IRS Proposed Transfer Pricing Regulations

by

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Overview

Over the past ten years many American multi-national enterprises have reduced their worldwide tax rate, using Cost Sharing Agreements (CSAs) to transfer intellectual property to tax havens. The U.S. Internal Revenue Service (IRS) has questioned whether taxpayers have made these transfers at arms-length values. In August, 2005 the IRS proposed new transfer pricing regulations to govern CSAs. These regulations propose an “investor model” to value contributions of pre-existing intellectual property to CSAs. These regulations draw upon modern financial theory, including present value concepts, to value intellectual property. If implemented, these proposed regulations will to increase transfer prices paid for intangible assets. The purpose of this paper is to explain the proposed regulations, identify key issues raised by these regulations, and to forecast likely responses to the regulations.

Background

Intellectual property is a key factor in business success. Intellectual property includes patents, copyrights, trademarks, and other intellectual know-how associated with development of technologically advanced products. Intellectual property development is the most important business activity in many advanced business sectors, such as software development and pharmaceuticals. Intellectual property can allow businesses to earn superior rates of return, so the stakes are high. As an indication of the growing importance of intellectual property, businesses now buy and sell intellectual property.1

Intellectual property development can be viewed in two distinct ways, one geographic, and one legal. A geographic perspective focuses upon the physical location scientists, engineers, and marketers develop intellectual property. A legal perspective focuses upon where that property is owned, protected and taxed.

American-based multi-national enterprises are the primary focus of this paper. The regulations are aimed at these businesses. American businesses have historically initiated development of intellectual property within U.S. geographic borders. U.S. intellectual property laws have protected and taxed profits generated from these assets. The geographic and legal views of intellectual property development are identical at this time. As firms expand abroad, they have
often drawn upon the skills of scientists, engineers, and marketers in these locations to develop intellectual property. From a geographic perspective, the intellectual property is developed in several locations, but it has generally been owned, protected and taxed by U.S. laws. Companies typically provide an arms-length markup for services provided by overseas subsidiaries to fund development, record profits and pay taxes in each jurisdiction.

Cost Sharing Agreements were introduced as an option to this model in 1968. In CSAs two or more affiliated legal corporations share intellectual property development costs. According to the 1968 treasury regulations CSAs need to reflect “an effort in good faith by the participating members to bear their respective shares of all costs and risks of development on an arms-length basis.”

These regulations further state: “(W)here a member of a group of controlled entities acquires an interest in the intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the (IRS) shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant’s arm’s length share of the costs and risk of developing the property…” No explicit direction was given concerning compensation for pre-existing intangible assets, but the arms-length standard was the standard valuation principle.

The Tax Reform Act of 1986 introduced the "commensurate with income" standard, a key modification to transfer pricing law. Congress believed businesses transferred intellectual property abroad with inadequate compensation, and there were few effective ways to value these transfers. The following was added to IRS §482: “In the case of any transfer (or license) of intangible property…the income with respect to such transfer or license shall be commensurate with income attributable to the intangible.” In other words, the price paid for the property must be related to the income earned from it. The relative importance of these two standards, “arm-length” and “commensurate with income,” plays an important part in U.S. transfer pricing law to this day.
**Current Regulations**

Current regulations governing CSAs were issued in 1995. A Cost Sharing Agreement is an agreement between two or more parties to share the costs of developing intangible property in proportion to the benefits earned by each participant. Participants share costs, but profit separately from the intellectual property created.

Intangible Development Costs include all operating expenses, and an arm’s length charge for property made available to the CSA. The regulations were modified in 2003 to specifically state the value of stock-based compensation, such as stock options, must be included in the Cost Sharing Agreement. This issue was litigated in a recent case, *Xilinx Inc. v. Commissioner*, discussed separately.

Costs must be shared in proportion with “Reasonably Anticipated Benefits.” Reasonably anticipated benefits are defined as “the aggregate benefits that (the controlled taxpayer) reasonably anticipates it will derive from covered intangibles.” Benefits are “additional income generated or costs saved by the use of the covered intangibles.” A CSA participant’s Reasonably Anticipated Benefits share equals its Reasonably Anticipated Benefits, divided by the sum of all participants’ Reasonably Anticipated Benefits. “(T)he most reliable estimate of Reasonably Anticipated Benefits” should be used to measure a controlled participant’s share of those benefits.

Reasonably Anticipated Benefits may be measured directly or indirectly. Direct calculations of income earned by an intangible asset are preferable. However it is frequently difficult to measure directly the profit generated by an intangible asset. In most cases taxpayers use an indirect measure of profit, such as units sold, to estimate the profit generated by an intangible asset.

Related taxpayers make equalizing payments to share costs proportionately with Reasonably Anticipated Benefits. For example, if a taxpayer expects to receive 60% of the benefits from the intangible assets created, it should absorb 60% of the costs. Suppose that organization X locally spends $1.1M per year developing intangible assets, while organization Y spends $900K per
year developing the same intangible assets, before any cost sharing payments. X needs to make an equalizing payment of $100K to Y, to apportion costs with reasonable anticipated benefits. Once that payment is made, X bears 60% of the costs, and Y absorbs 40%.

<table>
<thead>
<tr>
<th>Table I</th>
<th>Taxpayer X</th>
<th>Taxpayer Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Spending</td>
<td>$1,100,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Equalizing Payment (Receipt)</td>
<td>$100,000</td>
<td>($100,000)</td>
</tr>
<tr>
<td>Net Cost</td>
<td>$1,200,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Reasonably Anticipated Benefits</td>
<td>60%</td>
<td>40%</td>
</tr>
</tbody>
</table>

However once the intangible assets are created, organizations exploit separately the benefits of those assets. Actual benefits will differ from Reasonably Anticipated Benefits.

The 1995 regulations explicitly state other participants must compensate organizations for intangible asset contributions to the CSA. This compensation is known as a “buy-in” payment. The regulations state: “a controlled participant that makes intangible property available to a QCSA (Qualified Cost Sharing Agreement) will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it.” 14

The buy-in payment should equal “the arm’s length charge for the use of the intangible under the rules of Regulations §1.482-1 and §1.482-4 through §1.482-6, multiplied by the controlled participant’s share of Reasonably Anticipated Benefits.”15 These payments can be one-time payments, installment payments, or royalties.

Suppose taxpayers X, Y and Z form a Cost Sharing Agreement. Based upon Reasonably Anticipated Benefits, they share costs 40%, 35%, and 25% respectively. Taxpayer X contributes a pre-existing intangible asset worth $80K to the CSA. X should receive $48K from the other
two participants. Y needs to make a $28K payment (35% of $80K), and Z should make a $20K payment (25% of $80K) to taxpayer X.

