United States

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US Cost Sharing: Current Issues and Court Cases

This article discusses the evolution of the approach of the IRS to cost sharing arrangements; conflicts that were resolved in the courts; and future approaches that taxpayers must consider when constructing cost sharing arrangements.

1. Introduction

Over the past two decades the Internal Revenue Service (IRS) has been increasingly diligent in reviewing inter-company cost sharing arrangements (CSAs). The IRS has taken issue with taxpayers that the IRS believes use these arrangements as a means to transfer valuable intangible property to subsidiaries located in low-tax jurisdictions to the detriment of the US tax base. As a result, the IRS has revamped its approach to evaluating CSAs by changing the rules as they apply to the computation of the research and development (R&D) costs to be shared under a CSA. More importantly, it has changed the rules that apply to the computation of the so-called buy-in payment[1] which is designed to compensate the US taxpayer for the intangible property that it contributes to the CSA. In connection with this effort, the IRS has challenged a number of CSAs in the US Tax Court in an effort to compel taxpayers to value CSAs using the methods that the IRS supports. As is not surprising, the IRS' overhaul of cost sharing regulations has been met with significant resistance from taxpayers.

This article discusses the evolution of the IRS' approachto cost sharing arrangements; conflicts that were resolved in the courts; and future approaches that taxpayers must consider when constructing CSAs. This battle is not over. More changes can be expected as the pending cases work their way through the court system. In addition, the IRS may consider additional changes to the CSA rules to address the income shifting that it perceives is occurring.

2. What Are Cost Sharing Arrangements?

Suppose that a US company wishes to expand its business internationally by providing intangible property to a subsidiary located outside the United States, and the subsidiary will use that intangible property to manufacture and sell products to affiliated or unaffiliated sales companies outside the United States. The US company must make the rights to the intangible property available to its subsidiary. The question is, how? The company has two practical options. It could license the intangible property to the subsidiary in exchange for an arm's length royalty rate, or it could establish a CSA with the subsidiary through which the subsidiary gains the right to share in the use of the pre-existing intangible property to both manufacture and sell current products, and to develop and own new intangible property that is created under the CSA.

The licensing option is relatively straightforward. The subsidiary (the licensee) pays an arm's length royalty for the intangible property over the life of the licence arrangement. As a rule, the arrangement's life is limited to the life of the licensed intangible property. Conceptually, the royalty rate compensates the licensor for the intangible property that it previously developed. In relationships between unrelated parties, the licensee typically invests in the plant and equipment that is used to manufacture the products which incorporate the intangible property, and it ultimately assumes the risks associated with its investments, e.g. the market may not develop as anticipated and the licensee may suffer losses. Nevertheless, the licensee is still obligated to pay royalties to the licensor, although typically the royalty rate is applied to actual sales, which mitigates the risk in situations where the market fails to materialize as expected.

In arm's length relationships, the common view is that the income attributable to the intangible property should be divided between the licensor and licensee in a manner that provides each with income appropriate to its contribution. This outlook is also adopted in related-party agreements, i.e. if a licensee makes investments and assumes risks, the income attributable to the intangible property should be divided between licensor and licensee based on the value that each related party contributes.

The alternative to a licensing agreement is to establish a CSA. Under a CSA, the participants jointly fund future R&D, and the ownership of the resulting intangible property is divided in a predetermined manner, generally on a geographic market basis, although other bases can be used. The future R&D costs are split between the parties according to the anticipated benefits that each is expected to receive.

In addition, the offshore subsidiary must make a buy-in payment for the right to use the pre-existing intangible property both to manufacture and sell currently marketed products, and for the right to use that pre-existing intangible property to develop new intangible property and products. In return for the buy-in payment and the ongoing R&D funding, the subsidiary is the "owner" of the economic rights to exploit both existing and future intangi-

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1. This payment has had many different names over time. To simplify the discussion, the authors will use the historic name, "buy-in", regardless of the name used in the US cost sharing regulations.

ble property in markets outside the United States.[2] While this concept sounds simple, a host of issues has arisen surrounding its implementation, and this very simple concept has led to significant controversy between the IRS and US taxpayers, as will be summarized below

3. Issues with Cost Sharing

The issues that have arisen in the United States typically take one or both of two forms. The first concerns the computation of the R&D costs to be shared, while the second is related to the computation of the buy-in payment. Before considering these issues, a brief summary of the US rules is presented in order to illustrate how they have changed over time.

