December 4, 2006

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations For Cost Sharing Arrangements

Dear Commissioner Everson:

Enclosed are comments on Proposed Regulations for Cost Sharing Arrangements. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
    Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department
    Michael J. Desmond, Tax Legislative Counsel, Treasury Department
    Harry (Hal) J. Hicks, III, International Tax Counsel, Treasury Department
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    John Merrick, Special Counsel, Office of the Associate Chief Counsel (International), Internal Revenue Service
    Benedetta Kissel, Deputy Associate Chief Counsel (International), Internal Revenue Service
Comments on Proposed Regulations For
Cost Sharing Arrangements

These comments are submitted on behalf of the American Bar Association
Section of Taxation and have not been approved by the House of Delegates or Board of
Governors of the American Bar Association. Accordingly, they should not be construed
as representing the position of the American Bar Association.

Principal responsibility for the preparation of these comments was exercised by R. William Morgan, Rob Bossart, Daniel J. Frisch, Karl L. Kellar, Neal M. Kochman, and Victor H. Miesel. These comments were reviewed by Steve Wrappe, prior Chair of the Committee on Transfer Pricing, David Canale, current Chair of the Committee on Transfer Pricing, John Warner, Vice-Chair of the Committee on Transfer Pricing, Marc M. Levey of the Committee on Government Submissions, and Stephen E. Shay as Council Director of the Committee.

Although many of the members of the Section of Taxation who participated in
preparing these comments have clients who may be affected by the proposed regulations,
no such member (or firm or organization to which each member belongs) has been
engaged by a client to make a submission with respect to, or otherwise influence the
development or outcome of, the specific subject matter of these comments.

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EXECUTIVE SUMMARY

These comments address proposed amendments ("Proposed Regulations") to Treasury Regulations section 1.482-7 governing cost sharing arrangements ("CSAs") under section 482 of the Internal Revenue Code of 1986, as amended (the "Code"). The comments are in response to the solicitation for comments in a notice of proposed rulemaking published on August 29, 2005 in the Federal Register.

The Proposed Regulations would revise the existing Treasury Regulations under section 482 that govern qualified cost sharing arrangements ("QCSAs"). The Treasury Regulations permit taxpayers to be treated as owning, for federal income tax purposes, rights to developed intangibles in return for sharing in the cost of developing those intangibles and paying the value of pre-existing intangible property that is made available to the development process in proportion to their shares of the reasonably anticipated benefits to be derived from the developed intangibles. The preamble to the Proposed Regulations expresses concerns that taxpayers may have undervalued the intangibles and other resources that are made available to cost sharing arrangements and therefore that the parties contributing such intangibles and resources have been undercompensated for their contributions. We believe the Proposed Regulations provide a framework that would largely ensure that external contributions are adequately compensated for and that, on an ex ante basis are structured on arm's length economic terms. We therefore commend Treasury and the Internal Revenue Service for the thoughtful and rigorous effort that went into developing the Proposed Regulations.

We nevertheless believe certain modifications are worthy of consideration.

Our principal recommendations may be summarized as follows:

1. To promote simplification, the "investor model" and the specific methods for valuing external contributions should be eliminated and the valuation of those contributions should be made by reference to current Treasury Regulations section 1.482-4. The application of the investor model and the requirements of the specific valuation methods are extremely complex and are unnecessary so long as the principles of Treasury Regulations section 1.482-4 are applied to the appropriate "reference transaction" ("RT"): the transfer of all substantial rights (other than make-and-sell rights) to the contributed technology in perpetuity.

2. The separate periodic adjustment rules for CSAs should be eliminated because all necessary adjustments can be made under the existing rules of Treasury Regulations section 1.482-4. Separate periodic adjustments for the consideration for prior or contemporaneous transactions ("PCT Payments") based on variations between actual and projected results are inconsistent with the ex ante principles on which the RT concept is based, are -- due to the one-sided nature of such adjustments -- inconsistent with arm's length principles, and add substantial complexity to the cost sharing regulations.
3. The concept of external contributions, for which PCT Payments must be made, should be expanded to include contributions -- such as trademarks, installed customer base and customer lists -- that are expected to contribute to the exploitation of the cost shared intangibles.

4. Guidelines should be provided as to the appropriate tax treatment of joint development arrangements among controlled taxpayers that do not qualify as CSAs.

5. Consistent with the arm's length principle, CSA participants should be permitted flexibility as to the form that their post-formation acquisition (PFA) payments may take.

6. CSA participants should be allowed to divide cost-shared intangibles on a basis other than a territorial basis, so long as such divisions are consistent with industry practice.

7. A taxpayer's erroneous but good faith conclusion as to when a contribution is first "reasonably anticipated to contribute to developing the cost shared intangible" should not disqualify the arrangement from CSA treatment.

8. Some clarification should be provided as to the valuation of compensation costs attributable to stock options that have been converted from target corporation stock options in any acquisition by a CSA participant.

9. The "realistic alternatives" standard should take into account only those alternatives that entail risks that are substantially similar to risks in the CSA and should describe the alternatives that can be considered.

10. Taxpayers should be allowed to revise the participants' shares of reasonably anticipated benefits ("RAB shares") without such revision causing the termination of the existing CSA or creation of a new CSA.

11. If the special periodic adjustment rules for CSAs are retained, the presence of a Periodic Trigger should always be tested using the same discount rate used to convert periodic past and future sums into present values when calculating the PCT Payment.

12. The deadline for executing contracts and amendments should consider a taxpayer’s good faith but erroneous effort in determining whether the “contemporaneous” documentation requirements in for CSAs have been satisfied.

13. The transition rules now contained in the Proposed Regulations should be modified as follows:
a. Direct or indirect ownership changes in participants should not defeat the grandfathering of QCSAs;

b. Pre-regulation external contributions should not be re-evaluated under the revised regulations; and

c. Further guidance should be provided explicating the "substantial compliance" standard for determining whether QCSAs are grandfathered
**Introduction**

On August 22, 2005, the Internal Revenue Service (the "Service") issued a notice of proposed rulemaking that would amend Treas. Reg. §1.482-7, dealing with CSAs. The Proposed Regulations are lengthy and complex, and completely replace the current regulations, even to the extent of changing nomenclature. The elaborate system of nomenclature only adds to the confusion and complexity of these regulations. The Proposed Regulations also appear to reflect an unfounded belief by the Service that cost sharing as currently practiced under the existing regulations has been subject to widespread abuse and has led to generally inappropriate results.

While there may have been isolated instances of abuse under the current regulations, that has not generally been the case. Likewise, other than the on-going disputes concerning stock-based compensation costs, experience suggests that most problems have occurred in the area of the “buy-in” rather than the annual cost sharing contribution. These circumstances suggest that the total revocation and replacement of the existing cost sharing regulations is both unwise and unwarranted when potential changes to targeted areas can remedy problem areas while retaining the “simple to understand – simple to implement – simple to administer” benefits of the current cost sharing regulations.

Very generally, the current cost sharing regulations require the commonly controlled participants to allocate the costs of developing intangible property subject to the cost sharing arrangement on the basis of the reasonably anticipated benefits attributable to such development. Treas. Reg. §1.482-7(a)(2). To the extent a controlled participant makes pre-existing intangible property available to a cost sharing arrangement, the other controlled participants must make "buy-in payments," defined as the arm's length charge for use of the intangible, multiplied by each participant's share of reasonably anticipated benefits. Treas. Reg. §1.482-7(g)(1) and (2).

In recent years there has been considerable controversy concerning the proper implementation of these requirements, prompting the Service to issue the Proposed Regulations in an attempt to provide additional guidance, particularly for the determination of "the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. §1.482-1(b)(1). The Proposed Regulations, based on the premise that there are no comparable arm's length transactions that could provide a basis for making these required determinations, prescribe that the form of intercompany transfers of existing intangibles under cost sharing arrangements adopt the concept of a "Reference Transaction" ("RT") as the conceptual basis for the valuation of such transfers. Under that framework, transfers of existing intangibles are characterized as transfers of exclusive, perpetual rights subject to valuation under an "investor model."

We agree with the need for more guidance to facilitate voluntary compliance and to reduce controversy between the Service and taxpayers. We are in general agreement with the Service's view that uncontrolled transactions that are truly comparable to
controlled cost sharing arrangements are rare, if not non-existent. In fact, the same observation could apply to the rules which govern the intercompany transfers of both tangible and intangible property.

We are sympathetic to the Service's difficulty in attempting to develop regulations that achieve an arm's length result in the absence of third-party benchmark transactions. Indeed, we commend the Service's efforts in undertaking this task. But we join in the comments of other taxpayers and practitioners that the proposed regulations, if finalized in substantially their current form, will severely limit taxpayers' ability to enter into legitimate, non-abusive cost sharing arrangements, most often done for good and valid business purposes. We do not believe the Service intended that result – if it had, it could simply have repealed the cost sharing regulations, rather than issue hundreds of pages of complex new rules.

After careful consideration, we have adopted a two-track approach in our comments. First, we have made specific suggested changes to the structure and language of the Proposed Regulations. A copy of such revised Proposed Regulations (the “Edited Version”) is attached as Exhibit 1. We felt an approach based on directly editing the Proposed Regulations would make clear the importance of simplifying them so that they can be reasonably applied by the IRS and taxpayers, and would clearly demonstrate the result of this simplification (the Word document has been shortened from 102 pages to just 44 pages).

Our edited version of the Proposed Regulations (“Edited Version”) should not be construed as an attempt to re-write the regulations. We found it a helpful mechanism to provide context for our comments. Our edits are by no means exhaustive.1 But, we think the attached, revised Proposed Regulations, supplemented with this letter, will provide you with the clearest view and understanding of our concerns and approach.

Second, we decided that there were certain specific issues raised by the Proposed Regulations that needed to be addressed whether or not the structural changes that we recommended are implemented. These comments, as well as description of our proposed structural changes, are set forth below.

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1 We have attempted to edit existing examples to conform to our recommendations. We have also added a few additional examples. More examples should be added using common fact patterns to make clear the regulatory guidance. See in particular the Edited Version, §1.482-8.
Discussion

The Proposed Regulations introduce numerous concepts into the operation and administration of CSAs that are quite complex and unnecessary to ensure that CSA participants allocate developed intangible property rights among themselves consistent with the arm's length principles upon which transfer pricing is based. The Edited Version reflects our recommendations as to Proposed Structural changes that would remove these concepts from the Proposed Regulations and replace those concepts, where necessary, with references to the existing regulations under section 482.

As noted above there are also certain specific issues raised by the Proposed Regulations that we believe need to be addressed whether or not the structural changes that we recommend are implemented.

The first three items listed describe the structural changes that we recommend. The remaining items reflect our views on the technical issues that go beyond the recommended structural changes. One of those remaining items, item 11., below, is pertinent only in the event that our recommended structural change to eliminate the special periodic adjustment rules is not adopted.

1. **The "investor model" and all methods of the Proposed Regulations should be eliminated, with the standards for PCT valuations made by reference to existing Treas. Reg. §1.482-4.**

   In the Edited Version, Prop. Reg. §1.482-7(a)(2) would read:

   (2) *Methods for preliminary or contemporaneous transactions (PCTs).* The arm's length amount charged in a preliminary or contemporaneous transaction (PCT), as described in paragraph (b)(3) of this section, must be determined under the appropriate method or methods that would apply in the absence of a CSA for purposes of determining the arm's length consideration for a sale of the RT Rights pursuant to § 1.482-4. Each method must be applied in accordance with the provisions of §1.482-1, including best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), the arm's length range of §1.482-1(e), and the aggregation principle of §1.482-1(f)(2)(i), except as those provisions are modified in § 1.482-4 or paragraph (g) of this section.

   This is our primary simplifying revision, and eliminates nearly half the pages of the Proposed Regulations. Importantly, the context of PCT valuations for cost sharing purposes is retained through the RT. However, we have eliminated the investor model and the Proposed Regulations' income, market capitalization, acquisition price, and residual profit split methods.
We felt that the complexity of the Proposed Regulations could significantly reduce the utility of cost sharing. An important goal of regulatory guidance should be to permit taxpayers -- even those without the resources to hire the most sophisticated consultants -- to apply such guidance in a reasonable manner. We are sensitive to the need to balance comprehensive guidance, which can be too restrictive or contain detailed rules that lose sight of underlying policy goals, with more limited guidance, which can be subject to misinterpretation or abuse. For the Proposed Regulations, the risk of the former appears to be greater than the risk of the latter.

Complexity arises in part from attempts to develop new methods consistent with the "investor model." The investor model states that "The valuation amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in developing cost shared intangibles pursuant to the CSA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate ..." Prop. Reg. §1.482-7(g)(2)(viii)(A). As discussed below, the new methods may produce results inconsistent with the model. Specifically, the use of highly specific and formulary methods is likely to present compliance problems and needlessly to restrict a taxpayer's ability to apply the methods in a reasonable manner. For this reason, while retaining the concept of the RT, we have eliminated the investor model and the specified methods of the Proposed Regulations. For guidance on valuation methods for PCTs, we suggest cross-references to existing Treas. Reg. §1.482-4.

A. Reference Transaction

Among other provisions, Prop. Reg. §1.482-7(b) defines a CSA as a contractual agreement to share the costs of developing one or more intangibles under which controlled participants:

1. divide all interests in cost shared intangibles on a territorial basis,
2. enter into and effect cost sharing transactions ("CST") covering all intangible development costs ("IDC") and PCTs covering all external contributions; and,
3. as a result, individually own and exploit their respective interests in the cost shared intangibles without any further obligation to compensate one another for such interests. [Emphasis added.]

To regulate the notion of ownership in CSAs, the Proposed Regulations adopt a legal form of the transfer of PCTs as embodied in the RT. The RT is introduced to ensure that compensation for external contributions reflects the "full economic value" of contributed resources or capabilities. The RT is a transaction providing the benefit of all rights, exclusively and perpetually, in a resource or capability that a participant brings to a CSA. The Proposed Regulations require that the valuation of the PCT reflect the type
of transaction and contractual terms of the RT, which the preamble terms the "key concept in valuing the PCT." Preamble, C.1.

In our view, the objective of the RT is to recognize that the transfer of existing intangibles under a CSA has, in substance, the same economic effect as a sale and purchase of the intangible rights. The reason is that in substance the risk and benefits assumed by an acquirer of intangibles is similar whether characterized as a purchase or as a grant of exclusive, perpetual rights.²

By entering into a CSA, a taxpayer acknowledges that it has transferred an interest in an intangible which must be valued in a manner equivalent to a sale and purchase. If a taxpayer wishes to transfer only partial or restricted intangible rights, it has the option of not entering into a CSA and instead licensing make-and-sell rights to the existing intangibles under the methods of Treas. Reg. §1.482-4. However, if a taxpayer makes its existing intangibles available to a CSA for use in developing new intangibles, the taxpayer must recognize that each cost share participant will obtain exclusive and perpetual rights to pre-existing intangibles and therefore will be the economic owner of these rights.

The Proposed Regulations should make clear that under the RT, a PCT is treated as equivalent to, and has the same economic effect and consequence as, a purchase and sale of the contributed intangible rights. Given the complexities of Prop. Reg. §1.482-7, we recommend that the valuations of PCTs under this rule be made by cross-reference to existing Treas. Reg. §1.482-4, which governs any other sale of intangibles to a related party, with which taxpayers are already familiar, and with respect to which an established body of law and administrative practice already exists.

B. Complexity of Methods

The formulary nature of the methods in the Proposed Regulations (consisting of the income method, acquisition price method, market capitalization method, and residual profit split method) present the appearance of intercompany pricing under a safe harbor rather than the arm's length standard. Indeed, use of such methods appears to be directly contrary to the stated goal of the Proposed Regulations to reinforce the notion that cost sharing is to be governed by the arm's length standard. The Preamble to Prop. Reg. §1.482-7 states that "Transactions in connection with a CSA must produce results consistent with the arm's length standard. The Proposed Regulations, therefore, dispel the misconception that cost sharing is a safe harbor." Ultimately, therefore, the valuation of PCTs must abide by the arm's length standard. This is a critical feature of the Proposed Regulations, but the specific, formulary guidance for application of each method can be -- or at least appear to be -- inconsistent with the arm's length standard and the investor model. For example, the income and residual profit split methods derive PCT valuations on a pre-tax basis using the present value of territorial operating profits,

² The grant would also include provisions such as termination by acquirer only, unlimited fields of use, sublicense rights and other provisions which effectively shift full risk and benefits to acquirer.
while the market capitalization and acquisition price methods result in after-tax values using cash flows. These inconsistencies lead to uncertainty when trying to interpret the investor model and apply valuation methods that agree with it. Consequently, the formulary nature of the methods would create unintended problems with the methods' applications and the investor model's interpretation, particularly for methods that may not fit the facts and circumstances in every case. This problem recommends more general, rather than specific, guidance, particularly for PCT valuations.

We feel that this can be achieved by cross-reference to existing Treas. Reg. §1.482-4 for PCT valuation methods. The primary difference between the methods of the proposed regulations and the methods under the existing regulations is the requirement that rights be transferred under terms of the RT. Accordingly, the existing regulations could be modified, and more examples included, to provide guidance when exclusive, perpetual rights are transferred. For example:

- The income method using the CPM bases an arm's length PCT payment on an "applicable rate" applied to sales. The applicable rate is equal to an alternative rate less a cost contribution adjustment. The alternative rate is calculated, in part, by reducing future anticipated territorial profits by market returns for routine contributions and discounting to present value. This method is similar to the estimation of a royalty rate when applying the CPM method under the existing regulations, but the income methods require examination over a longer period of time as dictated by the RT rights.

- As stated in the proposed regulations, both the market capitalization and acquisition price methods represent application of the comparable uncontrolled transactions ("CUT") method. The primary difference from conventional CUTs is that these methods calculate present value directly (rather than as royalty rates) and typically under an assumption of exclusive, perpetual use (i.e., consistent with RT rights).

- The residual profit split method has been modified in the proposed regulations to account for the long-term nature of the transfer of RT rights.

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3 Prop. Reg. § 1.482-7(g)(4)(iv)(B).