<table>
<thead>
<tr>
<th>Table II</th>
<th>Taxpayer X</th>
<th>Taxpayer Y</th>
<th>Taxpayer Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of Intangible Asset Contributed</td>
<td>$80,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Payment Made (Received)</td>
<td>($48,000)</td>
<td>$28,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Net Cost</td>
<td>$32,000</td>
<td>$28,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Reasonably Anticipated Benefit Share</td>
<td>40%</td>
<td>35%</td>
<td>25%</td>
</tr>
</tbody>
</table>

If a participant “bears costs of intangible development that over a period of years are consistently and materially greater that its share of Reasonably Anticipated Benefits, then the (IRS) may conclude that the economic substance of the agreement …is inconsistent with the terms of the cost sharing arrangement.” 16 The IRS “may disregard such terms and impute an agreement consistent with the controlled participant’s code of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles.” 17 In other words, the IRS can revalue the buy-in, and charge the taxpayer with additional taxes, interest, and sometimes penalties. Given the high stakes involved, taxpayers frequently litigate these issues.

**Concern with Current Regulations**

Since the current regulations were enacted American-based multi-national enterprises have increasingly used CSAs to transfer intellectual property abroad. The IRS is concerned that buy-ins (which are now called Preliminary or Contemporaneous Transactions, or PCTs) are under-valued by U.S. taxpayers. An IRS spokesman recently said: “Intellectual property is a special case that may be difficult to value. The IRS is concerned that intellectual property is valued according to the arm’s length standard, and actively audits and contests transfers that do not meet this standard.” 18 As an example, in April, 2006 the software firm Symantec received a $1 billion tax bill for software licenses transferred to its Irish subsidiary. “The IRS contends the
licenses were transferred at inappropriately low valuations, which the company disputes,” said The Wall Street Journal.\(^\text{19}\)

In response, the IRS proposed new transfer pricing regulations in August, 2005. The regulations’ preamble elaborates upon its concern. “Experience in the administration of existing §1.482-7 has demonstrated the need for additional regulatory guidance to improve compliance with, and administration of, the cost sharing rules. In particular, there is a need for additional guidance regarding the external contributions for which arm’s length consideration must be provided as a condition of entering into the CSA.”\(^\text{20}\) According to the IRS, the new regulations are meant to support the arms-length transfer pricing standard.

The Wall Street Journal wrote: “The underlying concern is that American companies rely on the U.S. education system and other tax-supported infrastructure to produce a highly creative workforce, then moves the fruits of that labor abroad without due compensation to American society.”\(^\text{21}\) James Tobin echoed this concern: “The IRS has been especially concerned that taxpayers, through the buy-in component of CSAs, have been transferring intangible assets outside the United States for less than arms-length consideration.” \(^\text{22}\) Other technologically advanced nations share this concern.

The regulations remain proposals for three years, and do not apply during this period. Taxpayers can provide feedback and the IRS may modify the regulations. The regulations may become effective in 2008.

**Need for New Regulations**

The IRS believes new cost sharing regulations are necessary based on experience administering current rules. It believes CSAs are unlike any other business arrangements. This makes the search for arms-length transfer prices pointless. The IRS also believes it lacks the information necessary to govern CSAs effectively. Thus new regulations are necessary.
To explain the unique features of CSAs, the IRS states in the preamble to the proposed regulations:

“(G)uidance is necessary because of the fundamental differences in cost sharing arrangements between related parties as compared to any superficially similar arrangements that are entered into between unrelated parties. Such other arrangements typically involve a materially different division of costs, risks, and benefits than in cost sharing arrangements under the regulations. For example, other arrangements may contemplate joint, rather than separate, exploitation of results, or may tie the division of actual results to the magnitude of each party’s contributions (for example, by way of preferential returns). Those types of arrangements are not analogous to a cost sharing arrangement in which the controlled participants divide contributions in accordance with Reasonably Anticipated Benefits from separate exploitation of the resulting intangibles.”

If CSAs are indeed unique business arrangements, the search for comparable transfer prices becomes impossible. If there are no similar business structures, there are no comparable uncontrolled transactions, and thus no relevant transfer prices. The IRS apparently believes valuing intellectual property is difficult due to the CSA structure, not the inherent difficulties valuing intellectual property.

The IRS also believes it lacks information available to the taxpayer. The IRS faces “an asymmetry of information vis-à-vis the taxpayer. The taxpayer is in the best position to know its business and prospects. The Commissioner faces real challenges in ascertaining the reliability of the ex ante expectations of taxpayer’s initial arrangements in light of significantly different ex post outcomes…” Lacking good information, the IRS may believe a taxpayer has structured an arms-length buy-in. Years later, it may become apparent the price paid was inadequate. At that time the IRS may be legally restricted from taking action.

The IRS proposes an “investor model” to value intellectual property. The IRS believes it needs a new approach, since it lacks comparable transfer prices and adequate information. An investor model can address these issues, according to the IRS. In its view, investors evaluate business opportunities based upon their expectations, and attempt to maximize their return by selecting investments with the highest risk-adjusted returns. Controlled taxpayers should adopt the same perspective when analyzing CSAs. The preamble to the proposed regulations states: “Under
In this model, each controlled participant may be viewed as making an aggregate investment, attributable to both cost contributions (ongoing share of intangible development costs) and external contributions (the preexisting advantages which the parties bring into the arrangement)…In this regard, valuations are not appropriate if an investor would not undertake to invest in the arrangement because its total anticipated return is less than the total anticipated return that could have been achieved through an alternative investment that is realistically available to it.” 25

**Key Changes**

Maximizing tax revenue is a key IRS objective. The proposed regulations support this objective. To increase tax revenue, the IRS has proposed a number of important changes to CSAs, designed to increase CSA buy-ins.

CSA participants obtain permanent rights to intellectual property in a "Reference Transaction." The current regulations do not require permanent transfers. CSA participants have imposed time limitations on intellectual property transfers, reducing their value. As the preamble to the regulations states:

“The concept of the RT (Reference Transaction) was developed in response to arguments that have been encountered in the examination experience of the IRS under existing regulations. In numerous situations taxpayers have purported to confer only limited availability of resources or capabilities for purposes of the intangible development activity (IDA) under a CSA. An example is a short-term license of an existing technology. Under the existing regulations, such cases may, of course, be examined to assess whether the purported limitations conform to economic substance and the parties’ conduct…In addition, even if short-term licenses were respected, the continued availability of the contribution past the initial license term would require new license terms to be negotiated taking into account relevant factors, such as whether the likelihood of success of the IDA had materially changed in the interim. The proposed regulations address the problems administering such approaches more directly by requiring an upfront valuation of all external contributions which would be more difficult to calculate if it involved the valuation of a series of short-term licenses with terms contingent on such interim changes. Accordingly, the proposed regulations assume a reference transaction that does not allow for contingencies based on the expiration of short-term licenses that might require further renegotiation of the compensation for the external contribution.” 26
In other words, the intellectual property transfers must be permanent. Taxpayers cannot reduce buy-ins by limiting license duration.

Similarly, the proposed regulations require that CSA participants divide their markets permanently into non-overlapping geographies. Current regulations impose no such requirement. The intention is to increase the buy-in. Taxpayers have apparently argued that the U.S.-based Corporation may later compete with other CSA participants, and this risk reduces the value of the intellectual property transfer. The geographic restriction also may be designed to allocate the U.S. market to the U.S. CSA participant. David Canale, of Ernst and Young, said this change would likely increase tax revenue in the United States, noting “the United States is the largest consumer market in the world right now.” The proposed regulations consistently allocate the U.S. market to the American participant.