4. US Cost Sharing Rules

As recently as 30 years ago, the IRS and taxpayers were relatively aligned as regards the way in which buy-in payments should be calculated; oftentimes, the subsidiary made a yearly royalty payment based on the economic life of the specific intangible transferred. As will be seen, the IRS has contested this approach, and has taken the position that the transfer of intangible property to the CSA does not represent a licence of intangibles but, in substance, it represents a sale of a business opportunity and its associated revenue and profit streams.

In conjunction with this sale of a business opportunity, the IRS has taken the position that the transferred intangibles have a perpetual economic life and should be priced accordingly. This, of course, is logical if the transaction is properly characterized as the sale of a business opportunity. The key question concerns the proper characterization of the transfer of intangible property to the CSA, i.e. whether it is a licence of pre-existing intangible property (narrowly defined under existing definitions of intangible property) or the sale of a business. This question has not yet been addressed. In any event, the IRS position is that the transaction is, in substance, the sale of a business opportunity, which means that the IRS disallows a buy-in royalty payment computed based on the transferred intangible's finite economic life depreciated over a fixed timeline.

The second CSA issue, the computation of the R&D costs to be shared, is less contentious for many companies. Historically, the computation of the R&D costs to be shared was relatively straightforward, and there was little controversy surrounding those computations. Over the past several years, however, the IRS has become diligent in ensuring that all ongoing R&D costs, both explicit and implicit, are included in the pool of costs shared by the US and foreign companies. More specifically, employee stock option expenses provided to employees who participate in the CSA R&D activity must be included in the R&D costs to be shared under the CSA. The IRS has rewritten the CSA regulations to include this requirement and has litigated this issue, as will be discussed in more detail below.

The evolution of CSA regulations and the important court cases affecting CSAs are considered immediately below.

5. Commensurate-with-Income Standard

The original transfer pricing regulations, introduced in 1968, did not include any language on CSAs.[3] However, under the 1968 Regulations, all intercompany prices were required to be arm's length. These regulations contained no direct language regarding profitability, as the methods that were allowed under those regulations were transaction based and were designed to provide methods of computing intercompany prices, i.e. those regulations did not include any type of profit split method. Over time, the IRS became concerned about its inability to focus on differing levels of profit, particularly where high-value intangibles were involved. This was especially a concern in the case of licensing agreements and cost sharing arrangements, where the IRS believed that valuable intellectual property was being transferred out of the United States at prices that were not commensurate with the value of the intangible assets.

In 1986, Congress added the "commensurate-with-income standard" to section 482 of the Internal Revenue Code. The commensurate-with-income standard required that intercompany prices or royalty rates show that the return to the developer of the intangible property was commensurate with the income associated with its exploitation. For companies entering CSAs, this meant that special consideration now had to be given to the value of any intellectual property that was contributed to the arrangement.

Seagate v. Commissioner[4] was a foundational cost sharing case argued before the US Tax Court, and it was centred on the commensurate with income standard. Seagate-US was a leading manufacturer of hard disk drives for personal computers, and it entered into a CSA with its subsidiary, Seagate-Singapore. The related companies established a CSA to pay for the ongoing R&D costs, and Seagate-Singapore paid a yearly buy-in royalty for access to Seagate-US's pre-existing intangibles. This arrangement ultimately became the target of an IRS audit for the years 1983 to 1987.[5] The IRS concluded that Seagate-Singapore's income was not commensurate with the functions it performed because Seagate-Singapore was allowed to sell its products in the United States, a market developed by Seagate-US, and to exploit intangibles such as patents and sales contracts that had been developed by Seagate-US. The IRS argued that Seagate-Singapore should pay a royalty rate higher than 1% to Seagate-US for these valuable intangibles.