4 Prop. Reg. § 1.482-7(g)(5)(i) and Prop. Reg. § 1.482-7(g)(6)(i).

5 Prop. Reg. §1.482-7(g)(7)(i) states that "The residual profit split method may not be used where only one controlled participant makes significant nonroutine contributions to the development and exploitation of the cost shared intangibles" [emphasis added]. "Cost shared intangibles" are defined to mean any intangible developed or to be developed as a result of the IDA (see Prop. Reg. §1.482-7(j)(1)(ii)), or the intangible development area in which costs are incurred under the CSA for developing or attempting to develop intangibles (see Prop. Reg. §1.482-7(d)(1)). Under a cost sharing arrangement for the sharing of future research and development expenses, the definition of cost shared intangibles would exclude potentially valuable marketing intangibles used by one or both of the controlled parties. It would seem that the residual profit split method may well be an appropriate method to apply when one party contributes technology intangibles to a CSA, and the other party owns valuable marketing intangibles which it does not contribute to the CSA but uses to exploit the cost shared technology in its territory. However, guidance
Each method, albeit in slightly different form, is already included in the existing regulations. As discussed above, we recommend that the Proposed Regulations provide general valuation concepts for intangible transfers to CSAs (consistent with RT rights), and then provide additional examples in Treas. Reg. §1.482-4 for how such transfers might be valued. Such an approach eliminates the implication that the highly structured methods of the Proposed Regulations are the only "right" way to determine PCT values and allows taxpayers to apply well-know valuation techniques in a manner that fits their particular facts and circumstances.

2. The periodic adjustment rules should be deleted from the Proposed Regulations.

Another significant simplifying feature of the Edited Version is elimination of separate periodic adjustment rules under Prop.Reg. §1.482-7. This eliminates a separate set of complex periodic adjustment rules, which already exist under Treas. Reg. §1.482-4 in simpler form. Revision of existing rules is preferable to a redundant set of rules.

If payment for external contributions under an RT is to have the same economic effect and consequence as a sale of the resources or capabilities deemed to be transferred, the parties should not be able to adjust the payment based on differences between forecasted and actual results of intangible exploitation.6 Consistent with this principle, under the Proposed Regulations the taxpayer is stuck with its bargain and may not adjust results based on success or failure of the intangible development activity. Under the Proposed Regulations, there is no parity as the Service does not suffer this limitation. This "one-sided" rule, as currently proposed, is inconsistent with the principle behind RT and could, in our judgment, significantly reduce the utility of cost sharing. Moreover, the complexity of the rule would make it difficult for taxpayers to apply.

A. One-sided Adjustment and the RT Principle

The Proposed Regulations incorporate a one-sided periodic adjustment provision that enables the Service to adjust the returns earned by cost sharing participants when ex post outcomes are significantly different from ex ante expectations.7 In general, “significantly” for this purpose means a return that is more than twice or less than half of what was expected from exploitation of a pre-existing intangible (reduced to .67 to 1.5 for those who do not comply with the regulations’ documentation requirements). If an adjustment is warranted, it is made by applying a modified residual profit split method to the current year and all subsequent years.

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6 Evidence may be available in some cases showing that at arm's length parties negotiate a change in compensation contingent upon differences in forecasted and actual results.

7 See Prop. Reg. §1.482-7(i)(6).
A criticism of the new proposed rule that has been made by other commentators is that it would be one-sided. That is, the Service could make adjustments if expectations were exceeded, but participants would not be allowed to adjust for failures. Arm’s length parties would not agree to limit their upside without attempting to insulate their downside. The Service's response has been that the adjustment capability is one-sided to account for “information asymmetries” and that participants can protect the downside by entering into contingent agreements. That is to say, the Service seems to contend that, because a taxpayer knows its business better than the Service, it can structure its cost sharing deal on a basis that would preclude the need for its own periodic adjustments (e.g., automatic compensation adjustments).

Unfortunately, this rationale for the one-sided period adjustment is inconsistent with the spirit of transferred RT rights, and raises more questions about the true aim of the Proposed Regulations as an accurate interpretation of the arm's length standard.

As discussed above, we interpret the RT as a mechanism to recognize that the transfer of existing intangibles under a CSA has, in substance, the same economic effect as a sale and purchase of intangible rights. If this is true, and if the goal of the Proposed Regulations is to align this legal form with an arrangement's true economic substance, then the ability of a taxpayer annually to renegotiate the compensation contingent upon results to date would thwart the intended economic substance. The reason is that a long-term, exclusive arrangement (the form of RT rights), but with contingencies for allowing adjustment of future compensation, is no different -- from an economic point-of-view -- than a series of short-term agreements where compensation terms can be renegotiated upon termination (or the threat of termination). The goal of short-term agreements, or longer-term agreements with specific termination clauses and renegotiation rights, is to limit the risk of each party's uncertainty.\(^8\) The goal of cost sharing, as we understand it, is to ensure that each party develops an equity-type interest in intangibles to be developed and incurs all associated risks, including the risk of uncertain outcomes from exploiting the covered intangibles. It would be inconsistent with this goal to require taxpayers to enter into perpetual, exclusive agreements, but then require or allow them to provide contingencies for protection from bad outcomes. For such protection, a taxpayer could simply make available the existing intangible rights under a series of short-term licenses under Treas. Reg. §1.482-4.

For clarity and equity, we recommend that taxpayers and the Service be prevented from making periodic adjustments for differences in anticipated \textit{ex ante} and actual \textit{ex post} results under cost sharing. This recommendation would require revisions to Treas. Reg. §1.482-4(f)(2)(ii) to permit exceptions for cost sharing. We recognize that "information asymmetry" may present problems upon audit of cost sharing arrangements, and discuss below what other methods might be available to mitigate the effects of such asymmetry.

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\(^8\) See, for example, the discussion in Appendix D of the 1988 Treasury/IRS "Study of Intercompany Pricing" (the "White Paper"), IRS Notice 88-123, 1988-2 C.B. 458, 526-27.
B. Complexity of Periodic Adjustment Rules

The complexity of the periodic adjustments section of the Proposed Regulations is untenable and overwhelming. As discussed above, we are sensitive to the desire to provide detailed guidance in an attempt to limit misinterpretation or abuse, but the proposed periodic adjustment provisions are much too complex and would place a tremendous compliance burden on taxpayers. In part, this complexity stems from an uncertain, or at least unclear, theoretical basis for the periodic adjustment mechanism.

The preamble to the Proposed Regulations states that:

The proposed regulations build the CSA periodic adjustment provision upon the previously discussed investor model. The taxpayer's arrangement will be respected so long as the controlled participants’ actually experienced return ratio ("AERR"), equal to the present value of its actually experienced operating profits from exploiting cost shared intangibles divided by its investment in the CSA (consisting of the present value sum of its cost contributions and PCT payments), is within a specified periodic return ratio range ("PRRR"). The PRRR provides a band of comfort for actual return ratios of no more than 2 and no less than 1/2 ...

The AERR mechanism includes actual income from both the PCT payments and the cost contributions through the "adjustment year." It is consistent with a valid investor model to expect PCT payors to anticipate earning an arm's length return on an ex ante basis. However, it is inconsistent with a valid investor model to require CSA participants to earn a given rate of return (or even a specific range of returns) on an ex post basis, because the participants share in the risks of developing the intangibles. Therefore, it is not consistent with an investor model to test the PCT payment using a mechanism that includes ex post income attributable to both the pre-existing intangibles and intangibles developed under the CSA. Furthermore, any trigger mechanism intended to test the actual return attributable to the PCT payments alone would be difficult, if not impossible, to administer in light of ongoing cost contributions.

C. Alternatives and Limitations to Periodic Adjustments

We understand that information asymmetry would remain a concern even if the existing periodic adjustment rules of Treas. Reg. §1.482-4 were applied to CSAs. We offer the following alternative methods to reduce the potential of taxpayer abuse, and understand there may be other, equitable ways to limit opportunities for abuse.

- It is not clear that "information asymmetry" exists in the face of market-determined prices. Applications of a CUT method – like the market capitalization and acquisition price method -- rely on market-based information. At a minimum, therefore, PCT valuations using these methods (and possibly others) should be exempt from periodic adjustments.

- The most direct way to combat information asymmetry is to require that the valuation of external contributions be documented contemporaneously with the
CSA start date. Therefore, the CSA regulations should contain a thorough set of documentation requirements for PCT valuations similar to the documentation requirements under the section 6662 regulations.

- Require that the valuation of external contributions be subject to penalties under section 6662(e) and the "reasonableness" standard of the section 6662 regulations. See Treas. Reg. §1.6662-6(d)(2)(ii).

3. "External contributions" should be expanded to include "external exploitation contributions" as well as "external development contributions" under Prop. Reg. §1.482-7(b)(3)(i)-(iii).

An "external contribution" is defined in Prop. Reg. §1.482-7(b)(3)(ii) as "any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles and that a PCT Payee has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA." [Emphasis added.] This definition of external contributions excludes other resources or capabilities from which a PCT Payor may derive benefit, but which do not contribute to developing cost shared intangibles. As examples, a PCT Payor may derive benefit from the following resources or capabilities of the PCT Payee:

- Trademarks and trade names
- Customer lists, relationships, and goodwill
- Installed base of customers
- Experienced sales force

Consequently, in the Edited Version a PCT must be paid not only for a "resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles," but also those resources and capabilities which are expected to contribute to their exploitation. This change makes explicit that PCT Payors should compensate PCT Payees for valuable, non-development intangibles from which the PCT Payor derives benefit.

We have edited the relevant language in Prop. Reg. §1.482-7(b)(3) so that it would read as follows:

(3) PCTs -- (i) In general. A PCT is a controlled transaction in which each other controlled participant (PCT Payor) is obligated to compensate a controlled participant (PCT Payee) for external development contributions and external exploitation contributions of the PCT Payee.

(ii) External development contributions. An external development contribution consists of the rights set forth under the reference transaction (RT) in any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles and that a PCT Payee has developed, maintained, or acquired
externally to (whether prior to or during the course of) the CSA. For purposes of this section, external development contributions do not include rights in depreciable tangible property or land, and do not include rights in other resources acquired by IDCs. See paragraphs (b)(2) and (d)(1) of this section. Whether and when a contribution is "reasonably anticipated to contribute" to the development process is a matter of facts and circumstances. See Examples (1) and (3) of paragraph (b)(5)(iii).

(iii) External exploitation contributions. An external exploitation contribution consists of the rights set forth under the reference transaction (RT) in any resource or capability that is reasonably anticipated to contribute to exploiting cost shared intangibles and that a PCT Payee has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA. For purposes of this section, external exploitation contributions do not include rights in depreciable tangible property or land, and do not include rights in other resources acquired by IDCs. See paragraphs (b)(2) and (d)(1) of this section.

The point of this revision is to ensure that, like transactions between unrelated parties, cost share participants are compensated for any contributions they provide and pay for any contributions from which they derive benefit. Contributions need not relate only to "developing cost shared intangibles," but may also relate to exploitation of those intangibles.

Examples 1 and 2 of Prop. Reg. §1.482-7(b)(3)(viii) have been edited to make clearer the transfer of RT rights in exploitation intangibles. In Example 1, a software manufacture permits its subsidiary access to its established base of customers, sales to which are facilitated by the "look and feel" of and a similar command structure to existing products. The RTs in this example, as edited, would be the perpetual and exclusive provision of the benefit of all rights in the prior version of the software and its pre-existing exploitation intangibles. These intangibles may include the brand name under which the software is marketed, customer training materials, and access to the customer base to which future versions will be sold. In Example 2, as edited, a parent and its subsidiary share the IDCs for a research team in developing a new vaccine. In this case, the subsidiary already has an established sales force which marketed and sold similar products to health care professionals in its territory. Further, the new vaccine will be sold under a brand name not currently in use by the parent or subsidiary. Based on an analysis of the exploitation intangibles, the taxpayer determines that the value of the parent's external exploitation contributions for the subsidiary's territory is zero. Consequently, the RT in this case is the perpetual and exclusive provision of the benefits by the parent of its research team in the development of the cost shared vaccine only since no external exploitation contributions have been made by the parent.

As an alternative to defining a new class of exploitation-related external contributions (as defined above), these contributions could be specifically excluded from PCT payments in the same manner that "make-or-sell rights" are excluded from external
contributions under Prop. Reg. §1.482-7(c)(1). The goal under either formulation would be to highlight the fact that PCT Payors may derive benefit from other intangible assets effectively contributed by PCT Payees but not covered under the current definition of an "external contribution." PCT Payors would have responsibility for compensating PCT Payees for use of such intangibles, and would estimate that compensation under the rules of existing Treas. Reg. §1.482-4.

As described in Prop. Reg. §1.482-7(g)(2)(v), a best method analysis may determine that the method that provides the most reliable measure of an arm's length charge for multiple PCTs and other transactions not governed by the proposed cost sharing regulations, if any, is a method that determines the arm's length charge for the transactions on an aggregate basis. Therefore, taxpayers need not separately value external development contributions, external exploitation contributions, make-or-sell rights, or any other specific intangible from which a cost share participant derives value. Rather, these intangibles can be valued in total if such a method produces more reliable results.

4. Guidance is needed for joint development arrangements that are not CSAs

If an arrangement for the joint development of intangibles does not satisfy the specific requirements for CSA treatment set forth in the proposed regulations, the Preamble indicates that the arrangement would be subject to review under the general principles of section 482 other than the CSA rules. While not entirely clear, the statement appears to have been made to express the possibility that a controlled party joint intangible development arrangement that does not satisfy the requirements for CSA treatment may nonetheless be given effect for tax purposes if it comports with the arm's length standard.

We believe that the Service's openness to giving effect to cost sharing undertakings that are not CSAs is a welcome development. However, we are concerned that neither the proposed cost sharing regulations nor the current section 482 regulations provide any assurance that these arrangements will be respected or any guidance as to how section 482 would be applied if the cost sharing rules are inapplicable. The only apparent guidance in the current regulations is in Treas. Reg. §1.482-4(f)(3)(ii)(B), which provides that, in the case of an intangible that is not subject to legal protection -- as would appear to be the status of an intangible under development -- only one party, the "developer," can be treated as the owner of the item while all other parties that contribute to the development are considered "assistors," entitled only to be compensated at an arm's length rate for their development efforts. If that is in fact the way arrangements that are not acceptable CSAs are to be treated, joint ownership of a developed intangible will not be respected even if the arrangement closely resembles actual uncontrolled joint development arrangements or is based upon uncontrolled joint development models. To follow through on the language in the Preamble, the non-CSA section 482 regulations should be expanded to provide at least some assurance that joint development-and-ownership arrangements that do not qualify as CSAs will be respected in appropriate circumstances.
5. CSA participants should be allowed flexibility as to the form of post-formation acquisition ("PFA") payments

Although the proposed regulations would permit CSA participants to choose among a variety of forms in structuring most PCT Payments, those regulations would limit the form of the consideration for any external contribution acquired by the contributor after the CSA was formed to the form of consideration paid by such contributor.\(^9\) The form of consideration for these Post-Formation Acquisitions (PFAs) that were acquired with stock would have to be in cash.\(^10\) Thus, when a participant made a PFA in exchange for cash or stock payable at closing, the PCT Payors would be required to contribute their respective shares in the form of a lump sum cash payment. The Preamble to the proposed regulations indicates that the reason for so limiting the form of consideration for PFAs is to ensure that the cost and risks associated with the PFA are borne in proportion to the participants' RAB shares.

By so limiting the form of PCT Payments for PFAs, the proposed regulations would inappropriately deviate from the arm's length principle and could arbitrarily restrict the availability of CSA treatment without materially furthering the purpose or administrability of CSAs. A basic element of the arm's length standard as implemented by the current section 482 regulations is that related party taxpayers have the right to structure intercompany transactions as they see fit, provided there is economic substance to the transaction so structured.\(^11\) There are clearly legitimate business and economic reasons -- including cash flow considerations -- why, at arm's length, uncontrolled parties might not choose to structure the form of payment for an immediate re-transfer of intangible rights in the same form used by the transferor in acquiring such rights. Those considerations, in fact, may be the reason that the acquisition was not made jointly by the related party participants. Forcing PCT Payors to pay up front lump sum cash consideration for PFAs is likely to discourage full utilization of CSAs. Many such participants will not have the requisite cash on hand or access to capital to make such payments.

There is little reason to single out PFA payments for special treatment. The same concern that PCT Payments be in proportion to the PCT Payors' RAB shares is inherent for all external contributions, even those not attributable to PFAs. Although the consideration for external contributions that are not PFAs is not necessarily connected to the contributor's acquisition cost, nonetheless, the PCT Payments, properly valued, must be in proportion to the PCT Payors' RAB shares. However, the Proposed Regulations do permit the PCT Payments for non-PFA external contributions to be in any of a number of forms, including annual payments, provided that the value of total payments reflects the PCT Payors' RAB shares using an appropriate discount rate. Flexibility in the form of consideration for the re-transfer of intangible rights is built into the arm's length principle, most notably as applied in section 367(d). Under that provision, notwithstanding that intangible property may be acquired for a lump sum consideration in

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an uncontrolled transaction, the relevant regulations permit the section 367 "commensurate with income" tax consequences to be based on a royalty or annual payment model. The same arm's length considerations could be brought to bear in respect of PFAs without materially undermining the principle that the cost of such PFAs should be borne in proportion to the PCT Payors' RAB shares.

6. The Proposed Regulations should be revised to allow taxpayers to divide cost shared intangibles on other than a territorial basis, and should include examples based on industry practice.

The Proposed Regulations contain very specific requirements for determining whether an arrangement for the development of intangibles is a CSA. Included in the CSA criteria is the requirement that each participant be given the exclusive rights to exploit the cost shared intangible in one or more geographic territories (that consist of one or more countries). The Preamble invites comments as to other possible ways of allocating rights to the cost shared intangibles that would not present difficulties in accurately measuring and devising reliable projections for, and accounting for profits derived from, each participant's exploitation of the developed intangibles.