The new regulations grant the IRS the sole right to make adjustments to the CSA, to align costs with benefits. If the actual returns earned by certain taxpayers fall outside an acceptable range determined by IRS, it is empowered to make changes to the agreements. The proposed regulations state: “Because the guidance on periodic adjustments is intended to address the problem of information asymmetry, and because it is exceeding unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result, periodic adjustments of this type can only be exercised by the Commissioner.” These changes can include adding or removing costs from the Intangible Development Costs, changing shares for the CSA participants, or assigning unallocated territorial interests to participants. In other words, if the U.S. taxpayer undervalues the buy-in, the IRS is empowered to make whatever changes it determines necessary to revalue it, and increase U.S. tax revenue. But if the U.S. taxpayer overvalues the intellectual property buy-in, that valuation stands.

The regulations suggest ways the taxpayer can protect itself from IRS adjustments. The taxpayers can forecast future results more accurately. Taxpayers can use superior information to value buy-ins reasonably, rather than produce tax-advantaged results. As the IRS states, taxpayers should adopt “an arrangement that appropriately reflects the profit potential and risks associated with an intangible transfer, which it is in the best position to evaluate in an
economically realistic way.” 29 Furthermore, the regulations propose a range of acceptable returns that will not be revalued.

The IRS also suggests taxpayers consider contingent payment terms, as opposed to fixed payment terms, which are unrelated to actual performance. Contingent payments, based upon actual profits or other actual results, reduce the risk that intellectual property is improperly valued. The IRS states: “the uncertainty in valuing intangible property might lead them to adopt from the outset contingent terms of different varieties and degrees that allow for adjustment in light of actual profit experience.” 30

**The Investor Model**

To address concerns that intellectual property is improperly valued, the IRS proposes an investor model to value those asset transfers. The investor model employs discounted present value concepts drawn from finance. This model marks a significant departure from current transfer pricing law.

Introducing the investor model, the IRS states:

“Under the (investor) model, each controlled participant may be viewed as making an aggregate investment, attributable to both cost contributions (ongoing share of intangible development costs) and external contributions (the preexisting advantages which the parties bring to the arrangement), for purposes of achieving an anticipated return appropriate to the risks of the cost sharing arrangement over the term of the development and exploitation of the intangibles resulting from the arrangement. In particular, the investor model frames the guidance in the proposed regulations for valuing the external contributions that parties at arm’s length would not invest, along with their ongoing cost contributions, in the absence of an appropriate reward. In this regard, valuations are not appropriate if an investor would not undertake to invest in the arrangement because its total anticipated rate of return is less than the total anticipated return that could have been achieved through an alternative investment that is realistically available to it.” 31

The IRS proposes five methods to value intellectual property contributions, all consistent with the investor model. Three of the methods are new: the Income Method, the Acquisition Price Method, and the Market Capitalization Method. The Residual Profit Split Method is retained; however changes are proposed to make it consistent with the investor model. The regulations
preserve the Comparable Uncontrolled Transaction (CUT) method. Finally, a sixth unspecified method is permitted by the IRS, but it must be consistent with investor model principles.

The “best method rule” states taxpayers should select a method that best reflects the arms-length principle, based on facts and circumstances. The form of payment can be a lump-sum payment, or a royalty, based on either sales or profit.\(^\text{32}\)

Of the five methods proposed, two are expected to be used frequently. The Income Method applies when only one taxpayer contributes pre-existing intellectual property to a CSA. When two or more taxpayers make external contributions to CSAs the Residual Profit Split Method is used. Observers expect taxpayers will use the other three methods infrequently, since these methods derive values from market transactions, which are likely to be infrequent.

There is an overriding valuation investor model principle, applicable to all methods: “The valuation of the amount charged in a PCT (buy-in) 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…over the entire period of developing and exploiting the cost shared intangibles.”\(^\text{33}\) In other words, taxpayers should plan to earn a risk adjusted rate of return.

Investor model valuation extends “over the entire period of developing and exploiting the cost shared intangibles.”\(^\text{34}\) Technologically advanced products often lead to enhanced and improved versions. When these intangibles will lead to developing further intangibles “then the period in the preceding sentence includes the period of developing and exploiting such indirectly benefited intangibles.”\(^\text{35}\) Given that one product frequently leads to further versions, it is possible CSAs will extend long into the future.

As a result, the returns earned by CSA participants not contributing pre-existing intellectual property will be limited for many years. The regulations do not permit declining royalty rates over the life of the CSA. The profit earned by such participants is limited to “the appropriate
discount rate over the entire period of developing and exploiting such indirectly benefited intangibles.”36

During the life of the CSA, the taxpayer is responsible for updating and monitoring results, calculating returns, and updating documentation. Not complying with these requirements narrows the band of acceptable returns, and increases the likelihood of transfer pricing adjustments.

**Income Method**

As mentioned, the Income Method should be used when only one CSA participant contributes pre-existing intellectual property to the CSA. The buy-in is determined by analyzing a participant’s realistic alternatives to a CSA.37 As the proposed regulations state: “the arm’s length charge for a PCT payment will be an amount such that a controlled participant’s present value, as of the date of the PCT, of entering into a CSA equals the present value of its best realistic alternative.” 38 The regulations propose two ways the income method can be applied. One focuses upon options available to the organization transferring intellectual property to the CSA, called the PCT Payee. The second focuses upon the realistic alternatives available to the organization not transferring intellectual property, known as the PCT Payor. However the regulations also state that these two methods “do not exclude other possible applications of this method,” 39 as long as they are consistent with investor model principles.

Identifying alternatives available to the PCT Payee is an application of the Comparable Uncontrolled Transaction (CUT) methodology. “Under the CUT approach, the present value of the PCT Payment is determined on the basis of the present value of the income the PCT Payee would receive under its best realistic alternative to a CSA, such as developing and exploiting the cost shared intangibles itself.” 40 In other words, the organization contributing intellectual property to the CSA should calculate the present value of income assuming it exploited the intangible asset itself, without a CSA. It should compare this figure to the present value of income, assuming it enters into a CSA. The buy-in payment (PCT) should equalize the present value of income between alternatives.
Example: Suppose a multi-national enterprise invests in a new technology. In one scenario the domestic parent funds the investment itself and is the sole intellectual property owner. It could exploit the technology abroad by licensing the technology to overseas subsidiaries. The present value of this investment is $100M. As an alternative, it could form a CSA with an overseas subsidiary. In this option, the domestic parent owns the U.S. market, the subsidiary owns all other markets, and the intellectual property is owned jointly. If the present value of income in the U.S. market is $60M, then it should receive $40M from the overseas subsidiary, either as a lump-sum payment or through royalties. In the IRS view, a rational investor would demand the same profit, discounted to present value, with or without the CSA.

