IRS Issues Temporary and Proposed Cost Sharing Regulations

On December 31, 2008, the IRS issued temporary section 482 regulations governing cost sharing arrangements (CSAs) for the shared development of intangible assets by related parties. The temporary regulations, which took effect January 5, 2009, are 193 pages in length and make numerous changes to proposed regulations issued in August 2005. However, the temporary regulations maintain the proposed regulations' key concepts, including using an "investor model" for testing the arm's-length payment for contributions of intangibles or other assets to a CSA. The temporary regulations' rules will require a careful analysis of the benefits and risks of entering into a new cost sharing arrangement as well as a review of their implications for existing cost sharing arrangements.

The principal elements of the temporary regulations are highlighted below.

CSAs. A CSA is an arrangement in which participants share the costs and risks of developing intangibles in proportion to their share of the reasonably anticipated benefits.

- Participants in CSAs make payments to each other so that each participant's share of intangible development costs (IDCs) is in proportion to its respective share of anticipated benefits. IDCs include all costs, in cash or in kind (including stock-based compensation, but excluding acquisition costs for land or depreciable property), incurred in the ordinary course of business after the formation of a CSA that are directly identified with or reasonably allocable to the intangible development activity.
- Each participant must receive a non-overlapping perpetual and exclusive interest in the cost shared intangibles without further obligation to compensate another participant for such interest. The interests may be territorial, or, in an expansion from the proposed regulations, for a field of use (however, all anticipated uses must be assigned to a party to the CSA).
- A CSA must substantially comply with contractual, documentation, accounting, and reporting requirements specified in the regulations. These requirements include documenting the CSA by contract within 60 days of the first occurrence of an IDC. In addition, each participant must file its original "Statement of Controlled Participant to §1.482-7T Cost Sharing Arrangement" with the IRS, no later than 90 days after the first occurrence of an IDC to which the newly formed CSA applies.

PCTs. The temporary regulations use a new term, "platform contributions," to describe the scope of pre-existing assets that will contribute to development of the cost shared intangibles. All participants must commit to platform contribution transactions (PCTs), which are also known as buy-ins, to the extent that there are platform contributions. A platform contribution is any resource, capability, or right that a participant possesses, separately from the intangible development activity, whether developed or acquired prior to or during the course of the CSA, that is reasonably anticipated to contribute to developing cost shared intangibles.

PCT payments. The temporary regulations provide guidance on methods to determine an arm's-length amount to be charged in a PCT. The methods, which retain the perspective of the "investor model," include determining an arm's length PCT payment as follows:

- *Income method*: By reference to the best realistic alternative to the CSA, including licensing the intangible developed by an uncontrolled licensor that bears the entire risk of development;
- *Acquisition price method*: By reference to recent stock or asset acquisitions of an entire organization in an uncontrolled transaction where substantially all the target's non-routine contributions are covered by a PCT or PCTs;
- *Market capitalization method*: By reference to the average market capitalization of a participant whose stock is regularly traded on an established securities market where substantially all of the participant's non-routine contributions to the participant's business are covered by a PCT or PCTs; and
- *CUT, residual profit split and unspecified methods*: Other methods used to determine the arm's-length amount are the comparable uncontrolled transaction methods for intangible property and services, the residual profit split method and unspecified methods.

IRS adjustments (including periodic adjustments). The temporary regulations set out the ways the IRS may make periodic adjustments and other arm's-length allocations to the results of a CSA.

Transition for pre-existing CSAs. An arrangement in existence on January 5, 2009 will be considered a qualifying CSA, if it was a qualified CSA under the provisions of former regulation §1.482-7, but only if the written contract is amended, if necessary, by July 6, 2009.

Ropes & Gray would be pleased to assist clients in evaluating potential CSAs under the new rules and in assuring that pre-existing cost sharing arrangements conform to the temporary regulations. You may contact your regular Tax & Benefits Department contact if you have any questions about the temporary regulations or other transfer pricing issues.