We believe that the Proposed Regulations should be modified to permit participants in appropriate cases to own rights in the cost shared intangibles on a non-territorial basis to avoid introducing an arbitrary restriction on the availability of cost sharing treatment. Exclusive territorial ownership of the rights to cost shared intangibles is required neither by the arm's length standard nor the need to ensure that CSAs are not used to circumvent the rules governing intercompany transfers of intangibles. At arm's length, it is quite common for owners of intangibles to license those rights on a nonexclusive basis within various countries or other geographic locations. These arrangements may, however, be exclusive on a product line-by-product line, medium of delivery-by-medium of delivery or finished product-vs.-component basis. In these and other situations in which the rights of uncontrolled licensees are often not defined in terms of exclusive geographic rights, the intangible owner, particularly where it exploits the intangibles in the same territory as its licensee, must feel comfortable with the projections of likely sales or profits when it sets the royalty, license fee or other consideration. Moreover, in many cases, a nonexclusive right to use an intangible may be necessitated by legal requirements, such as antitrust considerations or technical standards-driven considerations. To require that a cost shared intangible be exploited on an exclusive territorial basis in these circumstances would be to deny CSA treatment without regard to the legal, technical and economic environment in which intangibles are developed and exploited.

Since comparable uncontrolled transactions are rarely, if ever, found in the context of cost shared intangibles, industry practices provide real world experiences that can be identified, measured, and evaluated. If industry practices allow a patent with potentially multiple applications to have only one or some of those applications as the

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12 Treas. Reg. §1.367(d)-1T(c).
13 Prop. Reg. §1.482-7(b)(4).
subject of a CSA which divides the rights on a territorial basis, rather than all rights and applications in the patent, the CSA should be respected. Likewise, each industry should be able to have the opportunity to identify ways that intangibles can be subdivided on a basis other than the entirety of the intangible territorially.

7. **The Proposed Regulations should be revised to provide that a taxpayer's erroneous but good faith conclusion as to when a contribution is first "reasonably anticipated to contribute to developing the cost shared intangible" will not disqualify the arrangement from CSA treatment.**

As the Proposed Regulations are structured, a taxpayer that makes an external contribution to an arrangement but does not enter into a written contract covering that contribution within 60 days of the date that the contribution is first "reasonably anticipated to contribute" to the arrangement risks losing CSA treatment, regardless of the reason for that failure. Prop. Reg. §§1.482-7(b)(3), 1.482-7(k)(1)(i) and (iii). As a result, when a participant makes available a resource or capability that is not initially anticipated to contribute to development, but that later is anticipated to contribute to development, a finding that the contribution should have been "reasonably anticipated to contribute" to development sooner than the participants so concluded would jeopardize CSA treatment for the entire arrangement. This risk seems unduly harsh, given that whether and when a contribution is "reasonably anticipated to contribute" to the development process is a matter of facts and circumstances. To disqualify an otherwise qualifying arrangement as a result of a good faith, but erroneous, conclusion as to when a contribution was first likely to contribute to the development process would seem to be a trap for the unwary.

Therefore, the participants' amendment of the contract governing an arrangement within 60 days of their good faith conclusion that the relevant resource or capability was first "reasonably anticipated to contribute" to development should be sufficient to satisfy the documentation requirements with respect to such contribution.

8. **An additional example in Prop. Reg. § 1.482-7(d)(5) should be added to provide clarification of the valuation of stock options in acquisitions.**

Under the proposed additional example that we recommend, a publicly traded Parent Company with a CSA acquires a Target Company with R&D employees who had Target Company options that are converted to Parent Company options valued by reference to P’s shares on the date of acquisition. Further, all of the Target’s researchers work on both the project which is the subject of the CSA as well as other (non-CSA) research projects. The amount of the exercise premium that becomes part of the CSA’s Intangible Development Cost pool when a former Target researcher exercises her Parent Company stock options requires a two-step calculation.
First, only the increase in the post-acquisition premium is taken into account because the Target researchers neither were Parent Company employees prior to the acquisition nor were working on the subject of Parent Company’s CSA. Second, because each researcher began to work on both CSA research projects and non-CSA research projects, the post-acquisition premium determined in the first step above must then be appropriately allocated between the time spent on CSA research projects and non-CSA research projects to calculate the amount of the exercise premium that becomes part of that year’s IDC pool.

9. The "realistic alternatives" standard in Prop. Reg. §1.482-7(g)(2)(iv) should not take into account alternatives that entail significantly different risks than the CSA and should describe the alternatives that can be considered.

Prop. Reg. §1.482-7(g)(2)(iv) explains the "realistic alternatives" principle as follows:

(3) Realistic alternatives. (i) In general -- Regardless of the method or methods used, evaluation of the arm's length charge for the PCT in question should take into account the general principle that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of a transaction, and only entered into a particular transaction, if no alternative is preferable. This condition is not met, for example, where for any controlled participant the total anticipated present value from entering into the CSA to that controlled participant, as of the date of the PCT, is less than the total anticipated present value that could be achieved through an alternative arrangement realistically available to that controlled participant. When applying the realistic alternatives principle, the reliability of the respective net present value calculations may need to be considered.

In concept, the principle that the amount or value of a PCT Payment should consider the present value of the "alternative arrangement[s] realistically available to" each participant is consistent with the arm's length standard as applied throughout the section 482 regulations. As we have noted, an external contribution of intangible rights to a CSA is the economic equivalent of a purchase and sale of the contributed rights (i.e., the transfer of exclusive perpetual rights, other than the make-and-sell rights, used in developing the cost shared intangible). However, the proposed regulations leave some significant gaps as to the proper application of this principle.

A. Realistic Alternatives Taken into Account Should be Limited to Courses of Action That Involve Similar Risks to the PCT Payee

The statement of the "realistic alternatives" principle in the Proposed Regulations does not appear to limit the type of alternative structures that should be considered. The alternatives that can be considered should be limited to alternative methods of developing and exploiting the cost shared intangible that, from the point of view of the contribution of the external contribution of the PCT Payee, entail a degree of risk similar to that undertaken by the PCT Payee under the CSA. This would ensure that the business judgment of the taxpayer concerning that risk is respected and that the return to the PCT Payor truly reflects the type of risks actually undertaken by it, as is required in Treas. Reg. §1.482-1(d)(3)(iii). The notion that the arm's length return to the taxpayer from one
means of developing and exploiting an intangible (i.e., cost sharing) can be dictated or judged in relation to an entirely different development and exploitation strategy is contrary to the arm's length standard. It would seem improbable at best that reliable adjustments could be made to take into account such significant differences.

**B. Further Guidance is Needed as to Which "Realistic Alternatives" Would be Considered**

It would appear that the "realistic alternatives" principle should apply only by taking into account, on an *ex ante* basis, the projected results under the appropriate alternative methods of developing and exploiting the cost shared intangible. The Proposed Regulations should explicitly state the *ex ante* nature of the "realistic alternatives" evaluation.

The Proposed Regulations do not provide any guidance as to what alternative transactions are to be taken into account in applying the principle. Thus, it is not clear whether only those alternatives actually considered and analyzed by the taxpayer prior to entering the CSA may be taken into account, or whether alternatives that are deemed by the IRS to be realistic must also be taken into consideration. At a minimum, the regulations should require that projections as to the present value of alternatives to be taken into account be based on data that were available to the taxpayer at the time it made its decision to undertake the CSA.

Finally, we believe that the final sentence of Prop. Reg. §1.482-7(g)(2)(iv) should be modified to make clear that, whenever net present value calculations are involved, the reliability of those calculations should be considered. The use of the phrase "may need to be considered" suggests that the "realistic alternatives" principle may in at least some cases be applied without regard to the reliability of the net present value calculations for the alternative. Any inference that the reliability of the projected present value data need not be taken into consideration, even in the context of a hypothetical transaction, is inconsistent with arm's length principles, as set forth in Treas. Reg. §1.482-1(c).

10. **Prop. Reg. § 1.482-7(i)(2)(ii)(A) should be revised to allow taxpayers to revise RAB shares without such revision causing the termination of the existing CSA or creation of a new CSA.**

Prop. Reg. § 1.482-7(e)(1) specifically provides that RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the CSA. As a result, written amendments to a CSA that update RAB shares and are consistent with the rules for modifying a CSA as well as the CSA document’s provisions concerning modifying that CSA will modify the existing CSA and will not be treated as either a termination of the existing CSA or as the creation of a new CSA.

Prop. Reg. § 1.482-7(a)(1) provides that the controlled participants "must share the intangible development costs (IDCs) in proportion to their reasonably anticipated benefits (RAB shares)." Because sharing IDCs on the basis of RAB shares is a
requirement for an arrangement to be a CSA, it is possible that a revision of RAB shares made in good faith recognition that the participants' prior RAB shares may not fully reflect changes in economic conditions or business operations and practices could cause the termination of the original CSA and the creation of a new CSA. Taxpayers who comply with amendments to their CSAs under circumstances required by the cost sharing regulations should have the comfort of knowing that their voluntary compliance does not put their entire CSA at risk. The Commissioner is still free to disagree with the CSA results on examination and propose adjustments within the scope of a valid CSA.

11. The presence of a periodic trigger should always be tested using the same discount rate used to convert past and future sums into present values when calculating PCT payment

In calculating the arm's length amount of a PCT Payment, the functional equivalent of the buy-in payment under the current cost sharing regulations, the proposed regulations would adopt an "investor model," under which the projected returns to the PCT Payor would be limited to (i) an arm's length return on its "routine" contribution to the exploitation of the developed intangible, plus (ii) the return that, based on the facts and circumstances, would be sought by an arm's length investor on a comparable investment.

Assuming that the periodic adjustment rules of Prop. Reg. §1.482-7(i)(6) are retained, we believe that calculation of when the Periodic Trigger applies should not be based on use of any participant's weighted average cost of capital (WACC), unless that is the appropriate discount rate used in making ex ante projections. Although the proposed regulations indicate that the appropriate investment return, or discount rate, would be determined under all the facts and circumstances, based on the risks of the investment, the default discount rate for determining whether the IRS could make a periodic adjustment of any PCT Payments would be the relevant WACC for participants that are publicly traded or are members of a group of publicly traded companies. In practice, it is likely that, once the Periodic Trigger were reached, the taxpayer would have the burden of proving that the disparity between the actual results and the projected results was not due to any under (or over) valuation of the external contributions to the CSA. Overcoming such a de facto burden is likely to be especially difficult because the major specified exception to periodic adjustments -- extraordinary unforeseeable events beyond the control of the participants -- appears to be quite narrow.

There would seem to be no reason not to use the same discount rate that is applicable in calculating the rate of return used to convert future or past sums into present value under Prop. Reg. §1.482-7(g)(2) for initially calculating the arm's length PCT Payment. This is the standard that the Proposed Regulations apply to taxpayers that are not publicly traded or affiliated with a publicly traded company. Using different discount rates for PCT Payment and Periodic Trigger purposes will, in some cases, artificially

cause a CSA to be -- and in other cases, prevent a CSA from being -- subject to periodic adjustments without any apparent economic or administrative justification.

12. **The Proposed Regulations should extend the date for executing contracts and amendments and should consider a taxpayer’s good faith but erroneous effort in determining whether the “contemporaneous” documentation requirements in Prop. Reg. § 1.482-7(k)(1)(iii) have been satisfied.**

The Proposed Regulations would disallow CSA treatment for any arrangement the documentation for which was executed more than 60 days after the first IDC. This result is overly harsh, particularly because any asserted failure to meet the 60-day deadline would not be discovered until an examination some two or more years later. As is reflected in the “Edited Version” of the Proposed Regulations, we recommend that the deadline be extended to the later to occur of (i) the final day of each participant’s respective taxable year in which the first occurrence of any IDC to which such agreement (or revision) is to apply, or (ii) the date 90 days after the first occurrence of any such IDC. We also recommend that, if the participants do not execute the appropriate written agreement within the time frame described above but do so in the taxable year following the relevant IDC, the Commissioner should give effect to the arrangement as a CSA as of that taxable year so long as the parties’ actions from the date of the IDC are consistent with CSA treatment. In such a case, the Commissioner would be authorized to make such adjustments to the prior fiscal year as are appropriate under the circumstances.

Therefore, assume that the participants make a good faith effort to properly record, sign and date a written CSA contract to comply with the rules for documentation that is no later than the end of the taxable year in which the initial IDC occurs or, if later, within 90 days of such IDC, but fail to execute the contract within the prescribed time. Under the timing rules set forth in the Edited Version, in such circumstances the CSA may still survive with respect to future years under a “saving” clause. However, the Commissioner would still have the discretion to treat transactions associated with the arrangement in the first year outside of the cost sharing regime.

For example, assume that the calendar year participants make their first IDC payments on November 15, 2006 and execute the CSA on March 15, 2007. Therefore, despite the participants' good faith efforts, the CSA fails to meet the timing tests with regard to “Year 1” of the CSA because it was not executed within 90 days after the first occurrence of any such IDC. Under such circumstances, the taxpayer has clearly made a good faith effort to comply. Therefore, it would be overly harsh and against public policy to say that the consequence of a technical timing error under such circumstances should lead to disregarding the CSA for all years.

Therefore, under the “Edited Version” of the Proposed Regulations, since the CSA was properly recorded, signed and dated prior to the end of 2007, the Treasury should respect the CSA as of the beginning of 2007 provided that the participants treated transactions associated with the putative CSA consistent with CSA treatment. However,
since the CSA was not valid with respect to 2006, the Commissioner on examination may make appropriate adjustments to take into account the taxpayer's failure to timely enter into the CSA. Thus, all Year 1 IDC funds flows will be accounted for as if no CSA existed. Likewise, all Year 1 PCT contributions will be deemed to be contributed on and valued as of the first day of Year 2.

In addition, any putative election that is made more than 12 months after the end of the Year 1 taxable year will be treated as invalid. In that case, the Commissioner may make all appropriate adjustments to clearly reflect the taxpayer’s income and expenses for all affected years. This concept of a “saving clause” for a good faith but erroneous effective date for an election is analogous to the “deemed effective date” provisions for honest taxpayer mistakes that are also found in the “check-the-box” effective date rules of Treas. Reg. § 301.7701-3(c)(1)(iii).

This is a balanced approach that will not discourage taxpayers from adopting CSAs where they are appropriate, while promoting accurate and timely taxpayer compliance. Providing flexibility but ensuring adverse, though not overly harsh, consequences for unintentional errors, promotes the balanced approach which should be the goal of these regulations.

13. Certain technical changes should be made in the transition rules of Prop. Reg. §1.482-7(m)

The Proposed Regulations, which would significantly change the rules governing cost sharing arrangements, would generally apply to all arrangements that commence on and after the date the final regulations are published in the Federal Register. Although QCSAs that began before the date that the Proposed Regulations were finalized would not have to satisfy all of the requirements of the Proposed Regulations, they would be treated as CSAs only if certain modifications to the participants’ contractual agreement were made within 120 days after finalization of the regulations. Furthermore, QCSAs would not be treated as CSAs by virtue of their QCSA status if, after the Proposed Regulations were finalized, (i) the arrangement did not "substantially comply" with the provisions of the revised cost sharing regulations as modified in certain respects, (ii) there were material changes in the scope of the arrangement, or (iii) 50 percent or more of the value of the interests in the cost shared intangible were owned directly or indirectly by persons who were not direct or indirect owners of such intangibles immediately before the regulations were finalized. Finally, PCTs occurring after the Proposed Regulations were finalized would be covered by the standards of those regulations and, if any such PCT caused a Periodic Trigger, the IRS would be authorized to review and make periodic adjustments with respect to even prior PCTs under the standards of the new regulations.

Several aspects of the transition rules are problematic.

A. Direct or Indirect Ownership Changes In Participants Should Not Defeat the Grandfathering of QCSAs
The rule that would apply the revised regulations to pre-existing QCSAs when 50 percent or more of the interests in the arrangement were held directly or indirectly by persons who were not direct or indirect owners of the arrangement immediately before the regulations were finalized appears to be unwarranted and would unnecessarily complicate changes in the ownership of QCSA participants. Except in extraordinary situations, the fact that equity ownership of a QCSA participant changes hands does not affect the nature of the arrangement or the relationship of the parties with respect to it and therefore should not change the rules governing its treatment. The parties to the arrangement, even if owned by persons that had no ownership at the outset, have a legitimate expectation that their arrangement will be judged in accordance with the rules applicable when the arrangement was entered.

Furthermore, this rule would be difficult to administer or arbitrarily complicate and stifle ownership changes prompted by business or structural considerations. In public company settings, it may be difficult or impossible to determine whether and when a cumulative 50 percent ownership change occurs. In non-public company settings, application of the new rules could be triggered by intrafamily ownership changes prompted by the implementation of estate planning techniques. In the absence of exceptions for related party transfers or the application of constructive ownership rules, it appears that even intragroup restructurings could trigger application of the revised rules to a pre-existing QCSA. The lack of any connection between the purpose for the ownership change and the nature or scope of the arrangement is likely to make this rule a trap for the unwary and may create more administrative issues, even for the Service, than contemplated.

B. Pre-Regulation External Contributions Should Not Be Re-Evaluated Under the Revised Regulations.

The ability of the Service to make periodic adjustments for prior PCTs based on the standards of the revised regulations in the event that a subsequent PCT caused a Periodic Trigger would add an inappropriate element of retroactivity to the new rules. In effect, participants that satisfied the requirements of the current regulations for external contributions could face periodic adjustments for the same contributions regardless of whether the subsequent, triggering PCT bore any relationship to those prior contributions. Barring evidence that a subsequent PCT was related to a PCT occurring prior to the effective date of the revised cost sharing regulations, the prior PCT should not be subject to review under the revised regulations.

C. There Is Need For Additional Guidance On the "Substantial Compliance" Standard For Determining Whether QCSAs Are Grandfathered.

In light of the markedly different standards that would govern cost sharing arrangements under the proposed regulations as compared to the standards under the current regulations, it is important that taxpayers have clear guidance as to when they could rely on the current regulations for pre-existing QCSAs. The proposed regulations would permit such reliance provided that pre-existing QCSAs "substantially compl[ied]" with the revised regulations as modified. Although the substantial compliance standard is
not objectionable in principle, the proposed regulations provide no guidance as to what types of deviations from the mandates of the revised regulations, as modified, would or would not constitute noncompliance that was sufficient to trigger wholesale application of the revised regulations. Although a substantial compliance standard is necessarily one that is applied based on all the facts and circumstances, it would be useful to set forth areas of technical compliance that would not cause the new rules to apply to a pre-existing QCSA in most or all cases. At a minimum, it would be useful to provide some examples that would illustrate situations in which technical noncompliance with the transitionally modified standards would not trigger full application of the revised regulations.
EXHIBIT 1

ABA TAX SECTION PROPOSED CHANGES TO PROPOSED COST SHARING REGULATIONS

Proposed Amendments to the Regulations

Accordingly, CFR parts 1 and 301 are proposed to be amended as follows:

PART 1 -- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.482-7A also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.367(a)-1T is amended by revising the second sentence of paragraph (d)(3) to read, in part, as follows:

§1.367(a)-1T Transfers to foreign corporations subject to section 367(a): In general (temporary).