<table>
<thead>
<tr>
<th>Table III</th>
<th>Option 1: Exploit WW through licensing (no CSA)</th>
<th>Option 2: CSA—value of US market</th>
<th>Option 2: CSA—value of international markets (excludes US)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present Value of Total Profits</td>
<td>$100M</td>
<td>$60M</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>$100M</td>
<td></td>
</tr>
<tr>
<td>Royalty Rate</td>
<td></td>
<td></td>
<td>40%</td>
</tr>
<tr>
<td>(Payment) Receipt</td>
<td></td>
<td>$40M</td>
<td>($40M)</td>
</tr>
<tr>
<td>Present Value of Total Profits</td>
<td>$100M</td>
<td>$100M</td>
<td></td>
</tr>
</tbody>
</table>

The U.S. parent obtains the same profit despite significantly reducing its investment, through sharing development costs. If it funds the investment itself, it bears the entire risk of failure. If it joins a CSA, the other participant shares the risk. Its reward is the discount rate.

As mentioned, the Income Method also permits a multi-national enterprise to analyze realistic alternatives available to the organization not contributing pre-existing intellectual property to the CSA. This is the PCT Payor. According to the proposed regulations: “Under this application, the present value of the anticipated PCT Payments is equal to the present value, as of the date of the PCT, of the PCT Payor’s anticipated profit from developing and exploiting cost shared intangibles.” 41 This limits the Payor’s return to the discount rate. As the regulations state, “This PCT Payment ensures that PCT Payors who do not furnish any external contributions to a PCT receive an appropriate ex ante risk adjusted return on their investment in the CSA.” 42 “An
appropriate return” means the discount rate. Any superior returns earned in the CSA belong to the participant making external contributions to the agreement.

Example: A pharmaceutical company is developing a new vaccine. In Year 1, the US parent (USP) and a wholly-owned foreign subsidiary, FS, form a CSA to complete development of the vaccine. USP contributes a partially-developed vaccine and an experienced R&D team to the CSA, which are external contributions to the CSA. FS makes no such contributions to the CSA. The total cost of completing the vaccine is estimated to be $100 million, in Year 1 dollars. USP and FS each have total projected sales of $100 million, in Year 1 dollars. Accordingly, the two organizations share development costs equally.

FS profits from sales made in territories allocated to it. Its territorial operating profits are projected to be $80 million, from the $100 million in sales minus $20 million in expenses. Its share of development costs ($50M) reduces total profits to $30 million. To compensate USP, FS needs to pay $30 million to USP. This could be a lump sum payment, or a royalty based on sales or profits. These payments reduce FS’s income to the risk-adjusted discount rate, which the IRS believes is the appropriate return, as FS contributed no pre-existing intellectual property to the CSA.

<table>
<thead>
<tr>
<th>Table IV</th>
<th>US Parent (USP)</th>
<th>Foreign Subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Territorial</td>
<td>Unlimited</td>
<td>$80M</td>
</tr>
<tr>
<td>Operating Profits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development Costs</td>
<td>$50M</td>
<td>$50M</td>
</tr>
<tr>
<td>Profit Net of Development</td>
<td>--</td>
<td>$30M</td>
</tr>
<tr>
<td>Costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment Received (Paid)</td>
<td>$30M</td>
<td>($30M)</td>
</tr>
</tbody>
</table>

Viewed from this perspective, the risk-reward opportunities for a potential CSA investor do not look attractive. If the CSA is not successful, it may lose its entire $50M investment. If it succeeds, the return is limited to the discount rate. The investment risk is high, but the potential reward is limited.
As the selected discount rate determines the maximum return, this figure is critically important. The regulations give taxpayers latitude selecting a discount rate, and recognize it should be risk-adjusted. The IRS states “the discount rate employed should be that which most appropriately reflects, as of the date of the PCT, the risks of development and exploitation of the intangibles anticipated to result from the CSA.”43 The regulations say the Weighted Average Cost of Capital (WACC) for a publicly traded firm with a comparable risk profile could serve as the discount rate. The regulations also state a company’s internal hurdle rate for investments bearing comparable risk could be an appropriate discount rate. Given the figure’s importance, and the discretion permitted in the regulations, this figure is likely to be controversial.

**Acquisition Price Method**

A merger triggers the Acquisition Price method. The firm revalues assets after the acquisition. The difference between the acquisition price and the value of the firm’s individual assets is unassigned, which is the intellectual property value, according to the regulations. If the acquired firm joins the CSA, this unassigned value is that firm’s external contribution to the CSA. The firm must contribute substantially all of the acquired company’s intellectual property to use this method.

The first step is calculating an “adjusted acquisition price.” The regulations state this is “the acquisition price of the target increased by the value of the target’s liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target’s tangible property on that date and by the value on that date of any other resources and capabilities not covered by a PCT or group of PCTs.” 44 Once the adjusted acquisition price is determined, the buy-in can be determined.

Example: A U.S parent corporation, known as USP, forms a Cost Sharing Agreement with an overseas subsidiary, FS, to produce Product Y. Based upon Reasonably Anticipated Benefits, the two organizations share costs 50/50. In the year following the CSA’s inception, USP buys Company X for $100 million. USP and Company X consolidate their financial results and file one tax return in the United States. Company X’s resources consist of its workforce, patents and technology intangibles, and tangible property. The firm contributes workforce, patents and
technology intangibles to the CSA. Company X has $20M in land and $10M in liabilities not contributed to the CSA. Under the Acquisition Price method, the intellectual property value is $90 million (the $100 million Acquisition Price, plus the $10M in liabilities, and less $20 million in net assets not contributed to the CSA). As FS bears 50% of CSA costs, it should make a $45M payment to USP, to compensate USP for Company X’s external contributions.

<table>
<thead>
<tr>
<th>Table V</th>
<th>US Parent (USP)</th>
<th>Company X</th>
<th>Foreign Subsidiary (FS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Sharing %</td>
<td>50%</td>
<td></td>
<td>50%</td>
</tr>
<tr>
<td>X’s Acquisition Price</td>
<td>$100M</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Value of Property not contributed to the CSA</td>
<td></td>
<td>$10M ($20M in assets less $10M in liabilities not contributed to CSA)</td>
<td></td>
</tr>
<tr>
<td>Value of Intangible Property contributed to CSA</td>
<td></td>
<td>$90M</td>
<td></td>
</tr>
<tr>
<td>Buy-in Received (Paid)</td>
<td>$45M</td>
<td></td>
<td>$(45M) 50% of $90M</td>
</tr>
</tbody>
</table>

Despite the proposed regulations, taxpayers may not agree the unassigned value equals the intellectual property value. There may be other factors, unrelated to intellectual property. The taxpayer has the option of identifying and valuing all intangible assets. But in the absence of comparable assets, it can be difficult to value them. However this method will be infrequently used.

**Market Capitalization Method**

The Market Capitalization Method is similar to the Acquisition Price Method. However the parent company’s market value determines the intellectual property value. As a result, this method can only be used when the parent company is publicly traded. Taxpayers use this method when they contribute substantially all the firm’s intellectual property to the CSA, consistent with the Acquisition Price Method. Similarly, taxpayers will use this method infrequently.
The regulations propose taxpayers use an average market capitalization, rather than the market value on the date of the PCT. “The average market capitalization is the average of the daily market capitalizations of the PCT Payee over a period of time beginning 60 days before the date of the PCT and ending on the date of the PCT,” according to the regulations. The apparent purpose is to create a more stable buy-in value. A more stable average market capitalization may also be a stronger legal position, should taxpayers challenge this method.

