controlled participants. Such other controlled participants are required, if necessary, to make arm's length buy-in payments to the platform contributor.

If a controlled taxpayer that is not a controlled participant contributes to developing a cost shared intangible, it must receive consideration from the other controlled participants under the rules of the new regulations. PCTs must be made as of the earliest date on or after the CSA is entered into on which a platform contribution is reasonably anticipated to contribute to developing cost shared intangibles.

Allocations by the IRS in connection with a CSA. The IRS may make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with the arm's length principle. The Commissioner may adjust a taxpayer's Cost Sharing Transactions (CSTs) to realign its IDC share with its RAB share. PCT allocations can also be made so that the results are arm's length.

The Commissioner may make an adjustment for an open taxable year and for all subsequent taxable years for the duration of the CSA activity with respect to all PCT payments if the Commissioner determines that, for a particular PCT (the "Trigger" PCT), a controlled participant has realized an Actually Experienced Return Ratio (AERR) that is outside the Periodic Return Ratio Range (PRRR), defined as the range from 0.667 to 1.5.[1] In the event of such a trigger, the Commissioner may make adjustments to all PCT payments between PCT Payors and Payees for the Adjustment Year and all subsequent years for the duration of the CSA activity.

Grandfathering Opportunities

A CSA in existence on 5 January 2009 will be grandfathered, in part, if, prior to such date, it was a qualified CSA under §1.482-7, and if the written contract is amended by 6 July 2009 to conform to the new regulations. When grandfathering an existing agreement, CSTs and PCTs occurring prior to 5 January 2009 are subject to the provisions of the old regulations. Specifically, PCTs under a pre-existing CSA are subject to the former periodic adjustment rules of §1.482-4 (f)(2) (5-year period) rather than the rules of paragraph (i)(6) of §1.482-7T (10-year period). The new restrictions on divisional interests also do not apply to grandfathered CSAs.

The 6 July 2009 deadline requires taxpayers wishing to receive grandfathered status for their pre-existing CSAs to execute an updated CSA contract.

New economic support for the arm's length character of an existing CSA arrangement is not part of the 6 July 2009 requirement. Nonetheless, a detailed economic analysis that includes an explanation of why the selected method constitutes the best method for measuring an arm's length result as well as an explanation of the economic assumptions (including alternative methods available, projections relied upon, and discount rates applied) is part of the general CSA documentation requirements under § 1.482-7T (k)(2) and must be provided within 30 days of an IRS request.

Economic Analysis

An important consideration regarding the economic analysis is that the general valuation principle, the arm's length standard, remains valid and applies to an economic analysis conducted under both the old and new regulations. The new regulations provide more refined methods to calculate the transaction price (cost share) that would result from arm's length negotiations between unrelated parties. Results that were in accordance with the arm's length principle under the old regulations will, in general, be in line under the new regulations.

Under the new "investor model" paradigm, a CSA participant that does not contribute pre-existing "operating intangibles" that support the combined intangible development activities should not earn more than it would have earned under a realistic risk-adjusted alternative such as licensing. Thus, for example, a foreign distribution affiliate that only provides financing should not earn more than under an alternative licensing scenario in which it licenses the developed intangibles from the other participant(s).

A CSA structure that allocates disproportionately high returns to such a "cash-box" participant will not be considered arm's length under the new regulations and may not have been considered arm's length under the old regulations.[2] The main challenge under both the old and new regulations is to identify the intercompany considerations (both PCT payments and cost shares, as well as related intercompany transactions) that would have resulted from an arm's length negotiation between independent parties. From an economic perspective, this arm's length price is the same irrespective of which regulations are applied. For grandfathered CSAs, demonstrating that the economic structure, in general, complies with both the old and new regulations is the key challenge.

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1 Alternatively, if the controlled participants have not substantially complied with the documentation requirements referenced in the new Regs., the PRRR will consist of return ratios that are not less than .8 nor more than 1.25.

2 The disproportionately high returns refer to the *ex ante* price setting process when the CSA is entered. In such cases, the IRS may adjust the CSTs to achieve arm's length results. However, if extraordinary events lead to higher *ex post* returns for the involved participants, including the financing participant, adjustments are not intended by the IRS as long as such extraordinary events could not have been reasonably anticipated at inception of the CSA.

Annual Update Process

The new regulations require a taxpayer to document the methods used to estimate each controlled participant's RAB share for each year during the course of the CSA, including all projections used to estimate benefits and all updates of RAB shares. Anticipated benefits are measured either on a direct basis, by reference to additional income to be generated or costs to be saved, or on an indirect basis. Indirect measures include units used, produced, or sold; sales; operating profits; residual profits; and other bases for measuring anticipated benefits if they show a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved. The new regulations also state that "it normally will be necessary to use the present value of the projected benefits to reliably determine RAB shares."

The annual update process typically involves four steps:

1. ***Review Changes in CSA Scope***
- Participants
- Intangible Development Activities

2. ***Determine Changes in Cost Base***
- Direct Development Cost
- Allocated Overhead (incl. stock-based compensation)

3. ***Update RAB Shares***
- Update Benefit Projections
- Calculate PV of Future RABs for each Participant

4. ***Calculate Annual CST Payments***

The update process includes a review to determine if the scope of the CSA has materially changed, a determination of the IDCs connected to the intangible development activities, and an updated analysis of the RAB shares for each participant. Updating the RAB shares includes updating the projected benefits that result for each participant from exploiting the developed intangibles in the assigned territory or field of use. These projections should be made by analysts that have a clear understanding of the specific market dynamics and value drivers faced by each participant.

Conclusion

The 6 July 2009 deadline requires taxpayers who wish to grandfather their pre-existing CSAs to execute an updated CSA contract that includes a list of the controlled participants, a description of the intangible development activity, and other conforming elements listed under 1.482-7T (k)(1). A new economic analysis is not part of this contractual requirement. However, as part of the general CSA documentation requirements, a taxpayer must provide a detailed economic analysis to the Commissioner within 30 days of a request. The focus of the economic analysis under the new regulations is to apply the new investor model approach to determine arm's length CSTs and PCTs. Because the underlying arm's length principle remains unchanged, results that were considered arm's length under the old regulations may also be considered arm's length under the new regulations. A rigorous application of economic valuation principles can support this determination and produce reliable and defensible results.

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