(d) * * *

(3) A person's entering into a cost sharing arrangement under §1.482-7 or acquiring rights to intangible property under such an arrangement shall not be considered a transfer of property described in section 367(a)(1). * * *

Par. 3. Section 1.482-7 is redesignated §1.482-7A and an undesignated centerheading preceding §1.482-7A is added to read as follows:

Regulations applicable on or before the date of publication of this document as a final regulation in the Federal Register.

Par. 4. Section 1.482-0 is amended by revising the entry for §1.482-7 to read as follows:

§1.482-0Outline of regulations under section 482

* * * *

§1.482-7Methods to determine taxable income in connection with a cost sharing arrangement.

(a) In general.

(1) RAB share method for cost sharing transactions (CSTs).
(2) Methods for preliminary or contemporaneous transactions (PCTs).

(3) Methods for other controlled transactions.

(i) Contribution to a CSA by a controlled taxpayer that is not a controlled participant.

(ii) Transfer of interest in a cost shared intangible.

(iii) Controlled transactions not in connection with a CSA.

(b) Cost sharing arrangement (CSA).

(1) In general.

(2) CSTs.

(i) In general.

(ii) Example.

(3) PCTs.

(i) In general.

(ii) External development contributions.

(iii) External exploitation contributions.

(iv) PCT Payments.

(v) Reference transaction (RT).

(vi) PFAs.

(vii) Form of payment.

(A) In general.

(B) No PCT Payor stock.

(viii) Date of a PCT.

(ix) Examples.

(4) Territorial division of interests.

(i) In general.

(ii) Other Bases
(iii) Examples.

(5) CSAs in substance or form.

(i) CSAs in substance.

(ii) CSAs in form.

(iii) Example.

(6) Treatment of CSAs.

(c) Make-or-sell rights excluded.

(1) In general.

(2) Examples.

(d) Intangible development costs (IDCs).

(1) Costs included in IDCs.

(2) Allocation of costs.

(3) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation with the IDA.

(iii) Measurement and timing of stock-based compensation IDC.

(A) In general.

(1) Transfers to which section 421 applies.

(2) Deductions of foreign controlled participants.

(3) Modification of stock option.

(4) Expiration or termination of CSA.

(B) Election with respect to options on publicly traded stock.

(1) In general.

(2) Publicly traded stock.

(3) Generally accepted accounting principles.
(4) Time and manner of making the election.

(C) Consistency.

(4) IDC share.

(5) Examples.

(e) Reasonably anticipated benefit shares (RAB shares).

(1) In general.

(2) Measure of benefits.

(i) In general.

(ii) Indirect bases for measuring benefits.

(A) Units used, produced, or sold.

(B) Sales.

(C) Operating profit.

(D) Other bases for measuring anticipated benefits.

(E) Examples.

(iii) Projections used to estimate benefits.

(A) In general.

(B) Examples.

(f) Changes in participation under a CSA.

(g) Principles generally applicable in the case of PCTs.

(1) Valuation consistent with upfront contractual terms and risk allocations.

(2) Projections.

(3) Reasonable alternatives.

(i) In general.

(ii) Examples.

(4) Discount rate.
(i) In general.

(ii) Examples.

(5) Accounting principles.

(i) In general.

(ii) Examples.

(h) Coordination with the arm’s length standard.

(i) Allocations by the Commissioner in connection with a CSA.

(1) In general.

(2) CST allocations.

(i) In general.

(ii) Adjustments to improve the reliability of projections used to RAB shares.

(A) Unreliable projections.

(B) Foreign-to-foreign adjustments.

(C) Correlative adjustments to PCTs.

(D) Examples.

(iii) Timing of CST allocations.

(3) PCT allocations.

(4) Allocations regarding changes in participation under a CSA.

(5) Allocations when CSTs are consistently and materially disproportionate to RAB shares.

(j) Definitions and special rules.

(1) Definitions.

(2) Special rules.

(i) Consolidated group.

(ii) Trade or business.

(iii) Partnership.
(3) Character.

(i) In general.

(ii) PCT Payments.

(iii) Examples.

(k) CSA contractual, documentation, accounting, and reporting requirements.

(1) CSA contractual requirements.

(i) In general.

(ii) Contractual provisions.

(iii) Meaning of contemporaneous.

(A) In general.

(B) Example.

(2) CSA documentation requirements.

(i) In general.

(ii) Additional CSA documentation requirements.

(iii) Coordination rules and production of documents.

(A) Coordination with penalty regulations.

(B) Production of documentation.

(3) CSA accounting requirements.

(i) In general.

(ii) Reliance on financial accounting.

(4) CSA reporting requirements.

(i) CSA Statement.

(ii) Content of CSA Statement.

(iii) Time for filing CSA Statement.

(A) 90-day rule.
(B) Annual return requirement.

(1) In general.

(2) Special filing rule for annual return requirement.

(iv) Examples.

(l) Effective date.

(m) Transition rule.

(1) In general.

(2) Termination of grandfather status.

(3) Transitional modification of applicable provisions.

* * * * *

Par. 5. Section 1.482-1 is amended by:

1. Revising the second sentence of paragraph (b)(2)(i).

2. Revising the last sentence of paragraph (c)(1).

The revisions read as follows:

§1.482-1 Allocation of income and deductions among taxpayers.

* * * * *

(b) * * *

(2) * * *

(i) * * * Section 1.482-7 provides the methods to be used to evaluate whether a cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * * See §1.482-7 for the applicable methods in the case of a cost sharing arrangement.

* * * * *

Par. 6. Section 1.482-4 is amended by


The addition reads as follows:

§1.482-4 Methods to determine taxable income in connection with a transfer of intangible property.

* * * * *

(f) * * *

(3) * * *

(iv) Cost sharing arrangements. The rules in this paragraph (f)(3) regarding ownership and assistance with respect to cost shared intangibles and cost sharing arrangements will apply only as provided in §1.482-7.

* * * * *

Par. 7. Section 1.482-5 is amended by revising the last sentence of paragraph (c)(2)(iv) to read as follows:

§1.482-5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by §1.482-7(d)(3)(i)) among the tested party and comparable parties.

* * * * *

Par. 8. Section 1.482-7 is added to read as follows:

§1.482-7 Methods to determine taxable income in connection with a cost sharing arrangement.

(a) In general. The arm's length amount charged in a controlled transaction reasonably anticipated to contribute to developing intangibles pursuant to a cost sharing arrangement (CSA), as described in paragraph (b) of this section, must be determined under a method described in this section. Each method must be applied in accordance with the provisions of §1.482-1, except as those provisions are modified in this section.

(1) RAB share method for cost sharing transactions (CSTs). The controlled participants that are parties to a cost sharing transaction (CST), as described in paragraph (b)(2) of this section, must share the intangible development costs (IDCs) of the cost shared intangibles in proportion to their shares of reasonably anticipated benefits (RAB shares). See paragraph (j)(1) of this section for the definitions of controlled participant, cost shared intangible, benefits, and reasonably anticipated benefits, and paragraphs (d) and (e) of this section regarding IDCs and RAB shares, respectively.
(2) Methods for preliminary or contemporaneous transactions (PCTs). The arm's length amount charged in a preliminary or contemporaneous transaction (PCT), as described in paragraph (b)(3) of this section, must be determined under the appropriate method or methods that would apply in the absence of a CSA for purposes of determining the arm's length consideration for a sale of the RT Rights pursuant to §1.482-4. Each method must be applied in accordance with the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), the arm's length range of §1.482-1(e), and the aggregation principle of §1.482-1(f)(2)(i), except as those provisions are modified in §1.482-4 or paragraph (g) of this section.

(3) Methods for other controlled transactions -- (i) Contribution to a CSA by a controlled taxpayer that is not a controlled participant. If a controlled taxpayer that is not a controlled participant contributes to developing the cost shared intangibles, it must receive consideration from the other controlled participants under the rules of §1.482-4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). Such consideration will be treated as an intangible development cost for purposes of paragraph (d) of this section.

(ii) Transfer of interest in a cost shared intangible. If at any time (during the term, or upon or after the termination, of a CSA) a controlled participant transfers an interest in a cost shared intangible to another controlled taxpayer, the controlled participant must receive an arm's length amount of consideration from the transferee under the rules of §§1.482-1 and 1.482-4 through 1.482-6.

(iii) Controlled transactions not in connection with a CSA. This section does not apply to a controlled transaction reasonably anticipated to contribute to developing intangibles pursuant to an arrangement that is not a CSA described in paragraph (b)(1) or paragraph (b)(5) of this section. Whether the results of any such controlled transaction are consistent with an arm's length result must be determined under the applicable rules of the section 482 regulations without regard to this section. For example, an arrangement for developing intangibles in which one controlled taxpayer's costs of developing the intangibles significantly exceeds its share of reasonably anticipated benefits from exploiting the developed intangibles would not in substance be a CSA, as described in paragraphs (b)(1)(i) through (iii) or paragraph (b)(5)(i) of this section. In such a case, unless the rules of this section are applicable by reason of paragraph (b)(5)(iii) of this section, the arrangement must be analyzed under other applicable sections of the section 482 regulations to determine whether it achieves arm’s length results, and if not, to determine any allocations by the Commissioner that are consistent with such other section 482 regulations.

(b) Cost sharing arrangement (CSA) -- (1) In general. A CSA to which the provisions of this section apply is a contractual agreement to share the costs of developing one or more intangibles under which the controlled participants --

(i) At the outset of the arrangement divide among themselves all interests in cost shared intangibles on a territorial or other commercially reasonable basis as described in paragraph (b)(4) of this section;

(ii) Enter into and effect CSTs covering all IDCs and PCTs covering all external development contributions and external exploitation contributions, as described in paragraphs (b)(2) and (b)(3) of this section, for purposes of developing or exploiting the cost shared intangibles under the CSA;

(iii) As a result, individually own and exploit their respective interests in the cost shared intangibles without any further obligation to compensate one another for such interests;

(iv) Substantially comply with the CSA contractual requirements that are described in paragraph (k)(1) of this section;

(v) Substantially comply with the CSA documentation requirements that are described in paragraph (k)(2) of this section;
(vi) Substantially comply with the CSA accounting requirements that are described in paragraph (k)(3) of this section; and

(vii) Substantially comply with the CSA reporting requirements that are described in paragraph (k)(4) of this section.

(2) CSTs -- (i) In general. CSTs are controlled transactions between or among controlled participants in which such participants share the IDCs of one or more cost shared intangibles in proportion to their respective RAB shares from their individual exploitation of their interests in the cost shared intangibles that they obtain under the CSA. Cost sharing payments may not be paid in shares of stock in the payor. See paragraphs (b)(4), (d), and (e) of this section for the rules regarding interests in cost shared intangibles, IDCs, and RAB shares, respectively.

(ii) Example. The following example illustrates the principles of this paragraph (b)(2):

*Example.* Companies C and D, who are members of the same controlled group, enter into a CSA that is described in paragraph (b)(1) of this section. In the first year of the CSA, C and D conduct the IDA, as described in paragraph (d)(1) of this section. The total IDCs in regard to such activity are $3,000,000 of which C and D pay $2,000,000 and $1,000,000, respectively, directly to third parties. As between C and D, however, their CSA specifies that they will share all IDCs in accordance with their RAB shares (as described in paragraph (e)(1) of this section), which are 60% for C and 40% for D. It follows that C should bear $1,800,000 of the total IDCs (60% of total IDCs of $3,000,000) and D should bear $1,200,000 of the total IDCs (40% of total IDCs of $3,000,000). D makes a CST payment to C of $200,000, that is, the amount by which D's share of IDCs in accordance with its RAB share exceeds the amount of IDCs initially borne by D ($1,200,000 - $1,000,000), and which also equals the amount by which the total IDCs initially borne by C exceeds its share of IDCs in accordance with its RAB share ($2,000,000 - $1,800,000). As a result of D's CST payment to C, C and D will bear amounts of total IDCs in accordance with their respective RAB shares.

(3) PCTs -- (i) In general. A PCT is a controlled transaction in which each other controlled participant (PCT Payor) is obligated to compensate a controlled participant (PCT Payee) for external development contributions and external exploitation contributions of the PCT Payee.

(ii) *External development contributions.* An external development contribution consists of the rights set forth under the reference transaction (RT) in any resource or capability that is reasonably anticipated to significantly contribute to developing cost shared intangibles and that a PCT Payee has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA. For purposes of this section, external development contributions do not include rights in depreciable tangible property or land, and do not include rights in other resources acquired by IDCs. See paragraphs (b)(2) and (d)(1) of this section. Whether and when a contribution is "reasonably anticipated to contribute" to the development process is a matter of facts and circumstances. See Examples 1 and 3 of paragraph (b)(5)(iii).

(iii) *External exploitation contributions.* An external exploitation contribution consists of the rights set forth under the reference transaction (RT) in any resource or capability that is reasonably anticipated to contribute to exploiting cost shared intangibles and that a PCT Payee has developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA. For purposes of this section, external exploitation contributions do not include rights in depreciable tangible property or land, and do not include rights in other resources acquired by IDCs. See paragraphs (b)(2) and (d)(1) of this section.

(iv) *PCT Payments.* The arm's length amount of the compensation due under a PCT (PCT Payment) will be determined pursuant to paragraph (a)(2) of this section applicable to the RT, as described in paragraph (b)(3)(v) of this section. The applicable method will yield a value for the compensation obligation of each PCT Payor consistent with the product of the combined value to all controlled...
participants of the external development and exploitation contributions that are the subject of the PCT multiplied by the PCT Payor’s RAB share.

(v) **Reference transaction (RT).** An RT is a transaction providing the benefits of all rights (RT Rights), exclusively and perpetually, in a resource or capability described in paragraph (b)(3)(ii) or (b)(3)(iii) of this section, excluding any rights to exploit an existing intangible without further development. See paragraph (c) of this section (Make-or-sell rights excluded). If a resource or capability is reasonably anticipated to contribute both to developing or exploiting cost shared intangibles and to other business activities of the PCT Payee, other than exploiting an existing intangible without further development, then the PCT Payment that would otherwise be determined with reference to the RT (which generally presumes a provision of exclusive and perpetual rights) may need to be prorated. Such proration is required to the extent it can be demonstrated that a portion of the value of the relevant PCT Payments otherwise determined under this section is attributable to such other business activities, and will be made on a reasonable basis in proportion to the relative economic value, as of the date of the PCT, reasonably anticipated to be derived from the resource or capability by the CSA Activity as compared to such other business activities of the PCT Payee. For purposes of §1.482-1(b)(2)(ii) and paragraph (a)(2) of this section, the controlled participants must include the type of transaction involved in the RT as part of the documentation of the RT required under paragraph (k)(2)(ii)(H) of this section. If different economically equivalent types of RTs are possible with respect to the relevant resource or capability, the controlled participants may designate the type of transaction involved in the RT. If the controlled participants fail to make this designation in their documentation, the Commissioner may make a designation consistent with the RT and other facts and circumstances. While the PCT Payee and PCT Payors must enter into the PCT providing for the relevant compensation obligation, they are not required to actually enter into the RT that is referenced for purposes of determining the magnitude of the compensation obligation under the PCT.

(vi) **PFAs.** A post formation acquisition (PFA) is an external development or exploitation 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 or exploiting cost shared intangibles. Resources or capabilities may be acquired in a PFA either directly, or indirectly through the acquisition of an interest in an entity or tier of entities.

(vii) **Form of payment -- (A) In general.** The consideration under a PCT for external development contributions and external exploitation contributions may take one or a combination of both of the following forms - -

1. Payments of a fixed amount, either paid in a lump sum payment or in installment payments spread over a specified period, with interest calculated in accordance with §1.482-2(a) (Loans or advances); or

2. Payments contingent on the exploitation of cost shared intangibles by the PCT Payor. The form of payment selected for any PCT, including the basis and structure of the payments, must be specified no later than the date of that PCT.

(B) **No PCT Payor Stock.** PCT Payments may not be paid in shares of stock in the PCT Payor.

(viii) **Date of a PCT.** The controlled participants must enter into a PCT as of the earliest date on or after the CSA is entered into on which the external contributions are reasonably anticipated to contribute to developing or exploiting cost shared intangibles.

(ix) **Examples.** The following examples illustrate the principles of this paragraph (b)(3). In each example, Companies P and S are members of the same controlled group, and execute a CSA that is described in paragraph (b)(1) of this section. The examples are as follows:
Example 1. Company P has developed and currently markets version 1.0 of a new software application XYZ. Company P markets the product through independent distributors in the U.S. and in non-U.S. markets. Use of Version 1.0 of the software requires significant customer training. Since customers become accustomed to the "look and feel" of the software, and become familiar with its menu-driven commands, customers are generally reluctant to switch to competing software suppliers which do not incorporate the same "look and feel" or command structure. Company P and Company S execute a CSA under which they will share the IDCs for developing future versions of XYZ. Version 1.0 is reasonably anticipated to contribute to the development of future versions of XYZ and therefore the RT rights in version 1.0 constitute an external development contribution of Company P for which compensation is due from Company S pursuant to a PCT. In addition, Company S is reasonably anticipated to derive benefits from the installed base of customers which currently use Version 1.0 of the software and therefore the RT rights in this installed base of customers constitute an external exploitation contribution of Company P for which compensation is due from Company S pursuant to a PCT. The applicable method and determination of the arm's length compensation due pursuant to each PCT will be based on the appropriate RT. The controlled participants designate each RT as a transfer of intangibles that would otherwise be governed by §1.482-4, if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT with respect to the contribution of Version 1.0 between Company P and Company S will be governed by §1.482-4 as supplemented by paragraph (g) of this section. The RT in this case is the perpetual and exclusive provision of the benefit of all rights in version 1.0 and preexisting exploitation intangibles, other than the rights described in paragraph (c) of this section (Make-or-sell rights excluded). This includes the exclusive right to use version 1.0 for purposes of research and the right to exploit any products that incorporated the platform technology of version 1.0, and would cover a term extending as long as the uncontrolled taxpayer were to continue to exploit future versions of XYZ or any other product based on the version 1.0 platform. Though Company P and Company S are not required to actually enter into the transaction described by the RT, the value of the compensation obligation of Company S for the PCT will reflect the full value of the external contributions defined by the RT, as limited by Company S's RAB share. Similarly, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company S and Company P for Company S's contribution of its customer lists will be governed by §1.482-4 as supplemented by paragraph (g) of this section.