Taxpayers must adjust this figure by the value of assets and liabilities not contributed to the CSA. “The adjusted average market capitalization is the average market capitalization of the PCT Payee increased by the value of the PCT Payee’s liabilities on the date of the PCT and decreased by the value on such date of the PCT Payee’s tangible property and any other resources and capabilities of the PCT Payee not covered by a PCT or group of PCTs.” To prevent manipulation, the IRS requires that companies contribute substantially all intellectual property to the CSA.

The arm’s length charge for the external contributions is apportioned with Reasonably Anticipated Benefits. The proposed regulations state: “Under the market capitalization method, the arm’s length charge for a PCT or group of PCTs covering resources and capabilities of the PCT Payee is equal to the adjusted average market capitalization, as divided among the controlled participants according to their respective RAB shares.”

Example: USP is a publicly traded U.S. firm, with no overseas subsidiaries. It creates a wholly-owned foreign subsidiary, FS. USP and FS will create a new generation of software products, based on intellectual property owned and developed by USP. USP contributes the intellectual property to the CSA. FS contributes no intellectual property to the CSA. Based on Reasonably Anticipated Benefits, USP will fund 60% of the CSA, and FS will fund 40%.

The average market capitalization for USP is $105 million, prior to the CSA’s formation. USP will not contribute $10 million in liabilities and $15 million in assets to the CSA. Using the market capitalization method, the intellectual property contribution is $100 million ($105 market
capitalization, plus $10 million liabilities, less $15 million in assets not contributed to the CSA). Therefore, FS owes a $40 million to USP.

<table>
<thead>
<tr>
<th>Table VI</th>
<th>US Parent (USP)</th>
<th>Foreign Subsidiary (FS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Sharing %</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>Market Capitalization</td>
<td>$105M</td>
<td></td>
</tr>
<tr>
<td>Net Value of Tangible Property (not part of CSA)</td>
<td>$5M ($15M land less $10M liabilities)</td>
<td></td>
</tr>
<tr>
<td>Intangible Property Value</td>
<td>$100M</td>
<td></td>
</tr>
<tr>
<td>Buy-in Received (Payment)</td>
<td>$40M</td>
<td>($40M)</td>
</tr>
<tr>
<td>Total Cost</td>
<td>$60M</td>
<td>$40M</td>
</tr>
</tbody>
</table>

Taxpayers will use this method infrequently. “The use of the market capitalization method ordinarily is limited to cases where substantially all of a PCT Payee’s nonroutine contributions are covered by a PCT,” says Rocco V. Femia.48

**Residual Profit Split Method**

The proposed regulations substantially modify the Residual Profit Split Method (RPSM). It is limited to situations in which more than one CSA participant makes significant external contributions to intellectual property development.49

RPSM first allocates to each participant “an amount of income to provide them with a market return for their routine external contributions….”50 “Routine contributions include contributions of tangible property, services and intangibles that are generally owned or provided by uncontrolled taxpayers in similar circumstances,”51 according to the proposed regulations. Routine contribution returns should be comparable to profits earned by businesses providing these services.

Taxpayers then allocate a portion of the profit or loss according to each participant’s cost contribution share. 52 In other words, each taxpayer recoups its cost contribution to the CSA.
The participants earn the discount rate upon these contributions, as the cost contributions are discounted to present value.

Residual profit is allocated to CSA participants based on the value of their nonroutine external contributions in the third and final step. “The relative value of nonroutine contributions of each controlled participant may be measured by external market benchmarks that reflect the fair market value of such nonroutine contributions.” Market measures for nonroutine external contributions are not readily available, which is one of primary reasons for the proposed regulations. Therefore the proposed regulations provide a second method to allocate residual profit. “Alternatively, the relative value of nonroutine contributions may be estimated by the capitalized cost of developing the nonroutine contributions and updates,” adjusted to present value.

Example: USP and its wholly-owned subsidiary, FS, separately develop new communications products. They form a Cost Sharing Agreement to combine these technologies. Prior to formation of the CSA, each has individually developed intellectual property which is essential to their combined product. Thus both make external contributions to the CSA. Prior to formation of the CSA, USP spent $3 million developing its technology, and FS spent $5 million. USP will exploit these technologies in the United States, and FS will exploit the technologies in the rest of the world. Based on demand forecasts, USP expects 40% of Reasonably Anticipated Benefits, and FS anticipates 60%.

CSA development costs will be $10M, in discounted dollars. Based on Reasonably Anticipated Benefits, USP will fund 40% of the costs, and FS will fund 60%. USP and FS expect to earn a total of $21 million worldwide from sales of the products, excluding the $10 million in cost contributions.

USP and FS each incur distribution expenses in their respective markets. These are routine contributions. Based on external market measures, they should earn $1 million on these contributions. “Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities…” USP’s expected
routine return is $.4M, and FS’s routine return is $.6M. After subtracting the routine return, $20 million remains unallocated. This completes the first step.

In the second step, the CSA participants recover their cost contributions. According to the proposed regulations, the “percentage allocable to the cost contribution share in this case is equal to each participant’s share of total anticipated IDCs divided by the difference between its total anticipated operating profits in its territory and total anticipated routine territory in its territory.” This is a convoluted way of saying each recovers its cost contribution. USP is entitled to recoup its $4M cost contribution, and FS recovers its $6M cost contribution. “This step would be equivalent to the cost contribution adjustment under the income method, and provides the participants a financing return for their investment in developing intangibles,” according to Neal M. Kochman.

In the final step, CSA participants allocate residual profit according to the value of their nonroutine, or external contributions. If the external values are not determinable, they may use intangible development costs to allocate remaining profit. USP spent $3 million and FS spent $5 million, so USP is entitled to 37.5%, and FS 62.5%. Thus USP earns $3.75 million of the residual profit, and FS earns $6.25 million.

The Residual Profit Split Method is summarized below:

<table>
<thead>
<tr>
<th>Table VII</th>
<th>USP</th>
<th>FS</th>
<th>Total</th>
<th>Step</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Earnings</td>
<td>--</td>
<td>--</td>
<td>$21.0 million</td>
<td></td>
</tr>
<tr>
<td>Return on routine contributions</td>
<td>$.4 million</td>
<td>$6.0 million</td>
<td>$1.0 million</td>
<td>One</td>
</tr>
<tr>
<td>Residual after step one</td>
<td>--</td>
<td>--</td>
<td>$20.0 million</td>
<td></td>
</tr>
<tr>
<td>Cost Contributions</td>
<td>$4.0 million</td>
<td>$6.0 million</td>
<td>$10.0 million</td>
<td>Two</td>
</tr>
<tr>
<td>Residual after step two</td>
<td>--</td>
<td>--</td>
<td>$10.0 million</td>
<td></td>
</tr>
<tr>
<td>External contributions</td>
<td>$3.0 million</td>
<td>$5.0 million</td>
<td>$8.0 million</td>
<td></td>
</tr>
<tr>
<td>Allocation %</td>
<td>37.5%</td>
<td>62.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit Allocation</td>
<td>$3.75 million</td>
<td>$6.25 million</td>
<td>$10.0 million</td>
<td>Three</td>
</tr>
<tr>
<td>Total Earnings Allocation</td>
<td>$8.15 million</td>
<td>$12.85 million</td>
<td>$21.0 million</td>
<td>Sum of steps one, two and three</td>
</tr>
</tbody>
</table>
Total Profit | $4.15 million | $6.85 million | $11 million | Total earnings less costs incurred

Note the Residual Profit Split Method allocates future profits. It does not determine CSA buy-ins. This is because both parties make external contributions to the CSA. If a third party participates in the CSA, and it made no external contributions to the agreement, it would receive no residual profit in the final step.

To summarize, taxpayers should use the Residual Profit Split Method when two or more organizations make nonroutine external contribution to a CSA. A market rate of return should be earned on routine contributions to the CSA. Each participant is entitled to recover its cost contribution. Taxpayers allocate the remaining profit based on either the value of intellectual property contributed, or the costs incurred to develop those external contributions.

**Comparable Uncontrolled Transaction Method**

The Comparable Uncontrolled Transaction method is retained in the proposed regulations. Taxpayers should evaluate a PCT (buy-in) “by reference to the amount charged in a comparable uncontrolled transaction.”58 Once that figure is determined it “must then be multiplied by each PCT Payor’s respective RAB (Reasonably Anticipated Benefits) share in order to determine the arm’s length PCT Payment due from each PCT Payor.”59 However, once again it is not expected this approach will be used frequently, as the IRS believes there are few, if any, business relationships comparable to a CSA.

**Unspecified Methods**

Consistent with current law, the IRS regulations permit taxpayers to adopt unspecified methods. However any unspecified method must be consistent with the investor model, and derive values based upon realistic alternatives available to the taxpayer.

The regulations state: “Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a
particular transaction if none of the alternatives is preferable to it. Therefore, in establishing whether a PCT (buy-in) achieved an arm’s length result, an unspecified method should provide information on the prices or profits that the controlled participant could have realized by choosing a realistic alternative to the CSA.”  

Practical Issues with the Proposed Regulations

Industry and professional tax organizations are very critical of the proposed regulations. There are many practical problems with the regulations, such as difficulties complying with, interpreting, and administering the regulations. There are also conceptual problems with the regulations, such as whether they are consistent with the arms-length transfer pricing principle, and whether they achieve their intent. Practical issues will be discussed first, and conceptual issues next.

Determining the appropriate discount rate may not be easy. Discounting future profits by a risk-adjusted rate is sound. In financial theory each investment should have its own discount rate, reflecting that project’s risk. The regulations support this approach. Since this figure determines where profits are earned, it is extremely important to many parties. But determining the risk of a project, and the appropriate risk-adjusted discount rate, is inherently speculative. The proposed regulations permit taxpayer discretion, and this latitude will lead to disputes with the IRS. “Instead, a discount rate that takes into account the unique risks and rewards of a CSA must be developed – a highly subjective exercise likely to increase controversy between the taxpayer and the IRS,” the Tax Executives Institute (TEI) says. In the absence of clearer guidance from the IRS, taxpayers and the IRS will dispute this figure.

The regulations presume businesses have the ability to forecast future results accurately, and thus organize operations to achieve tax-advantaged results. But many businesses believe long-range forecasts are often unreliable. Some businesses do not require detailed financial plans more than a year in advance, because they consider such forecasts undependable. This is particularly true in the technology and pharmaceutical industries. Highly competitive industries, facing rapidly changing technologies, find it difficult to forecast financial results accurately years in advance.
The Court noted in the *Xilinx v. Commissioner* how difficult it is for taxpayers to predict the future, commenting that taxpayers “are merely required to be compliant, not prescient.”

Furthermore, technology development is inherently speculative. “It is difficult to identify in advance those technologies that may turn out to be critical or the platform for future development. Uncertainty is inherent in the nature of R&D, and crucial developments can sometimes only be identified with the benefit of hindsight. Many extremely valuable products (such as penicillin) were the result of serendipity, having been discovered by scientists driving toward different objectives,” says TEI. At the CSA's inception, participants may honestly attempt to comply with the regulations. But technology breakthroughs often lead to products never contemplated at inception. If the investment is extremely successful, a buy-in may appear undervalued in retrospect. If the buy-in is over-valued, however, the taxpayer cannot revalue it. The regulations do not indicate the IRS should do so. Taxpayers may view these regulations as “heads I win, tails you lose.”

Related to this, Baker & McKenzie believes the IRS’s proposal it should have the sole power to make transfer pricing adjustments is inconsistent with current transfer pricing law. An existing regulation “clearly grants taxpayers the discretion to adjust their financial statement results in a timely filed return if necessary to achieve an arm’s length outcome,” they say. “The proposed regulations’ ill-conceived attempt to tip the commensurate-with-income scales should be reversed, and if it is not removed from the final regulations, the authors fully expect it to be unceremoniously rejected by a reviewing court.” It is significant when taxpayers believe the regulations may not survive legal challenge.

The proposed regulations appear confusing to many tax experts, a group that interprets ambiguous and complicated tax law regularly. “It is unclear, however, how the specified valuation methods interact with the investor model and the realistically available alternative principle. Equally unclear is whether the investor method and the realistically available alternative standards are one and the same, and, even if they are not, why both are necessary,” says TEI. “Rather than creating five very complex valuation methods, the better approach
would be to use the valuation methods already established under the regulations covering the transfer of intangible property.”

Finally, critics believe the additional reporting requirements, complexity of the regulations, and the likely IRS disputes will increase the taxpayer’s administrative burden. Neil Kochman commented: “in trying to guard against bargain transfers of existing intangibles, the proposal would place huge upfront burdens on participants in CSAs and, at least in the eyes of many practitioners, would unduly limit the potential upside from entering into a CSA.”

**Conceptual Issues with the Proposed Regulations**

As explained previously, the IRS argues CSAs are unique business arrangements, unlike any “superficially similar” business agreements. In its view, investor model regulations are necessary because it is not possible to find similar business structures. CSAs are unique, as participants share intellectual property development costs, but separately benefit. In the absence of comparable business arrangements, finding useful transfer prices is not possible.

However the IRS’s position is not correct. There are a number of business agreements similar to CSAs. One writer noted that GM, DaimlerChrysler, and BMW recently partnered to develop a hybrid engine, which each company plans to use in its own autos. “In short,” says the author, “under this arrangement, the participants will have worldwide, nonexclusive rights to the separate exploitation of the co-developed technology, a type of arrangement consistent with the current cost sharing regulations but not permitted under the Proposed Regulations.” Similarly, Hewlett-Packard and Intel each invested hundreds of millions to develop an integrated circuit, Itanium, that each corporation exploits separately. Hewlett-Packard incorporates the integrated circuit in computer servers, while Intel sells it to HP competitors. HP and Intel shared costs, but profit from the products separately. On another occasion, Hewlett-Packard and Oki Semiconductor built a printed circuit board factory in Puerto Rico. The two companies shared the costs of the factory. HP used the facility to supply its internal needs for printed circuit boards in Puerto Rico, while Oki sold its 50% share to external customers. HP transferred the products
internally at cost, while Oki sold the products to external customers at market prices. HP and Oki shared costs, and separately exploited the assets.