Example 2. Company P and Company S execute a CSA under which they will share the IDCs for developing Vaccine Z, but not Vaccine A, which Company P intends to develop and market on its own. Company P will commit its research team that has successfully developed a number of other vaccines to the project. The expertise and existing integration of the research team is a unique resource or capability of Company P which is reasonably anticipated to contribute to the development of Vaccine Z and therefore the RT Rights in the research team constitute an external development contribution for which compensation is due from Company S as part of a PCT. However, members of the research team will work on the development of both Vaccines Z and A. Company S previously employed a sales force which marketed and distributed similar pharmaceutical products to health care professionals. The new vaccines will be sold under brand names not existing at the CSA start date. As a result, Company S was not anticipated to benefit from the contribution of any exploitation intangibles from Company P. In this case, the taxpayer determined that the value of the external exploitation contributions made by Company P was zero. The applicable method and determination of the arm's length compensation due pursuant to the PCT will be based on the RT. The controlled parties designate the RT as a provision of services that would otherwise be governed by §1.482-2(b)(3)(first sentence) if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by §1.482-2(b)(3)(first sentence). The RT in this case is the perpetual and exclusive provision of the benefits by Company P of its research team to the development of Vaccine Z by the uncontrolled party, but not Vaccine A. Because the IDCs include the ongoing compensation of the researchers, the compensation obligation under the PCT is only for the value of the commitment of the research team by Company P to the CSA's development efforts net of such researcher compensation, allocated between Vaccines Z and A. Though Company P and Company S are not required to actually enter into the
transaction described by the RT, the value of the compensation obligation of Company S for the PCT will reflect the full value of provision of services described in the RT, as limited by Company S's RAB share.

Example 3. In Year 1, Company P and Company S execute a CSA under which they will share the IDCs for developing Product X. In Year 3, Company P acquires Company X in a tax-free stock-for-stock acquisition. Company X is a start-up technology company with negligible amounts of tangible property and liabilities. Company X joins in the filing of a U.S. consolidated income tax return with USP and is treated as one taxpayer with Company P under paragraph (j)(2)(i) of this section. Accordingly, under paragraph (b)(3)(v) of this section, Company P's acquisition of the stock of Company X will be treated as an indirect acquisition of the resources and capabilities of Company X. Likewise, under paragraph (b)(3)(vii)(B) of this section, the value of the acquisition shares will be converted to a cash equivalent that can be paid either as a fixed amount (in a lump sum or over a period of years with interest) or contingent on the PCT Payor's exploitation of the intangible, as is specified on or before the PCT. The in-process technology and workforce of Company X acquired by Company P are reasonably anticipated to contribute to the development of product Z and therefore the RT Rights in the in-process technology and workforce of Company X are external development contributions for which compensation is due to Company P from Company S under a PCT. Furthermore, because these external development contributions were acquired by Company P in an uncontrolled transaction that took place after the formation of the CSA, they are also PFAs. Accordingly, the consideration due from S under the PCT is the cash-equivalent of the acquisition shares multiplied by S's RAB share.

(4) Division of interests -- (i) Territorial basis. Pursuant to paragraph (b)(1)(i) of this section, at the outset of the CSA the controlled participants may divide among themselves all interests in cost shared intangibles on a territorial basis as follows. If the controlled participants divide the interests in the cost shared intangible on a territorial basis, the entire world must be divided into two or more non-overlapping geographic territories. Each controlled participant must receive at least one such territory, and in the aggregate all the participants must receive all such territories. Each controlled participant must be entitled to the perpetual and exclusive right to the profits from transactions of any member of the controlled group that includes the controlled participant with uncontrolled taxpayers regarding property or services for use, consumption, or disposition in such controlled participant's territory or territories, to the extent that such profits are attributable to cost shared intangibles. Absent the controlled participant's or other member of its controlled group's actual knowledge or reason to know otherwise, for purposes of the preceding sentence such use, consumption, or disposition of property or services will be considered to occur at the location(s) to which notices and other communications to the uncontrolled taxpayer(s) are to be provided in accordance with the contractual provisions of the relevant transactions.

(ii) Other Bases. Pursuant to paragraph (b)(1)(i) of this section, other bases for division of all interests in the cost shared intangible may, in some circumstances, be appropriate, but only if, in the aggregate, all interests in the cost shared intangible are divided among the participants and such basis is commercially reasonable and consistent with comparable uncontrolled transactions or industry practices. Possible non-territorial bases for the division of the interests in the cost shared intangible include product line-by-product line, medium of delivery-by-medium of delivery and installed-vs.-component part. Interests in the cost shared intangible that are divided on a non-territorial basis may be subdivided on a territorial basis so long as such subdivision is commercially reasonable, consistent with comparable uncontrolled transactions or industry practices and divides all interests in the cost shared intangible among the participants.

(iii) Examples. The following example illustrates the principles of this paragraph (b)(4):

Example 1. Companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. Under the CSA, P receives the interest in product Z in the United States and S receives the interest in product Z in the rest of the world, as described in paragraph (b)(4)(i) of this section. Both P and S have plants for manufacturing product Z located in their respective geographic territories. However, for commercial reasons product Z is nevertheless manufactured by P in the United States for sale to customers in certain locations just outside the United States in close proximity to P's
U.S. manufacturing plant. Because S owns the territorial rights outside the United States, intercompany compensation must be provided for between P and S to ensure that S realizes all the cost shared intangible profits from sales of product Z to customers in such proximate areas, even though the manufacturing is done by P in the United States. The pricing of such intercompany compensation must also ensure that P realizes an appropriate manufacturing return for its efforts. Benefits projected with respect to such sales will be included for purposes of estimating S’s, but not P’s, RAB share.

Example 2. Company P has developed and started marketing a new heart medication in an ingestible tablet form, for which it owns the world-wide rights to the manufacturing intangibles. During post-FDA approval clinical testing, it discovers that half of the active ingredient group who suffer from cataracts reported noticeable improvement. Company P and its foreign subsidiary FS enter into a CSA to develop a liquid form of the product (Cx) for direct application by an eye dropper to the eyes as a treatment for cataracts. Such development may or may not rely on the current strength of the tablet dosage and will clearly need a new formulation for an eye dropper solution delivery system. The CSA does not cover any future development of any heart medication. Company P receives the interest in product Cx in the United States and FS receives the interest in product Cx in the rest of the world. No relevant data is available on comparable uncontrolled transactions in the pharmaceutical industry. However, it is common industry practice to have agreements involving one indication of a multi-indication active ingredient. Therefore, even though the CSA does not provide for future development of any heart medication, the territorial division of interests for a specific indication that is consistent with industry practices meets the requirements described in paragraph (b)(4)(ii).

(5) CSAs in substance or form -- (i) CSAs in substance. The Commissioner may apply, consistently with the rules of §1.482-1(d)(3)(ii)(B) (Identifying contractual terms), the rules of this section to any arrangement that in substance constitutes a CSA described in paragraphs (b)(1)(i) through (iii) of this section, notwithstanding a failure to comply with any requirement of this section.

(ii) CSAs in form. Provided the requirements of paragraphs (b)(1)(iv) through (vii) are met with respect to an arrangement among controlled taxpayers,

(A) The Commissioner must apply the rules of this section to any such arrangement that the controlled taxpayers reasonably concluded to be a CSA, as described in paragraph (b)(1) of this section; and

(B) Otherwise, the Commissioner may apply the rules of this section to any other such arrangement.

(iii) Examples. The following examples illustrate the principles of this paragraph (b)(5). In the examples, assume that Companies P and S are both members of the same controlled group. The examples are as follows:

Example 1. (i) P owns the patent on a formula for a capsulated pain reliever, P-Cap. P reasonably anticipates, pending further research and experimentation, that the P-Cap formula could form the platform for a formula for P-Ves, an effervescent version of P-Cap. P also owns proprietary software that it reasonably anticipates to be critical to the research efforts. P and S execute a CSA by which they agree to proportionally share the costs and risks of developing a formula for P-Ves. The agreement reflects the various contractual requirements described in paragraph (k)(1) of this section and P and S comply with the documentation, accounting and reporting requirements of paragraphs (k)(2) through (4) of this section. Both the patent for P-Cap and the software are reasonably anticipated to contribute to the development of P-Ves and therefore are external development contributions for which compensation is due from S as part of PCTs. Though P and S enter into a PCT for the P-Cap patent, they fail to enter into a PCT for the software.

(ii) In this case, P and S have substantially complied with the contractual requirements of paragraph (k)(1) of this section and the documentation, accounting and reporting requirements of paragraphs (k)(2) through (4) of this section and therefore have met the formal requirements of paragraphs (b)(1)(iv)
through (vii) of this section. However, because they did not enter into a PCT, as required under paragraph (b)(1)(i) of this section, for the software that was reasonably anticipated to be critical to the development of P-Ves, they cannot reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(ii)(A) of this section to apply the rules of this section to their arrangement. Nevertheless, pursuant to paragraph (b)(5)(ii)(B), the Commissioner may apply the rules of this section and treat P and S as entering into a PCT for the software in accordance with the requirements of paragraph (b)(1)(i) of this section, and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may decide that the arrangement is not a CSA described in paragraph (b)(1) of this section and therefore that this section's provisions do not apply in determining whether the arrangement reaches arm's length results. In this case, the arrangement would be analyzed under the methods under the section 482 regulations, without regard to this section, to determine whether the arrangement reaches such results.

**Example 2.** The facts are the same as *Example 1* except that P and S do enter into a PCT for the software. Although the Commissioner determines that the PCT Payments for the software were not arm's length, nevertheless, under the facts and circumstances at the time they entered into the CSA and PCTs, P and S reasonably concluded their arrangement to be a CSA. Because P and S have met the requirements of paragraphs (b)(1)(iv) through (vii) and reasonably concluded their arrangement is a CSA, pursuant to paragraph (b)(5)(ii)(A) of this section, the Commissioner must apply the rules of this section to their arrangement. Accordingly, the Commissioner treats the arrangement as a CSA and makes adjustments to the PCT Payments as appropriate under this section to achieve an arm's length result for the PCT for the software.

**Example 3** The facts are the same as Example 2 except that P and S do enter into a PCT for the software on an arm's length basis. However, they do not reasonably believe that prior test results kept on suppository delivery systems kept in a suppository test data base (DBST1) would significantly contribute to the development of an effervescent version of P-Cap. Therefore, they do not enter into a PCT for the test data base. Two years later the research team makes a breakthrough discovery based on the efforts of a research team member who looked at the DBST1 test results for ideas since nothing until then was working. The parties then amend the CSA to include a PCT for the suppository test data base. Since the test data base was not reasonably expected to significantly contribute to developing the cost shared intangibles at the start of the CSA, the Commissioner treats the initial arrangement as a CSA. Once the parties discovered that another resource could significantly contribute to developing the cost shared intangibles and added it in writing to the existing CSA, the Commissioner treats the amended arrangement as a CSA.

(6) **Treatment of CSAs.** See §301.7701-1(c) of this chapter for the treatment of CSAs for purposes of the Internal Revenue Code.

(c) **Make-or-sell rights excluded** -- (1) In general. Any right to exploit an existing intangible without further development, such as the right to make or sell existing products, does not constitute an external development contribution to a CSA, as described in paragraph (b)(3) of this section. Thus, the arm's length compensation for such rights does not satisfy the compensation obligation under a PCT.

(2) **Examples.** The following examples illustrate the principles of this paragraph (c):

**Example 1.** P and S, who are members of the same controlled group, execute a CSA that is described in paragraph (b)(1) of this section. Under the CSA, P and S will bear their proportional shares of IDCs for developing the second generation of ABC, a computer software program. Prior to that arrangement, P had incurred substantial costs and risks to develop ABC. Concurrently with entering into the arrangement, P (as the licensor) executes a license with S (as the licensee) by which S may make and sell copies of the existing ABC. Such make-and-sell rights do not constitute an external development contribution to the CSA. The rules of §§1.482-1 and 1.482-4 through 1.482-6, without regard to the rules of this section, must be applied to determine the arm's length consideration in connection with the make-and-sell licensing arrangement. In certain circumstances this determination of the arm's length consideration may
be done on an aggregate basis with the evaluation of compensation obligations pursuant to PCTs entered into by P and S in connection with the CSA. See paragraph (g)(2)(v) of this section.

**Example 2.** (i) P, a software company, has developed and currently exploits software program ABC. P and S enter into a CSA to develop future generations of ABC. The ABC source code is the platform on which future generations of ABC will be built and is therefore an external development contribution of P for which compensation is due from S pursuant to a PCT. Concurrently with entering into the CSA, P licenses to S the make-and-sell rights for the current version of ABC. P has entered into similar licenses with uncontrolled parties calling for sales-based royalty payments at a rate of 20%. The current version of ABC has an expected product life of three years. P and S enter into a contingent payment agreement to cover both the PCT Payments due from S for P's external development contribution and for the make-and-sell license. Based on the uncontrolled make-and-sell licenses, P and S agree on a sales-based royalty rate of 20% in Year 1 that declines on a straight line basis to 0% over the 3 year product life of ABC.

(ii) The make-and-sell rights for the current version of ABC are not external development contributions, though paragraph (g)(2)(v) of this section provides for the possibility that the most reliable determination of an arm's length charge for the PCT and the make-and-sell license may be one that values the two transactions in the aggregate. A contingent payment schedule based on the uncontrolled make-and-sell licenses may provide an arm's length charge for the separate make-and-sell license between P and S, provided the royalty rates in the uncontrolled licenses similarly decline, but as a measure of the aggregate PCT and license payments it does not account for the arm's length value of P's external development contributions which include the RT Rights in the source code and future development rights in ABC.

(d) Intangible development costs (IDCs) -- (1) Costs included in IDCs. For purposes of this section, IDCs mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the activity under the CSA of developing or attempting to develop intangibles (IDA). IDCs shall also include the arm's length rental charge for the use of any land or depreciable tangible property (as determined under §1.482-2(c) (Use of tangible property)) directly identified with, or reasonably allocable to, the IDA. Reference to generally accepted accounting principles or federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs. IDCs do not include interest expense, foreign income taxes (as defined in §1.901-2(a)), or domestic income taxes.

(2) Allocation of costs. If a particular cost is reasonably allocable both to the IDA and to other business activities, the cost must be allocated on a reasonable basis between the IDA and such other business activities in proportion to the relative economic value that the IDA and such other business activities are anticipated to derive over time as a result of such cost.

(3) Stock-based compensation -- (i) In general. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) Identification of stock-based compensation with the IDA. The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of
a new stock option for purposes of this paragraph (d)(3)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) **Measurement and timing of stock-based compensation IDC -- (A) In general.** Except as otherwise provided in this paragraph (d)(3)(iii), the cost attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an IDC under this section for the taxable year for which the deduction is allowable.

1) **Transfers to which section 421 applies.** Solely for purposes of this paragraph (d)(3)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

2) **Deductions of foreign controlled participants.** Solely for purposes of this paragraph (d)(3)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

3) **Modification of stock option.** Solely for purposes of this paragraph (d)(3)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(3)(ii) of this section, to constitute the grant of a new stock option not identified with, or reasonably allocable to, the IDA, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an IDC as of the date of the modification.

4) **Expiration or termination of CSA.** Solely for purposes of this paragraph (d)(3)(iii)(A), if an item of stock-based compensation identified with, or reasonably allocable to, the IDA is not exercised during the term of a CSA, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the CSA, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(3)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an IDC as of the date of the expiration or termination of the CSA.

(B) **Election with respect to options on publicly traded stock -- (1) In general.** With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all IDCs attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

2) **Publicly traded stock.** As used in this paragraph (d)(3)(iii)(B), the term **publicly traded stock** means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

3) **Generally accepted accounting principles.** For purposes of this paragraph (d)(3)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either --
(i) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(ii) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(4) **Time and manner of making the election.** The election described in this paragraph (d)(3)(iii)(B) is made by an explicit reference to the election in the written CSA required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to paragraph (d)(3)(iii)(C) of this section. In the case of a CSA in existence on August 26, 2003, the election by written amendment to the CSA may be made without the consent of the Commissioner if such amendment is entered into not later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003.

(C) **Consistency.** Generally, all controlled participants in a CSA taking options on publicly traded stock into account under paragraph (d)(3)(iii)(A) or (d)(3)(iii)(B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that CSA. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioners consent is obtained. All controlled participants in the CSA must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(3)(iii)(B) of this section upon the formation of the CSA, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(3)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(4) **IDC share.** A controlled participant's IDC share for a taxable year is equal to the controlled participant's cost contribution for the taxable year, divided by the sum of all IDCs for the taxable year. A controlled participant's cost contribution for a taxable year means all of the IDCs initially borne by the controlled participant, plus all of the cost sharing payments that the participant makes to other controlled participants, minus all of the cost sharing payments that the participant receives from other controlled participants.

(5) **Examples.** The following examples illustrate this paragraph (d):

*Example 1.* Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a better mousetrap. USS and FP share the costs of FP's R&D facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company. Based on the facts and circumstances, the cost of the conference facility cannot be directly identified with, and is not reasonably allocable to, the IDA. In this case, the cost of the conference facility must be excluded from the amount of IDCs.
Example 2. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop intangibles for producing a new device. USP and FS share the costs of an R&D facility, the salaries of the facility’s researchers, and reasonable overhead costs attributable to the project. Although USP also incurs costs related to field testing of the device, USP does not include those costs in the IDCs that USP and FS will share under the CSA. The Commissioner may determine, based on the facts and circumstances, that the costs of field testing are IDCs that the participants must share.