Businesses also make other business agreements prohibited by the regulations. For example “taxpayers frequently enter into third-party agreements that provide for nonexclusive, overlapping rights. For example, rights to exploit digital products may be licensed nonexclusively through multiple licenses that, in turn, distribute to overlapping territories, using various media for distribution,” 69 says TEI. When businesses arrangements differ from IRS requirements, the investor model does not support the arms-length standard.

Similarly, the IRS says new regulations are necessary because taxpayers have superior information. Many question whether taxpayers truly have an information advantage. Taxpayers know more about their business prospects than the IRS. At the same time, the IRS has substantial information not available to taxpayers. For example, the IRS negotiates Advanced Pricing Agreements (APA) with many taxpayers. Taxpayers and the IRS agree upon company-specific transfer pricing policies in these agreements. The IRS has the advantage of negotiating APAs with many taxpayers, which it shares internally. However taxpayers cannot share their agreements. The IRS also has the ability to review tax returns for many organizations, and focus its legal resources on promising cases. Taxpayers do not have the ability to compare tax returns and assess risk. One can argue who has superior information, but the IRS is not consistently at a disadvantage. However the IRS argues that its information is consistently inferior, and this is one of the key reasons it proposes the investor model.

One significant change in the proposed regulations affects the risk/reward incentives of related taxpayers. The proposed regulations shift the relationship between controlled taxpayers in ways uncontrolled parties would not do. For example, suppose a U.S. headquartered business was contemplating a risky, $100M investment that showed great potential. Without a CSA it would bear the entire $100M risk, but would have the opportunity to exploit the product throughout the world through licensing. Alternatively, it could enter into a CSA with an overseas subsidiary. Based on Reasonably Anticipated Benefits, each organization would fund half the $100M investment.
If the investment succeeds the overseas subsidiary could earn no more than the discount rate. It could lose its entire $50M investment if it failed. This is not an attractive risk/reward relationship. While a high discount rate could compensate the subsidiary for the risk borne, the IRS has the power to reduce this figure. With the benefit of hindsight, risky investments might appear to be sure bets, and the IRS is likely to dispute high discount rates earned on successful investments.

Would an unrelated party make a risky investment with limited profit potential? This is unlikely. As one article noted: “Thus, a party that makes a financial contribution to the CSA fully shares in the downside risk and only receives a small portion of the upside benefits of the developments that it helps to fund.” 70 The arrangement does not appear equitable, and seems inconsistent with the arms-length principle. If the regulations supported the arms-length standard, one would expect examples of investors accepting similar terms. The IRS provides no evidence such agreements exist, as there may be none.

Others have criticized the profit limitations on organizations not contributing intellectual property to a CSA. Managers want to add value to a company, and most do not support investments in projects not demonstrating the possibility of a positive NPV. “Finance theory says you should undertake an investment if the rate of return will be equal to or greater than the cost of capital—that is, will have a net present value of zero or higher,” said Vinay Kapoor, of the investment banking firm Houlihan, Lokey, Howard and Zukin. 71 Given the inherent difficulty predicting future returns, many taxpayers only consider investments with positive net present values and large safety margins. A potential investment that will earn, at best, zero net present value, does not sound attractive.

Related to this, the proposed regulations allocate too much value to external contributions. According to the proposed regulations if only one organization makes an external contribution to the CSA, it should earn all residual profit, after other participants earn the discount rate on the investment. Taken to its logical extreme, suppose two organizations form a CSA to develop a new product. Based upon Reasonably Anticipated Benefits, they share the $100M investment.
50/50. Organization A makes an external contribution valued at $1K, and Organization B makes no external contribution. Based upon this $1K contribution, Organization A is entitled to earn all residual profits, and Organization B earns no more than the discount rate. This makes no economic sense. Unrelated parties would not allocate all residual profits based upon a modest intellectual property contribution.

At the same time, the regulations do not value contributions made to the CSA after inception. In the above example, if Organization B contributed its most talented employees to the CSA, and they made many intellectual property contributions to the CSA, Organization B would earn no more than the discount rate. If it contributed its least talented employees, and they contributed nothing, it would still earn the discount rate. The regulations offer no incentives to add value. Unrelated parties would not agree to this. As explained earlier, the 1968 treasury regulations said CSAs should reflect: “an effort in good faith by the participating members to bear their respective shares of all costs and risks of development on an arms-length basis.” The proposed regulations do not achieve this objective.

The Residual Profit Split Method also makes little economic sense. When two or more organizations make external contributions to the CSA, they share profits based on the value of their external contributions, however modest. Suppose two organizations agree to make a $100M investment. Organization A makes a $9K external contribution, and Organization B makes a $1K contribution. Thus Organization A earns ninety percent of residual profits. The CSA allocates residual profits on a $100M investment based upon miniscule external contributions. The investor model places too much value upon pre-existing intellectual property, in ways that can lead to irrational residual profit allocations.

While it is clear the regulation’s intent is to increase U.S. tax revenue, it is not certain this goal will be realized. Tax professionals will use the regulations to their advantage. Given that profit is allocated based on external contributions, tax professionals will consider this when CSAs are structured. Before formation of the CSA, an organization in low-tax jurisdictions could make a modest external contribution that would entitle it to earn all residual profit. By assigning
excessive value to external contributions, the regulations provide ways to achieve tax-advantaged results.

The regulations prohibit declining royalty rates, and this also assigns excessive value to pre-existing intellectual property contributions, particularly since the regulations govern future products. When one product leads to successors, the regulations apply. To take a well-known example, in the early 1980’s Microsoft released its DOS operating system. DOS led to many versions of Windows, which were significant product improvements. Soon Microsoft will release a new operating system, Vista, its latest version. Following the IRS logic, DOS led to all subsequent Microsoft operating systems, and all residual profits should be associated with DOS. All other investments and improvements should earn a financing rate of return, funded by a discount rate that may be difficult to determine. But Microsoft's many enhancements and improvements upon DOS contributed to the company's success. Today’s operating system bears little resemblance to DOS, a crude operating system purchased for $25,000. DOS would have died quickly without these improvements. Economists can argue about how to apportion economic value between DOS and its many improvements, but to associate all residual value to DOS is unreasonable. Declining royalty rates make economic sense in certain circumstances.

Finally, the Tax Executives Institute disagrees with the premise each CSA participant is, in effect, managing a portfolio of potential investments. While CSA participants are separate legal corporations, they do not manage their own investment portfolio. In most multi-national enterprises, a company’s senior management makes major product, investment and technology decisions. Companies form subsidiaries to facilitate overseas sales. Senior management makes decisions concerning the location of overseas R&D teams, based on local talent and costs, among other factors. But each overseas subsidiary lacks the authority to chart its own investment strategy. “In a CSA there is little, if any, opportunity for any party to manage risk through diversification or to divest itself of underperforming assets – characteristics of a true investment,” says TEI. In summary, the IRS investor model is inconsistent with the way multi-national enterprises operate.
What is a Taxpayer to Do?

Reaction to the proposed regulations has been almost uniformly negative. After issuing the proposed regulations, the IRS invited comments from taxpayers, who responded critically. Most urged the IRS to make substantial modifications to the regulations, or suggested they be withdrawn. Given that the regulations are unpopular with U.S.-based multinational enterprises, how would they respond to the proposed regulations?

One option would be to ignore the proposed regulations altogether. IRS Code is a higher source of legal authority than regulations, as Congress approves the IRS code, and Congress does not review regulations. Regulations are the IRS’ interpretation of the Code, and Courts may overrule regulations inconsistent with the Code. Taxpayers may argue the regulations contradict both the arms-length and commensurate with income principles in IRS Code §482. Taxpayers can provide evidence that CSAs are not unique business arrangements, and that arms-length valuation approaches exist. They can provide evidence that the proposed regulations are inconsistent with current regulations and current transfer pricing law. They can also argue the proposed regulations contradict other regulations. In particular, the proposal that only the IRS should have the empowered to make retroactive CSA changes appears inconsistent with other regulations. As David Canale of Ernst & Young says: “I see no language that says all Section 482 rules apply to both taxpayers and the IRS except for commensurate with income.” 74 And the taxpayer victory in Xilinx v. Commissioner demonstrates the taxpayers can defeat the IRS in Court, particularly when the taxpayer provides evidence its transfer pricing policies are consistent with the arms-length standard.

Taxpayers could also craft CSAs now, before the IRS enacts the proposed regulations. Taxpayers will find the current regulations less restrictive than the proposals, and may want to form CSAs before they take effect. The proposed regulations do provide transition rules, which encourage taxpayers currently in CSAs to migrate to the new regulations. But they do not require taxpayers to adopt the new rules. Conforming to current regulations would also add legal support to the taxpayer’s position that it complies with the arms-length principle, should the IRS later challenge its transfer pricing policies.
Transferring intellectual property overseas is another option. Punitive regulations are not in effect in other countries. This would require the sale of the intellectual property, but today many multi-national enterprises have substantial cash abroad, and may want to transfer cash to the U.S. Once firms transfer the intellectual property abroad, they would not be subject to the regulations, and they could fund U.S. R&D through cost-plus markups. Ironically, there is a large body of U.S. tax law providing guidance on these transfer prices.

In addition, many U.S. firms have already established substantial R&D operations abroad. They can document the contributions of those organizations. If the proposed regulations are approved as written, taxpayers can structure CSAs with tax objectives in mind. Businesses could structure CSAs to achieve tax objectives. Firms could allocate profits to organizations already located in tax havens. In other words, firms might accept the regulations and use them to achieve tax-advantaged results.

Each of the above alternatives demonstrates that intellectual property is highly portable, and U.S. based multi-national enterprises have many options to respond. It is doubtful whether restrictive regulations can achieve their intent. Given taxpayer objections and options, some speculate the regulations will be substantially altered. The IRS may not have the ability to implement restrictive regulations on global businesses.

Is there anything businesses might find attractive in the proposed regulations? While the IRS aimed the regulations at U.S. headquartered firms, they would apply to firms headquartered abroad, as well. These firms could apply these regulations on their U.S. operations. As James Tobin wrote: “the proposed regulations could create an enhanced avenue by which foreign MNCs (multi-national corporations) could generate deductions that would effectively strip earnings from the United States though the CSA by way of cost-sharing payments, as well as royalties or other consideration for foreign-contributed intangibles.” It is quite possible the proposed regulations will achieve the opposite of their intent.
Invention Shop or Troll Factory?, “Financial Times, page 11, April 26, 2006

1 1968 Regs. §1.482-2(d)(4)

2 Ibid

3 IRS §482

4 Regs. §1.482-7(b)(1)-(4)

5 Regs. §1.482-7(d)(2) and §1.482-2(c)

6 Regs. §1.482-7(d)(2)(i)

7 Xilinx Inc. v. Commissioner (125 T.C. No. 4) 8/30/05

8 Regs. §1.482-7(f)(1)

9 Regs. §1.482-7(e)(2)

10 Regs. §1.482-7(e)(1)

11 Regs. §1.482-7(f)(3)(i)

12 See Audit Checklist, Doc. Set Four, (directing IRS examiners to test Reasonably Anticipated Benefits shares against actual results.

13 Regs. §1.482-7(g)(1)

14 Regs. §1.482-7(g)(2)

15 Regs. §1.482-7(g)(5)

16 Ibid

17 Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe,” The Wall Street

18 Journal; November 7, 2005, page 1

19 “Symantec bucks ‘$1 Billion Tax Bill Sought by IRS,’” The Wall Street Journal; April 21, 2006; page B5


Journal; November 7, 2005, page 1


23 Preamble to Proposed Regulations, 70 Fed. Reg. 51115, pages 6-7 (8/29/05)

24 Preamble to Proposed Regulations, 70 Fed. Reg. 51115, page 58 (8/29/05)


27 “Proposed Cost Sharing Rules Propose Investor Model,” BNA Tax Management Inc., 8/31/05


30 Preamble to Proposed Regulations, 70 Fed. Reg. 51115, page 59 (8/29/05)

31 Preamble to Proposed Regulations, 70 Fed. Reg. 51115, page 7 (8/29/05)

32 Prop. Regs. §1.482-7(g)(2)(ix)

33 Prop. Regs. §1.482-7(g)(2)(viii)

34 Ibid


36 Prop. Regs. §1.482-7(g)(2)(viii)(B)(iv)

37 Prop. Regs. §1.482-7(g)(4)

38 Prop. Regs. §1.482-7(g)(4)(ii)

39 Ibid

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

41 Prop. Regs. §1.482-7(g)(4)(iv)(A)

42 Ibid


44 Prop. Regs. §1.482-7(g)(5)(iii)

45 Prop. Regs. §1.482-7(g)(6)(iii)

46 Prop. Regs. §1.482-7(g)(6)(iv)

47 Prop. Regs. §1.482-7(g)(6)(ii)

Prop. Regs. §1.482-7(g)(7)(i)


Prop. Regs. §1.482-7(g)(7)(iii)(B)

Prop. Regs. §1.482-7(g)(7)(iii)(C)(2)

Prop. Regs. §1.482-7(g)(7)(iii)(C)(3)

Ibid

Prop. Regs. §1.482-7(g)(7)(iii)(B)

Prop. Regs. §1.482-7(g)(7)(v)(vii)


Prop. Regs. §1.482-7(g)(3)

Ibid

Prop. Regs. §1.482-7(g)(8)


Xilinx Inc. v. Commissioner (125 T.C. No. 4) 8/30/05


Kirschenbaum and Rahim, “The IRS Cost Sharing Proposal: Throwing Some Logs on the Fire,” 14 Transfer Pricing Report 433 (9/14/05)


Ibid


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