Example 3. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop a new process patent. USP employs researchers who perform R&D functions in connection both with the development of the new process patent and with the development of a new design patent the development of which is outside the scope of the CSA. During years covered by the CSA, USP compensates such employees with cash salaries, stock-based compensation, or a combination of both. USP and FS anticipate that the economic value attributable to such employees will be derived from the process patent and the design patent at a relative proportion of 75% and 25%, respectively. Applying the principles of paragraph (d)(2) of this section, 75% of the compensation of such employees must be allocated to the development of the new process patent and, thus, treated as IDCs. With respect to the cash salary compensation, the IDC is 75% of the face value of the cash. With respect to the stock-based compensation, the IDC is 75% of the value of the stock-based compensation as determined under paragraph (d)(3)(iii) of this section.

Example 4. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a new computer source code. FP’s executive officers who oversee a research facility and employees dedicated solely to the IDA have additional responsibilities, including oversight of other research facilities and employees not in any way relevant to the development of the new computer source code. The full amount of the costs of the research facility and employees dedicated solely to the IDA can be directly identified with the IDA and, therefore, are IDCs. In addition, the participants determine that, of the economic value attributable to the executive officers, the new computer source code’s share is 50%. Applying the principles of paragraph (d)(2) of this section, 50% of the compensation of such executives must be allocated to the development of the new computer source code and, thus, treated as IDCs.

Example 5. U.S. Parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop a new laser scalpel. USP is a public company traded on the US NASDAQ, has four different medical devises sold worldwide, and every employee has stock options. USP acquires the shares of TargetCo for cash and hires all of its research team to work on both the new laser scalpel as well as other R&D projects. The TargetCo research team had TargetCo options prior to the acquisition which could be valued as of the acquisition date by reference to USP’s shares and the cash acquisition price. The TargetCo options were converted into USP options on the acquisition date using the relevant USP values as of the acquisition date. As a result, only the increase in value of the USP options exercised by a former TargetCo research team member over the value of such options as of the acquisition date shall be counted as an IDC for this purpose, and then only to the extent that cost is allocated between the researchers’ efforts on behalf of the new laser scalpel and the researcher’s efforts on non-CSA R&D.

(e) Reasonably anticipated benefits share (RAB share) -- (1) In general. A controlled participant’s share of reasonably anticipated benefits (RAB share) is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits of all the controlled participants. See paragraph (j)(1)(v) of this section (defining reasonably anticipated benefits). RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the CSA. As a result, written amendments to a CSA that update RAB shares and are consistent with the rules for modifying a CSA as well as the CSA provisions concerning modifying that CSA will modify the existing CSA and will not be treated as either a termination of the existing CSA or as the creation of a new CSA. For purposes of determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most current reliable data regarding past and projected future results as is available at such time. A controlled participant’s RAB share must be determined by using the most reliable estimate. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in
the analysis must be taken into account, consistent with §1.482-1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of RAB shares - -

(A) The basis used for measuring benefits, as described in paragraph (e)(2)(i) of this section; and

(B) The projections used to estimate benefits, as described in paragraph (e)(2)(iii) of this section.

(2) Measure of benefits -- (i) In general. In order to estimate a controlled participant's RAB share, the amount of each controlled participant's reasonably anticipated benefits must be measured on a basis that is consistent for all such participants. See paragraph (e)(2)(ii)(E) Example 8 of this section. If a controlled participant transfers a cost shared intangible to another controlled taxpayer, other than by way of a transfer described in paragraph (f) of this section, that participant's benefits from the transferred intangible must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Reasonably anticipated benefits are measured either on a direct basis, by reference to estimated benefits to be generated by the use of cost shared intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to benefits to be generated. Such indirect bases of measurement of anticipated benefits are described in paragraph (e)(2)(ii) of this section. A controlled participant's reasonably anticipated benefits must be measured on the basis, whether direct or indirect, that most reliably determines RAB shares. In determining which of two bases of measurement is most reliable, the factors set forth in §1.482-1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in cost shared intangibles. See Example 6 of paragraph (e)(2)(ii)(E) of this section.

(ii) Indirect bases for measuring anticipated benefits. Indirect bases for measuring anticipated benefits from participation in a CSA include the following:

(A) Units used, produced, or sold. Units of items used, produced, or sold by each controlled participant in the business activities in which cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the cost shared intangibles per unit of the item or items used, produced, or sold. This circumstance is most likely to arise when the cost shared intangibles are exploited by the controlled participants in the use, production, or sale of substantially uniform items under similar economic conditions.

(B) Sales. Sales by each controlled participant in the business activities in which cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to cost shared intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting cost shared intangibles are not substantial relative to the revenues generated, or if the principal effect of using cost shared intangibles is to increase the controlled participants' revenues (for example, through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring RAB shares unless each controlled participant operates at the same market level (for example, manufacturing, distribution, etc.).
(C) Operating profit. Operating profit of each controlled participant from the activities in which cost shared intangibles are exploited, as determined before any expense (including amortization) on account of IDCs, may be used as an indirect basis for measuring anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that such profit is largely attributable to the use of cost shared intangibles, or if the share of profits attributable to the use of cost shared intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when cost shared intangibles are closely associated with the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) Other bases for measuring anticipated benefits. Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of cost shared intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from using the cost shared intangibles.

(E) Examples. The following examples illustrate this paragraph (e)(2)(ii):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a CSA to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of $2 per unit of feedstock produced and rates for each are expected to remain similar in the future. The new process, if it is successful, will reduce the amount of electricity required by each company to produce a unit of the feedstock by 50%. Therefore, the cost savings each company is expected to achieve after implementing the new process are $1 per unit of feedstock produced. Under the CSA, FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring RAB shares and dividing the IDCs because each controlled participant is expected to have a similar $1 (50% of current charge of $2) decrease in costs per unit of the feedstock produced.

Example 2. The facts are the same as in Example 1, except that currently USS pays $3 per unit of feedstock produced for electricity while FP pays $6 per unit of feedstock produced. In this case, units produced is not the most reliable basis for measuring RAB shares and dividing the IDCs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The Commissioner determines that the most reliable measure of RAB shares may be based on units of the feedstock produced if FP's units are weighted relative to USS' units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings of $3 per unit of the feedstock (50% reduction of current charge of $6) would be twice USS's savings of $1.50 per unit of feedstock (50% reduction of current charge of $3) from any new process eventually developed.

Example 3. The facts are the same as in Example 2, except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring RAB shares. In order to reliably determine RAB shares, the Commissioner offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

Example 4. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the rest of the world. USP and FS divide costs on the basis of anticipated operating
profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the United States, whereas drug prices are regulated in many non-U.S. jurisdictions. In both controlled participants' territories, the operating profits are almost entirely attributable to the use of the cost shared intangible. In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 5. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a CSA to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the CSA, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the controlled participants' respective markets.

(ii) If the research and development is successful, the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. This price premium will be a similar premium per dollar of sales in each territory. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 6. The facts are the same as in Example 5, except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring RAB shares unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 7. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not measure benefits based on the number of entry-level employees hired by each. Rather, they measure benefits based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring RAB shares is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a CSA to develop computer software that each will market and install on customers' computer systems. The controlled participants measure benefits on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1’s licensing income (which is a percentage of the licensees’ sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each controlled participant is not the most reliable because all of the benefits received by controlled participants are not taken into account. In order to reliably determine RAB shares, FS1’s projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other controlled participants’ projected benefits from sales (for example, all controlled participants might measure their benefits on the basis of operating profit).

(iii) Projections used to estimate benefits -- (A) In general. The reliability of an estimate of RAB shares also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development activities under the CSA and the receipt of benefits, a projection of the time over which
benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the cost shared intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it normally will be necessary to use the present discounted value of the projected benefits to reliably determine RAB shares. See paragraph (g)(2)(vi) of this section for guidance on discount rates used for this purpose. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of RAB shares. This circumstance is most likely to occur when the CSA is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the cost shared intangibles is unlikely to change, the cost shared intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) **Examples.** The following examples illustrate the principles of this paragraph (e)(2)(iii):

*Example 1.* (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop a new car model. The controlled participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66 2/3% of each year's IDCs and FP bears 33 1/3% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. In order to reflect USS' one-year lag in introducing new car models, a more reliable projection of each participant's RAB share would be based on a projection of all four years of sales for each participant, discounted to present value.

*Example 2.* U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new and improved household cleaning products. Both controlled participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to produce unusual profits for either controlled participant. The controlled participants divide costs on the basis of each controlled participant's current sales of household cleaning products. In this case, the controlled participants' RAB shares are reliably projected by current sales of cleaning products.

*Example 3.* The facts are the same as in *Example 2*, except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The controlled participants' RAB shares are not reliably projected by current sales of cleaning products. FS's benefit projections should take into account its growth in sales.

*Example 4.* Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each controlled participant's current sales of fertilizers and insecticides. The market shares of the controlled participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The controlled participants' projections of RAB shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of RAB shares would take into account the expanding market share for insecticides.

(f) **Changes in participation under a CSA** -- In the case of any change in participation under a CSA as the result of a controlled transfer of all or part of a controlled participant's territorial rights under the CSA, as described in paragraph (b)(4) of this section, along with the assumption by the transferee of the associated obligations under the CSA, the transferee will be treated as succeeding to the transferor's prior history under the CSA, including the transferor's cost contributions, benefits derived, and PCT
Payments attributable to such rights or obligations. The transferor must receive an arm's-length amount of consideration from the transferee under the rules of §§1.482-1 and 1.482-4 through 1.482-6, as described in paragraph (a)(3)(ii) of this section. For purposes of this section, such a change in participation under a CSA includes, for example, any transaction in which --

(1) A controlled participant transfers all or part of its rights to another controlled participant that assumes the associated obligations under a CSA;

(2) A new controlled participant enters an ongoing CSA and acquires any territorial rights and assumes associated obligations under the CSA; or

(3) A controlled participant withdraws from an ongoing CSA, or otherwise abandons or relinquishes territorial rights and associated obligations under the CSA.

(g) Principles generally applicable in the case of PCTs -- The following principles apply, as appropriate, to the use of any of the methods pursuant to § 1.482-4 used to determine the arm's-length charge for a PCT under paragraph (a)(2) of this section.

(1) Valuations consistent with upfront contractual terms and risk allocations. The application of any method as of any time must be consistent with the applicable contractual terms and allocation of risk under the CSA and this section among the controlled participants as of the date of the PCT, unless there has been a change in such terms or allocation made in return for arm's-length consideration.

(2) Projections. The reliability of an estimate of the value of external contributions in connection with a PCT will often depend upon the reliability of projections used in making the estimate. Projections necessary for this purpose may include a projection of sales, IDCs, routine operating expenses, and costs of sales. For these purposes, projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements in this paragraph (a)(2) of this section and this paragraph (g).

(3) Realistic alternatives. (i) In general -- Regardless of the method or methods used, evaluation of the arm's length charge for the PCT in question should take into account the general principle that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of a transaction, and only entered into a particular transaction, if no alternative is preferable. This condition is not met, for example, where for any controlled participant the total anticipated present value from entering into the CSA to that controlled participant, as of the date of the PCT, is less than the total anticipated present value that could be achieved through an alternative arrangement realistically available to that controlled participant. When applying the realistic alternatives principle, the reliability of the respective net present value calculations, if any, should be considered.

(ii) Examples. The following examples illustrate the principles of this paragraph (g)(3):

Example 1. (i) P, a corporation, and S, a wholly-owned subsidiary of P, enter into a CSA to develop a gyroscopic personal transportation device (the product). Under the arrangement, P will undertake all of the R&D, and manufacture and market the product in Country X. S will make CST payments to P for its appropriate share of P's R&D costs, and manufacture and market the product in the rest of the world. P owns existing patents and trade secrets associated with gyroscopic applications. These patents and trade secrets are reasonably anticipated to contribute to the development of the product and are therefore the RT Rights in the patents and trade secrets are external development contributions for which compensation is due from S as part of a PCT.

(ii) S's manufacturing and distribution activities under the CSA will be routine in nature, and identical to the activities it would undertake if it alternatively licensed the product from P. S does not derive any exploitation benefits from P and the external exploitation contribution of P is therefore zero.
(iii) Reasonably reliable estimates indicate that P could self-develop and license the product outside of the Country X for a royalty of 20% of sales. Based on reliable financial projections that include all future development costs and licensing revenue, the net present value of this licensing alternative to P for the non-Country X market (measured as of the date of the PCT) would be $500 million of operating income. Thus, based on this realistic alternative, the anticipated net present value under the CSA to P in the non-Country X market (measured as of the date of the PCT), including R&D reimbursement and PCT Payments from S, should not be less than $500 million.

Example 2. (i) The facts are the same as Example 1, except that there are no reliable estimates of the value to P from the licensing alternative to the CSA. However, reasonably reliable estimates indicate that S can earn a 10% mark-up on total accounting costs related to its routine manufacturing and distribution activities.

(ii) P undertakes an economic analysis that derives S's cost contributions under the CSA, based on reliable financial projections. Based on this and further economic analysis, P determines S's PCT Payment as a certain lump sum amount to be paid as of the date of the PCT.

(iii) Based on reliable financial projections that include S's cost contributions and that incorporate S's PCT Payment, and using a discount rate of D%, appropriate for the riskiness of the CSA (see paragraph (g)(2)(vi) of this section), the anticipated net present value to S under the CSA (measured at the time of the PCT) is $800 million. Of this amount, $100 million is the portion associated with the 10% markup on S's total accounting costs from its manufacturing and distribution activities, utilizing its existing investment in plant and equipment.

(iv) In evaluating the PCT under the CSA, the Commissioner concludes that the respective activities undertaken by P and S would be identical regardless of whether the arrangement was undertaken as a CSA or as a licensing arrangement. That is, under either alternative, P would undertake all research activities and S would undertake routine manufacturing and distribution activities associated with its territory. Consequently, in every year the total anticipated combined nominal profits of P and S would be identical regardless of whether the arrangement was undertaken as a CSA or as a licensing arrangement. In addition, the Commissioner considers the fact that S's economic role in the CSA (beyond its routine activities) is merely that of an investor. A similarly situated investor would be willing to invest an amount in a similar R&D project such that it earns an anticipated return on that investment of D% and therefore has a net present value of $0 on the project (not taking into account any returns to routine activities). If S were to realize a D% return on its lump sum PCT Payment, then the anticipated net present value to S of the CSA would be $100 million, equal to the $100 million anticipated net present value related to S's manufacturing and distribution activities, utilizing its existing investment in plant and equipment, plus the $0 anticipated net present value from the investment in the form of the lump sum PCT Payment in the IDA of the CSA at a D% discount rate.

(v) The lump sum PCT Payment computed by P results in S having significantly higher anticipated discounted profitability, and therefore, in this case, higher anticipated nominal profitability, than it could achieve under the licensing alternative. By implication, P must correspondingly earn lower nominal profits under the CSA than it would under the licensing alternative (that is, S's enhanced profitability under the CSA is matched dollar-for-dollar by P's reduced profitability under the CSA). Consequently, the Commissioner concludes that P is earning a lower anticipated return through the CSA than it could achieve under its realistic alternative to the CSA, and that consequently S's lump sum PCT Payment under-compensates P for its external contributions.

Example 3. (i) The facts are the same as Example 2 except as follows. Based on reliable financial projections that include S's cost contributions and S's PCT Payment, discounted at a rate of D% to reflect the riskiness of the CSA, the anticipated net present value to S under the CSA (measured as of the date of the PCT) is $50 million. Instead of entering the CSA, S has the realistic alternative of investing in an R&D project with similar risk, at an anticipated return of D%, and manufacturing and distributing products
unrelated to the gyroscopic personal transportation device to the same extent as its manufacturing and
distribution under the CSA, with the same anticipated 10% mark-up on total costs.

(ii) Under its realistic alternative, at a discount rate of D%, S anticipates a present value of $100 million
from the routine manufacturing and distribution and $0 from the R&D investment, for a total of $100
million.

(iii) Because the lump sum PCT Payment made by S results in S having a considerably lower anticipated
net present value than S could achieve through an alternative arrangement realistically available to it, the
Commissioner may conclude that the lump sum PCT Payment overcompensates P for its external
development contribution.

(4) Discount rate -- (i) In general. Some calculations set forth in this paragraph (g) and elsewhere in this
section require determining a rate of return which is used to convert a future or past monetary sum
associated with a particular set of activities or transactions into a present value. For this purpose, a
discount rate should be used that 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. Depending on the particular facts and circumstances, the risk involved and thus, the
discount rate, may differ among a company's various activities or transactions. Normally, discount rates
are most reliably determined by reference to market information. For example, the weighted average cost
of capital (WACC) or some other reasonable method applied to the relevant activities and transactions
derived using any reasonably acceptable method under the taxpayer's facts and circumstances might
provide the most reliable discount rate. In such cases, this calculation might most reliably be based on
information from uncontrolled companies whose business activities as a whole constitute comparable
uncontrolled transactions. Where a company is publicly traded and its CSA involves substantially the
same risk as projects undertaken by the company as a whole, then the calculation of the discount rate
applied to the relevant activities and transactions might most reliably be based on the company's own
hurdle rate, internal rate of return or WACC. Depending on comparability and reliability considerations,
including the extent to which the company's hurdle rate reflects market information and is used in a
similar manner in the controlled and uncontrolled transactions, in some circumstances discount rates
might be most reliably determined by reference to other data such as a company's internal hurdle rate for
projects of comparable risk.

(ii) Examples. The following examples illustrate the principles of this paragraph (g)(4):

Example 1. USPharm, a publicly traded U.S. pharmaceutical company, enters into a CSA with FPharm,
its wholly-owned foreign subsidiary. Under the agreement both controlled participants agree to share the
research costs of developing a specific drug compound called T. USPharm is also engaged in another
development project for compounds U and V, which involves different risks than the T development
project and which is not part of the CSA. However, there are a large number of uncontrolled publicly
traded U.S. companies, for which information can be reliably derived, that are highly comparable to
USPharm but that conduct research only on compounds similar to T involving risks similar to those of the
T development project. At the commencement of the CSA (Year 1), USPharm and FPharm enter into a
PCT with respect to external development contributions owned by USPharm in the form of the RT Rights
in its pre-existing drug research. As part of the method that USPharm determines will most reliably
calculate PCT Payments, a discount rate is needed to convert future monetary sums into a present value.
After analysis, USPharm concludes that the discount rate is most reliably determined by calculating a
WACC based on the information relating to the comparable uncontrolled companies with suitable
adjustments for factors such as differences in capital structure between USPharm and the comparables,
and for the stability and other statistical properties of the beta measurement of the comparables.

Example 2. The facts are the same as in Example 1 except that the T development project is the only
business activity of USPharm and FPharm and no reliable data exists on uncontrolled companies
undertaking similar activities and risk as those associated with the CSA. After analysis, USPharm
concludes that the discount rate is most reliably determined by reference to its own WACC. USPharm
funds its operations with debt and common stock. Debt comprises 40% of its financing and USPharm's cost of debt is 6%. Equity comprises the remaining 60% of financing. USPharm is publicly traded and its equity beta is 1.25. Using third party information, USPharm concluded that the appropriate risk-free rate and equity risk premium are X% and Y%, respectively, implying a return on USPharm's equity of Z% \[ X\% + (1.25 \cdot Y\% \] . The weighted average cost of capital is calculated by blending and weighting the after-tax cost of debt and the cost of equity according to percentage of total financing. USPharm's weighted average cost of capital is W% \[(6\% \cdot 0.4) + (Z\% \cdot 0.6)\] .

Example 3. Use of a documented discount rate. The facts are the same as Example 1 except that no data exists on uncontrolled companies undertaking similar activities and risks as those associated with the CSA. USPharm has documented a hurdle rate of 12% that it uses as the minimum anticipated return for its business investments having a comparable risk profile. The Commissioner examines USPharm's documentation and concludes that the hurdle rate provides a reliable discount rate in this case.

(5) Accounting principles -- (i) In general. Allocations or other valuations done for accounting purposes may provide a useful starting point but will not be conclusive for purposes of assessing or applying methods to evaluate the arm's length charge in a PCT, particularly where the accounting treatment of an asset is inconsistent with its economic value.

(ii) Examples. The following examples illustrate the principles of this paragraph (g)(5):

Example 1. (i) USP, a U.S. corporation and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop software programs with application in the medical field. Company X is an uncontrolled software company located in the United States that is engaged in developing software programs that could significantly enhance the programs being developed by USP and FSub. Company X is still in a startup phase, so it has no currently exploitable products or marketing intangibles and its workforce consists of a team of software developers. Company X has negligible liabilities and tangible property. In Year 2, USP purchases Company X as part of an uncontrolled transaction in order to acquire its in-process technology and workforce for purposes of the development activities of the CSA. USP files a consolidated return that includes Company X. For accounting purposes, $50 million of the $100 million acquisition price is allocated to the in-process technology and workforce, and the residual $50 million is allocated to goodwill.

(ii) The in-process technology and workforce of Company X acquired by USP are reasonably anticipated to contribute to developing cost shared intangibles and therefore the RT Rights in the in-process technology and workforce of Company X external development contributions for which FSub must compensate USP as part of a PCT. In determining whether to apply the comparable uncontrolled transaction method under §1.482-4 or another method for purposes of evaluating the arm's length charge in the PCT, relevant comparability and reliability considerations must be weighed in light of the general principles of paragraph (g)(2) of this section. The allocation for accounting purposes raises an issue as to the reliability of using the CUT method in this case because it indicates that a significant portion of the value of Company X's assets is allocable to goodwill, which is often difficult to value reliably and which, depending on the facts and circumstances, might not be attributable to external development contributions that are to be compensated by PCTs. Such goodwill most likely is not attributable to external exploitation contributions since Company X had not marketing intangibles at the CSA start date.

(iii) Paragraph (g)(2)(vii) of this section provides that accounting treatment may be a starting point, but is not determinative for purposes of assessing or applying methods to evaluate the arm's length charge in a PCT. The facts here reveal that Company X has nothing of economic value aside from its in-process technology and assembled workforce. The $50 million of the acquisition price allocated to goodwill for accounting purposes, therefore, is economically attributable to either or both the in-process technology and the workforce. That moots the potential issue under the CUT method of the reliability of valuation of assets not to be compensated by PCTs, since there are no such assets. Assuming the CUT method is otherwise the most reliable method, the aggregate value of Company X's in-process technology and workforce is the full acquisition price of $100 million. Accordingly, the aggregate value of the arm's length
PCT Payments due from FSub to USP for the external development contributions consisting of the RT Rights in Company X's in-process technology and workforce will equal $100 million multiplied by FSub's RAB share.

**Example 2.** (i) The facts are the same as in Example 1, except that Company X is a mature software business in the United States with a successful current generation of software that it markets under a recognized trademark, in addition to having the research team and new generation software in process that could significantly enhance the programs being developed under USP's and FSub's CSA. USP continues Company X's existing business and integrates the research team and the in-process technology into the efforts under its CSA with FSub. For accounting purposes, the $100 million acquisition price for acquiring Company X is allocated $50 million to existing software and trademark, $25 million to in-process technology and research workforce, and the residual $25 million to goodwill and going concern value.

(ii) In this case an analysis of the facts indicates a likelihood, consistent with the allocation under the accounting treatment (although not necessarily in the same amount), of goodwill and going concern value economically attributable to the existing U.S. software business. As such, these intangibles may represent external exploitation contributions to the extent FSub will derive benefit from use of such intangibles in its sales or licenses of cost shared intangibles. These intangibles may not represent the external development contributions consisting of the RT Rights in the in-process technology and research workforce.

(h) **Coordination with the arm's length standard.** A CSA produces results that are consistent with an arm's length result within the meaning of §1.482-1(b)(1) if, and only if, each controlled participant's IDC share (as determined under paragraph (d)(4) of this section) equals its RAB share (as required by paragraph (a)(1) of this section), and all other requirements of this section are satisfied.

(i) **Allocations by the Commissioner in connection with a CSA -- (1) In general.** The Commissioner may make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result, in accordance with the provisions of this paragraph (i).

(2) **CST allocations -- (i) In general.** The Commissioner may make allocations to adjust the results of a CST so that the results are consistent with an arm's length result, including any allocations to make each controlled participant's IDC share, as determined under paragraph (d)(4) of this section, equal to that participant's RAB share, as determined under paragraph (e)(1) of this section. Such allocations may result from, for purposes of CST determinations, adjustments to --

(A) Redetermine IDCs by adding any costs (or cost categories) that are directly identified with, or are reasonably allocable to, the IDA, or by removing any costs (or cost categories) that are not IDCs;

(B) Reallocate costs between the IDA and other business activities;

(C) Improve the reliability of the selection or application of the basis used for measuring benefits for purposes of estimating a controlled participant's RAB share;

(D) Improve the reliability of the projections used to estimate RAB shares, including adjustments described in paragraph (i)(2)(ii) of this section; and

(E) Allocate among the controlled participants any unallocated interests in cost shared intangibles.

(ii) **Adjustments to improve the reliability of projections used to estimate RAB shares -- (A) Unreliable projections.** A significant divergence between projected benefit shares and benefit shares adjusted to take into account any available actual benefits to date (adjusted benefit shares) may indicate that the
projections were not reliable for purposes of estimating RAB shares. Consistent with paragraph (e)(1) of this section, a taxpayer which discovers such divergence prior to examination of the years covered by that CSA may make written amendments to that CSA to update the RAB shares in a manner that is consistent with the rules for modifying a CSA as well as the CSA provisions concerning modifying that CSA. It must also provide a means of correcting the prior erroneous RAB shares for the years covered. Under such circumstances, such taxpayer actions will modify the existing CSA and will not be treated as either a termination of the existing CSA or as the creation of a new CSA. Absent such action by a taxpayer, the Commissioner may use adjusted benefit shares as the most reliable measure of RAB shares and adjust IDC shares accordingly. The projected benefit shares will not be considered unreliable, as applied in a given taxable year, based on a divergence from adjusted benefit shares for every controlled participant that is less than or equal to 20% of the participant's projected benefits share. Further, the Commissioner will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the controlled participants, which could not reasonably have been anticipated at the time that costs were shared. The Commissioner generally may adjust projections of benefits used to calculate benefit shares in accordance with the provisions of §1.482-1. In particular, if benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. For purposes of this paragraph, all controlled participants that are not U.S. persons are treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection of RAB shares will be made to the IDC shares of foreign controlled participants only if there is a matching adjustment to the IDC shares of controlled participants that are U.S. persons. Nothing in this paragraph (i)(2)(ii)(A) prevents the Commissioner from making an allocation if taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures its anticipated benefits based on units sold, and the Commissioner determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(B) Foreign-to-foreign adjustments. Adjustments to IDC shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(C) Correlative adjustments to PCTs. Correlative adjustments will be made to any PCT Payments of a fixed amount that were determined based on RAB shares which are subsequently adjusted on a finding that they were based on unreliable projections. No correlative adjustments will be made to contingent PCT Payments regardless of whether RAB shares were used as a parameter in the valuation of those payments.

(D) Examples. The following examples illustrate the principles of this paragraph (i)(2)(ii):

Example 1. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new food products, dividing costs on the basis of projected sales two years in the future. In Year 1, USP and FS project that their sales in Year 3 will be equal, and they divide costs accordingly. In Year 3, the Commissioner examines the controlled participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The Commissioner agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's adjusted and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for Year 3 is reliable.

Example 2. The facts are the same as in Example 1, except that in Year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and adjusted benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the controlled participants. The Commissioner concludes that the projected benefit shares were unreliable, and uses adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.
Example 3. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a CSA in Year 1. They project that they will begin to receive benefits from covered intangibles in Years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In Years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the controlled participants’ projections, the Commissioner compares the adjusted benefit shares to the projected benefit shares. Although USP’s adjusted benefit share (50%) is within 20% of its projected benefit share (60%), FS’s adjusted benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the Commissioner may conclude that the controlled participants’ projections were not reliable and may use adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 4. Three controlled taxpayers, USP, FS1 and FS2 enter into a CSA. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The controlled participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Adjusted benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the controlled participants’ projections, the Commissioner compares these adjusted benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single controlled participant. The adjusted benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US controlled participants’ adjusted benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the Commissioner concludes that the controlled participants’ projections of future benefits were reliable, despite the fact that FS2’s adjusted benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 5. The facts are the same as in Example 4. In addition, the Commissioner determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the Commissioner concludes that the controlled participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1’s earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to paragraph (i)(2)(ii)(B) of this section, the Commissioner may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2’s projection of future benefits was unreliable and the variation between adjusted and projected benefits had the effect of substantially reducing USP’s U.S. income tax liability (on account of FS1 subpart F income).

Example 6. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA in 1996 to develop a new treatment for baldness. USS’s interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

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<th>Year</th>
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<th>FP</th>
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<td>40</td>
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(B) In Year 1, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the Year 1, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In Year 6 the Commissioner examines the cost sharing arrangement. USS and FP have obtained the following sales results through the Year 5:

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<th>Year</th>
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<td>6</td>
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<td>10</td>
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(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by Year 5 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the Commissioner determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these adjusted benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between adjusted and projected benefit shares.
Example 7. (i) The facts are the same as in Example 6, except that the actual sales results through Year 5 are as follows:

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<th>Year</th>
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<tbody>
<tr>
<td>1</td>
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<td>17</td>
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<td>5</td>
<td>36</td>
<td>55</td>
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(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the Commissioner determines that for the remaining years the following sales projections are more reliable than the original projections:

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<tr>
<th>Year</th>
<th>USS</th>
<th>FP</th>
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<tbody>
<tr>
<td>6</td>
<td>36</td>
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(iii) Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These adjusted benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were unreliable. The Commissioner adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(iii) Timing of CST allocations. If the Commissioner makes an allocation to adjust the results of a CST, the allocation must be reflected for tax purposes in the year in which the IDCs were incurred. When a cost sharing payment is owed by one controlled participant to another controlled participant, the Commissioner may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of §1.482-2(a) (Loans or advances).

(3) PCT allocations. The Commissioner may make allocations to adjust the results of a PCT so that the results are consistent with an arm's length result in accordance with the provisions of the applicable
sections of the section 482 regulations, as determined pursuant to paragraph (a)(2) of this section. The Commissioner may not make such adjustments with respect to any taxable year that is closed, but may make adjustments to the amount of PCT Payments due in any subsequent open year so that such subsequent-year PCT Payments are consistent with the PCT Payments that would have been made in such subsequent years had the PCT been conducted on an arm’s length basis as determined pursuant to paragraph (a)(2) of this section.

(4) **Allocations regarding changes in participation under a CSA.** The Commissioner may make allocations to adjust the results of any controlled transaction described in paragraph (f) of this section, if the controlled participants do not reflect arm’s length results in relation to any such transaction.

(5) **Allocations when CSTs are consistently and materially disproportionate to RAB shares.** If a controlled participant bears IDC shares that are consistently and materially greater or lesser than its RAB share, then the Commissioner may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the CSA. In such a case, the Commissioner may disregard such terms and impute an agreement that is consistent with the controlled participants’ course of conduct, under which a controlled participant that bore a disproportionately greater IDC share received additional interests in the cost shared intangibles. See §1.482-1(d)(3)(ii)(B) (Identifying contractual terms) and §1.482-4(f)(3)(ii) (Identification of owner). Such additional interests will consist of partial undivided interests in another controlled participant’s territory. Accordingly, that controlled participant must receive arm's length consideration from any controlled participant whose IDC share is less than its RAB share over time, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6.

(j) **Definitions and special rules -- (1) Definitions.** For purposes of this section:

(i) **Controlled participant** means a controlled taxpayer, as defined under §1.482-1(i)(5), that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits, as defined in paragraph (j)(1)(iv) of this section, from exploiting one or more cost shared intangibles.

(ii) **Cost shared intangible** means any intangible, within the meaning of §1.482-4(b), developed or to be developed as a result of the IDA, as described in paragraph (d)(1) of this section, including any portion of such intangible that reflects an external development contribution and an external exploitation intangible, as described in paragraph (b)(3)(ii) and (b)(3)(iii) of this section.

(iii) **An interest in an intangible** includes any commercially transferable interest, the benefits of which are susceptible of valuation.

(iv) **Benefits** mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.

(v) A controlled participant’s **reasonably anticipated benefits** mean the aggregate benefits that reasonably may be anticipated to be derived from exploiting cost shared intangibles.

(vi) **Territorial operating profit or loss** means the operating profit or loss as separately earned by each controlled participant in its geographic territory or other basis by which its rights are defined, as described in paragraph (b)(4) of this section, from the CSA activity, determined before any expense (including amortization) on account of IDCs, routine external contributions, and nonroutine contributions.

(vii) The **CSA Activity** is the activity of developing and exploiting cost shared intangibles.

(viii) **Examples.** The following examples illustrate the principles of this paragraph (j)(1):
Example 1. Controlled participant. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a CSA with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The CSA provides that USS will receive the rights to exploit the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to exploit this process in the United States, USS is not a controlled participant because it will not derive a benefit from the exploiting the intangible developed under the CSA.

Example 2. Controlled participants. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a CSA to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R+D is not assigned any rights to exploit the intangibles. R+D's activity consists solely in carrying out research for the group. It is reliably projected that the RAB shares of USP and FS will be 66 2/3% and 33 1/3%, respectively, and the parties' agreement provides that USP and FS will reimburse 66 2/3% and 33 1/3%, respectively, of the IDCs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (j)(1)(i) of this section, because it will not derive any benefits from exploiting cost shared intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of paragraph (a)(3) of this section and §1.482-4(f)(3)(iii). Such consideration must be treated as IDCs incurred by USP and FS in proportion to their RAB shares (i.e., 66 2/3% and 33 1/3%, respectively). R+D will not be considered to bear any share of the IDCs under the arrangement.

Example 3. Cost shared intangible. U.S. Parent (USP) has developed and currently exploits an antihistamine, XY, which is manufactured in tablet form. USP enters into a CSA with its wholly-owned foreign subsidiary (FS) to develop XYZ, a new improved version of XY that will be manufactured as a nasal spray. XYZ is a cost shared intangible under the CSA.

Example 4. Cost shared intangible. The facts are the same as in Example 3, except that instead of developing XYZ, the controlled participants develop ABC, a cure for the common cold. ABC is a cost shared intangible under the CSA.

Example 5. Reasonably anticipated benefits. Controlled parties A and B enter into a cost sharing arrangement to develop product and process intangibles for an already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of $100M from sales of Product P until it became obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of $20M in present value revenue from the product intangible, while B reasonably anticipates only an increase of $10M. Further, A and B each reasonably anticipate spending an extra $5M present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving $2M present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($20M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($10M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $7M. Thus A's reasonably anticipated benefits are $17M and B's reasonably anticipated benefits are $7M.
(2) Special rules -- (i) Consolidated group. For purposes of this section, all members of the same consolidated group shall be treated as one taxpayer. For purposes of this paragraph (j)(2)(i), the term consolidated group means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

(ii) Trade or business. A participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in a trade or business within the United States solely by reason of its participation in a CSA described in paragraph (b)(1) of this section. See generally §1.864-2(a).

(iii) Partnership. A CSA, or an arrangement to which the Commissioner applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K of the Internal Revenue Code apply. See §301.7701-1(c) of this chapter.

(3) Character -- (i) In general. CST payments generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (j)(3), a controlled participant's payment required under a CSA is deemed to be reduced to the extent of any payments owed to it under the CSA from other controlled participants. Each payment received by a payee will be treated as coming pro rata from payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the CSA. Payments received in excess of such deductions will be treated as in consideration for use of the land and tangible property furnished for purposes of the CSA by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in §1.41-6(e). Any payment made or received by a taxpayer pursuant to an arrangement that the Commissioner determines not to be a CSA will be subject to the provisions of §§1.482-1 and 1.482-4 through 1.482-6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(ii) PCT Payments. A PCT Payor's payment required under paragraphs (b)(1)(ii) and (b)(3) of this section is deemed to be reduced to the extent of any payments owed to it under such paragraphs from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors. PCT Payments will be characterized consistently with the designation of the type of transaction involved in the RT pursuant to paragraph (b)(iv) of this section. Depending on such designation, such payments will be treated as either consideration for a transfer of an interest in intangible property or for services.

(iii) Examples. The following examples illustrate this paragraph (j)(3):

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a CSA to develop a miniature widget, the Small R. Based on RAB shares, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal IDCs are operating costs incurred by FS in Country Z of 100X annually, and costs incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X. The payment will be treated as a reimbursement of 20X of USP's costs in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in Example 1, except that the 100X of costs borne by USP consist of 5X of costs incurred by USP in the United States and 95X of arm's length rental charge, as described in paragraph (d)(1) of this section, for the use of a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction
pro rata of the 5X deduction for costs and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

Example 3. (i) Four members A, B, C, and D of a controlled group form a CSA to develop the next generation technology for their business. Based on RAB shares, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length values of the external contributions they respectively own are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final PCT Payments among A, B, C, and D are shown in the table as follows:

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments</td>
<td>&lt;40&gt;</td>
<td>&lt;21&gt;</td>
<td>&lt;37.5&gt;</td>
</tr>
<tr>
<td>Receipts</td>
<td>48</td>
<td>34</td>
<td>22.5</td>
</tr>
<tr>
<td>Final</td>
<td>8</td>
<td>13</td>
<td>&lt;15&gt;</td>
</tr>
</tbody>
</table>

(ii) The first row/first column shows A’s provisional PCT Payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A’s RAB share of 40%. The second row/first column shows A’s provisional PCT receipts equal to the sum of the products of 80X and B’s, C’s, and D’s RAB shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final PCT receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

(k) CSA contractual, documentation, accounting, and reporting requirements -- (1) CSA contractual requirements -- (i) In general. A CSA that is described in paragraph (b)(1) of this section must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the CSA and that includes the contractual provisions described in this paragraph (k)(1).

(ii) Contractual provisions. The written contract described in this paragraph (k)(1) must include provisions that --

(A) List the controlled participants and any other members of the controlled group that are reasonably anticipated to benefit from the use of the cost shared intangibles, including the address of each domestic entity and the country of organization of each foreign entity;

(B) Describe the scope of the IDA to be undertaken, including each cost shared intangible or class of cost shared intangibles that the controlled participants intend to develop under the CSA;

(C) Specify the functions and risks that each controlled participant will undertake in connection with the CSA;

(D) Divide among the controlled participants all interests in cost shared intangibles and specify each controlled participant’s interest in the cost shared intangibles, as described in paragraph (b)(4) of this section, that it will own and exploit without any further obligation to compensate any other controlled participant for such interest;

(E) Provide a method to calculate the controlled participants’ RAB shares, based on factors that can reasonably be expected to reflect the participants’ shares of anticipated benefits, and require that such RAB shares must be updated, as described in paragraph (e)(1) of this section (see also paragraph (k)(2)(ii)(F) of this section);
(F) Enumerate all categories of IDCs to be shared under the CSA;

(G) Specify that the controlled participants must use a consistent method of accounting to determine IDCs and RAB shares, as described in paragraphs (d) and (e) of this section, respectively, and must translate foreign currencies on a consistent basis;

(H) Require the controlled participants to enter into CSTs covering all IDCs, as described in paragraph (b)(2) of this section, in connection with the CSA;

(I) Require the controlled participants to enter into PCTs covering all external contributions, both external development contributions and external exploitation contributions, as described in paragraph (b)(3) of this section, in connection with the CSA; and

(J) Specify the duration of the CSA, the conditions under which the CSA may be modified or terminated, and the consequences of a modification or termination (including consequences described under the rules of paragraph (f) of this section).

(iii) Meaning of contemporaneous -- (A) In general. For purposes of this paragraph (k)(1), a written contractual agreement is contemporaneous with the formation (or revision) of a CSA if, and only if, the controlled participants record the CSA, in its entirety, in a document that they sign and date no later than the later to occur of (i) the final day of each participant's respective taxable year in which the first occurrence of any IDC described in paragraph (d) of this section to which such agreement (or revision) is to apply, or (ii) the date 90 days after the first occurrence of any such IDC. However, if the written agreement which fails the tests of both (i) and (ii) and is executed no later than the end of the first taxable year of each recipient after such participant's taxable year in which the first IDC occurs, and also provided that the parties' actions from the time of such first IDC until the time that the written agreement is executed are consistent with the CSA under such circumstances, then the Commissioner shall treat the arrangement as a CSA as of the taxable year in which the written agreement is executed and may make such adjustments to the prior taxable year as are appropriate under the circumstances.

(B) Examples. The following example illustrates the principles of this paragraph (k)(1)(iii):

Example 1. Companies A and B, both of which are members of the same controlled group and both of which are calendar year taxpayers, commence an IDA on March 1, Year 1. Company A pays the first IDCs in relation to the IDA, as cash salaries to A's research staff, for the staff's work during the first week of March, Year 1. A and B, however, do not sign and date any written contractual agreement until August 1, Year 1, whereupon they execute a "Cost Sharing Agreement" that purports to be "effective as of" March 1 of Year 1. The arrangement meets the requirement that the participants record their arrangement in a written contractual agreement that is contemporaneous with the formation of a CSA because it was executed in the same taxable year of each participant as occurred the first IDC to which the agreement relates.

Example 2. The facts are the same as in Example 1, except that the taxable years of Companies A and B both end on June 30. The arrangement fails to meet the requirement that the participants record their arrangement in a written contract that is contemporaneous with the formation of the CSA because the agreement was not executed on or before June 30, the end of the participants' taxable year in which the first IDC occurred, which was more than 90 days after such IDC occurred. However, since the timing of the participants' written agreement does meet the test of paragraph (k)(1)(iii)(A) of this section, the Commissioner will accept the arrangement as a CSA beginning in Year 2 but may make such adjustments to the taxpayer's Year 1 results as are appropriate under the circumstances.

(2) CSA documentation requirements -- (i) In general. The controlled participants must timely update and maintain sufficient documentation to establish that the participants have met the CSA contractual
requirements of paragraph (k)(1) of this section and the additional CSA documentation requirements of this paragraph (k)(2).

(ii) Additional CSA documentation requirements. The controlled participants to a CSA must timely update and maintain documentation sufficient to --

(A) Identify the cost shared intangibles that the controlled participants have developed or intend to develop under the CSA, together with each controlled participant's interest therein;

(B) Establish that each controlled participant reasonably anticipates that it will derive benefits from exploiting cost shared intangibles;

(C) Describe the functions and risks that each controlled participant has undertaken during the term of the CSA;

(D) Provide an overview of each controlled participant's business segments, including an analysis of the economic and legal factors that affect CST and PCT pricing;

(E) Establish the amount of each controlled participant's IDCs for each taxable year under the CSA, including all IDCs attributable to stock-based compensation, as described in paragraph (d)(3) of this section (including the method of measurement and timing used in determining such IDCs, and the data, as of the date of grant, used to identify stock-based compensation with the IDA);

(F) Describe the method used to estimate each controlled participant's RAB share for each year during the course of the CSA, including --

(1) All projections used to estimate benefits;

(2) All updates of the RAB shares in accordance with paragraph (e)(1) of this section; and

(3) An explanation of why that method was selected and why the method provides the most reliable measure for estimating RAB shares;

(G) Describe all external development and exploitation contributions, as described in paragraph (b)(3)(ii) and (b)(3)(iii) of this section;

(H) Describe the RT for each PCT or group of PCTs;

(I) Specify the form of payment due under each PCT or group of PCTs;

(J) Describe and explain the method selected to determine the arm's length payment due under each PCT, including --

(1) An explanation of why the method selected constitutes the best method, as described in §1.482-1(c)(2), for measuring an arm's length result;

(2) The economic analyses, data, and projections relied upon in developing and selecting the best method, including the source of the data and projections use;

(3) Each alternative method that was considered, and the reason or reasons that the alternative method was not selected;
(4) Any data that the controlled participant obtains, after the CSA takes effect, that would help determine if the controlled participant method selected has been applied in a reasonable manner;

(5) The discount rate, where applicable, used to value each payment due under a PCT, and a demonstration that the discount rate used is consistent with the principles of paragraph (g)(4) of this section;

(6) The estimated arm's length values of any external development and exploitation contributions as of the dates of the relevant PCTs; and

(7) A discussion, where applicable, of why transactions were or were not aggregated under the principles of paragraph (a)(2) of this section.

(K) Consistent with paragraph (e) of this section and paragraph (k)(1)(iii)(A) of this section, the effect of written amendments made by the taxpayer prior to the Commissioner examining such taxable year(s) is to allow the taxpayer to amend its CSA in a manner consistent with these regulations. As a result, the Commissioner will accept the treatment of the amended arrangement as a CSA that is operational as of the effective date provided under paragraph (k)(1)(iii)(A) of this section while reserving the right to make such examination adjustments as are necessary under the circumstances.

(iii) Coordination rules and production of documents -- (A) Coordination with penalty regulations. See §1.6662-6(d)(2)(iii)(D) regarding coordination of the rules of this paragraph (k) with the documentation requirements for purposes of the accuracy-related penalty under section 6662(e) and (h).

(B) Production of documentation. Each controlled participant must provide to the Commissioner, within 30 days of a request, the items described in paragraphs (k)(2) and (3) of this section. The time for compliance described in this paragraph (k)(2)(iii)(B) may be extended at the discretion of the Commissioner.

(3) CSA accounting requirements -- (i) In general. The controlled participants must maintain books and records (and related or underlying data and information) that are sufficient to --

(A) Establish that the controlled participants have used (and are using) a consistent method of accounting to measure costs and benefits;

(B) Translate foreign currencies on a consistent basis; and

(C) To the extent that the method materially differs from U.S. generally accepted accounting principles, explain any such material differences.

(ii) Reliance on financial accounting. For purposes of this section, the controlled participants may not rely solely upon financial accounting to establish satisfaction of the accounting requirements of this paragraph (k)(3). Rather, the method of accounting must clearly reflect income. *Thor Power Tools Co. v. Commissioner*, 439 U.S. 522 (1979).

(4) CSA reporting requirements -- (i) CSA Statement. Each controlled participant must file with the Internal Revenue Service, in the manner described in this paragraph (k)(4), a "Statement of Controlled Participant to §1.482-7 Cost Sharing Arrangement" (CSA Statement) that complies with the requirements of this paragraph (k)(4).

(ii) Content of CSA Statement. The CSA Statement of each controlled participant must --

(A) State that the participant is a controlled participant in a CSA;
(B) Provide the controlled participant's taxpayer identification number;

(C) List the other controlled participants in the CSA, the country of organization of each such participant, and the taxpayer identification number of each such participant;

(D) Specify the earliest date that any IDC described in paragraph (d)(1) of this section occurred; and

(E) Indicate the date on which the controlled participants formed (or revised) the CSA and, if different from such date, the date on which the controlled participants recorded the CSA (or any revision) contemporaneously in accordance with paragraphs (k)(1)(i) and (iii) of this section.

(iii) Time for filing CSA Statement -- (A) 90-day rule. Each controlled participant must file its original CSA Statement with the Internal Revenue Service Ogden Campus, no later than 90 days after the first occurrence of an IDC to which the newly-formed CSA applies, as described in paragraph (k)(1)(iii)(A) of this section, or, in the case of a taxpayer that became a controlled participant after the formation of the CSA, no later than 90 days after such taxpayer became a controlled participant. A CSA Statement filed in accordance with this paragraph (k)(4)(iii)(A) must be dated and signed, under penalties of perjury, by an officer of the controlled participant who is duly authorized (under local law) to sign the statement on behalf of the controlled participant.

(B) Annual return requirement -- (1) In general. Each controlled participant must attach to its U.S. income tax return, for each taxable year for the duration of the CSA, a copy of the original CSA Statement that the controlled participant filed in accordance with the 90-day rule of paragraph (k)(4)(iii)(A) of this section. In addition, the controlled participant must update the information reflected on the original CSA Statement annually by attaching a schedule that documents changes in such information over time.

(2) Special filing rule for annual return requirement. If a controlled participant is not required to file a U.S. income tax return, the participant must ensure that the copy or copies of the CSA Statement and any updates are attached to Schedule M of any Form 5471, any Form 5472, or any Form 8865, filed with respect to that participant.

(iv) Examples. The following examples illustrate this paragraph (k)(4). In each example, Companies A and B are members of the same controlled group. The examples are as follows:

Example 1. A and B, both of which file U.S. tax returns, agree to share the costs of developing a new chemical formula in accordance with the provisions of this section. On March 30, Year 1, A and B record their agreement in a written contract styled, "Cost Sharing Agreement." The contract applies by its terms to IDCs occurring after March 1, Year 1. The first IDCs to which the CSA applies occurred on March 15, Year 1. To comply with paragraph (k)(4)(iii)(A) of this section, A and B individually must file separate CSA Statements no later than 90 days after March 15, Year 1 (June 13, Year 1). Further, to comply with paragraph (k)(4)(iii)(B) of this section, A and B must attach copies of their respective CSA Statements to their respective Year 1 U.S. income tax returns.

Example 2. The facts are the same as in Example 1, except that a year has passed and C, which files a U.S. tax return, joined the CSA on May 9, Year 2. To comply with the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, A and B must each attach copies of their respective CSA Statements (as filed for Year 1) to their respective Year 2 income tax returns, along with a schedule updated appropriately to reflect the changes in information described in paragraph (k)(4)(ii) of this section resulting from the addition of C to the CSA. To comply with both the 90-day rule described in paragraph (k)(4)(iii)(A) of this section and the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, C must file a CSA Statement no later than 90 days after May 9, Year 2 (August 7, Year 2), and must attach a copy of such CSA Statement to its Year 2 income tax return.
(l) **Effective date.** This section applies on the date of publication of this document as a final regulation in the Federal Register.

(m) **Transition rule -- (1) In general.** Subject to paragraph (m)(2) of this section, an arrangement in existence before the date of publication of this document as a final regulation in the Federal Register will be considered a CSA, as described under paragraph (b) of this section, if, prior to such date, it was a qualified cost sharing arrangement under the provisions of §1.482-7 (as contained in the 26 CFR part 1 edition revised as of January 1, 1996, hereafter referred to as "former §1.482-7"), but only if the written contract, as described in paragraph (k)(1) of this section, is amended, if necessary, to conform with the provisions of this section, as modified by paragraph (m)(3) of this section, by the close of the 120th day after the date of publication of this document as a final regulation in the Federal Register.

(2) **Termination of grandfather status.** Notwithstanding paragraph (m)(1) of this section, an arrangement otherwise therein described will not be considered a CSA from the earliest of --

(i) A failure of the controlled participants to substantially comply with the provisions of this section, as modified by paragraph (m)(3) of this section; or

(ii) A material change in the scope of the arrangement, such as a material expansion of the activities undertaken beyond the scope of the intangible development area, as described in former §1.482-7(b)(4)(iv), as of the date of publication of this document as a final regulation in the Federal Register.

(3) **Transitional modification of applicable provisions.** For purposes of this paragraph (m), conformity and substantial compliance with the provisions of this section shall be determined with the following modifications:

(i) CSTs and PCTs occurring prior to the date of publication of this document as a final regulation in the Federal Register shall be subject to the provisions of former §1.482-7 rather than this section.

(ii) Paragraph (b)(1)(i) and paragraph (b)(4) of this section shall not apply.

(iii) Paragraph (k)(1)(ii)(D) of this section shall not apply.

(iv) Paragraph (k)(1)(ii)(H) and paragraph (k)(1)(ii)(I) of this section shall be construed as applying only to transactions entered into on or after the date of publication of this document as a final regulation in the Federal Register.

(v) The deadline for recordation of the revised written contractual agreement pursuant to paragraph (k)(1)(iii) of this section shall be no later than the 120th day after the date of publication of this document as a final regulation in the Federal Register.

(vi) Paragraphs (k)(2)(ii)(G) through (J) of this section shall be construed as applying only with reference to PCTs entered into on or after the date of publication of this document as a final regulation in the Federal Register.

(vii) Paragraph (k)(4)(iii)(A) shall be construed as requiring a CSA Statement with respect to the revised written contractual agreement described in paragraph (m)(3)(iv) of this section no later than the 180th day after the date of publication of this document as a final regulation in the Federal Register.

(viii) Paragraph (k)(4)(iii)(B) shall be construed as only applying for taxable years ending after the filing of the CSA Statement described in paragraph (m)(3)(vii) of this section.
Par. 9. Section 1.482-8 is amended by adding *Examples 10 through 15* at the end of the section to read as follows:

§1.482-8 *Examples of the best method rule.*

* * * * *

Par. 10. Section 1.861-17 is amended by revising paragraph (c)(3)(iv) to read as follows:

§1.861-17 *Allocation and apportionment of research and experimental expenditures.*

* * * * *

(c) * * *

(3) * * *

(iv) *Effect of cost sharing arrangements.* If the corporation controlled by the taxpayer has entered into a cost sharing arrangement, in accordance with the provisions of §1.482-7, with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense.

* * * * *

Par. 11. Section 1.6662-6 is amended by:

1. Removing the third and fourth sentence of paragraph (d)(2)(i)

2. Adding paragraph (D) to paragraph (d)(2)(iii).

The addition reads as follows:

§1.6662-6 *Transaction between persons described in section 482 and net section 482 transfer price adjustments.*

* * * * *

(d) * * *

(2) * * *

(iii) * * *

(D) Satisfaction of the documentation requirements described in §1.482-7(k)(2) for the purpose of complying with the rules for CSAs under §1.482-7 also satisfies all of the documentation requirements listed in paragraph (d)(2)(iii)(B) of this section, except the requirements listed in paragraphs (2) and (10) of such paragraph, with respect to CSTs and PCTs described in §1.482-7(b)(2) and (3), provided that the documentation also satisfies the requirements of paragraph (d)(2)(iii)(A) of this section.

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PART 301 -- PROCEDURE AND ADMINISTRATION

Par. 12. The authority for part 301 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 13. Section 301.7701-1 is amended by revising paragraph (c) to read as follows:

§301.7701-1 Classification of organizations for federal tax purposes.

* * * * *

(c) Cost sharing arrangements. A cost sharing arrangement that is described in §1.482-7 of this chapter, including any arrangement that the Commissioner treats as a CSA under §1.482-7(b)(5) of this chapter, is not recognized as a separate entity for purposes of the Internal Revenue Code. See §1.482-7 of this chapter for the rules regarding CSAs.

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