The experts presented by both the IRS and Seagate agreed that R&D costs should be allocated based on the bene-

2. Typically, companies centralize the legal ownership of intangible property. In this article, "ownership" refers to the right to earn the income attributable to the intangible property at issue, which is sometimes referred to as "economic ownership".
3. The IRS had proposed cost sharing regulations. However, these regulations were not issued in final form.
4. *Seagate Technology Inc., et al. v. Commissioner*, 102, T.C.149 (1994).
5. Other issues were included in this case; however, the authors are solely examining the issues related to the CSA.

fits each entity expected to receive; however they disagreed on the valuation of these expected benefits. The Tax Court determined that the IRS's allocation of costs based on future production was not an arm's length method to measure expected benefits. The Court noted that neither party introduced comparable third-party cost sharing arrangements, and stated:

> [...] we have no unrelated transactions to use as a guide to our decision. Accordingly, we use our best judgment and conclude that 75 percent of the R&D expenses should be allocated to Seagate Singapore and 25 percent should be allocated to Seagate Scotts Valley [US].[6]

The Tax Court accepted that the computation of Seagate-Singapore's buy-in was a standard operating practice. However, the Court ruled that Seagate-US transferred marketing intangibles in addition to the manufacturing intangibles to Seagate-Singapore, and increased the buy-in royalty payment from its original amount of 1% of revenue to 3%.[7] Although the Court increased Seagate-Singapore's buy-in royalty rate, the Court's decision was important in that it reinforced the commonly held approach to value CSA intangible buy-in payments with a royalty rate.

6. The 1995 Regulations

In December 1995, the IRS issued its first set of cost sharing regulations, which became effective on 1 January 1996 (the 1995 Regulations). Under the 1995 Regulations, the cost sharing valuations were based on a payer/payee model. Shared costs were treated as a cost of developing the intangible by the designated payer and a reimbursement of those costs to the payee. The rights enjoyed by cost sharing participants were often divided territorially, e.g. each participant was given the right to a bundle of ongoing and historical intangibles necessary to conduct business in its own territory.

One of the key considerations in the 1995 regulations was the introduction of the buy-in payment.[8] A buy-in payment was required for all cost sharing participants for the use of pre-existing technology that was contributed by another participant. In general terms, all participants were required to make equivalent contributions at the start-up of the CSA, either in cash or in kind. Participants that did not contribute intellectual property, or did not contribute a sufficient share of the total intellectual property, were required to compensate the participants that provided more than their fair share. The 1995 Regulations state that the buy-in should be valued under one of four methods, namely:
– the comparable uncontrolled transaction (CUT) method;
– the comparable profits method;
– one of the profit split methods; or
– other, unspecified methods.

While there is no hierarchy of methods in the US transfer pricing regulations, it is generally agreed that if one of the prescribed methods can be applied, then that method is highly likely to provide more reliable results than use of an unspecified method. As a result, cost sharing participants typically supported their buy-in payments using a CUT analysis based on third-party licence agreements, or they used a profit split method if more than one party contributed valuable intangible property.[9]

The 1995 Regulations also held that the on-going R&D costs should be shared based on the benefit each participant was expected to receive from those expenditures. The 1995 Regulations were in effect for the tax years that applied to Xilinx Corporation in its Tax Court case, *Xilinx v. Commissioner*.[10] In 1995, Xilinx-US, a manufacturer and seller of software systems, established Xilinx-Ireland, a subsidiary. The related parties entered into a CSA to jointly develop new technology. In accordance with the CSA Regulations in effect for that year, the CSA specified that R&D costs would be allocated based on each party's anticipated benefits from the new technology. However, costs from employee stock options issued to employees who were engaged in R&D were not included in the cost pool, and the IRS alleged that these costs should be included.[11]

Xilinx asserted that the third-party arm's length transactions it provided to the Court did not include employee stock options, and therefore its own intercompany transaction need not include employee stock options in the cost pool.[12] The Tax Court acknowledged that the United States is on an arm's length standard that applies to all intercompany transactions, including cost sharing arrangements. The Tax Court's August 2005 decision held that the commensurate with income standard does not replace the arm's length standard. The Court wrote: "Contrary to [IRS's] contentions, the commensurate-with-income standard was intended to supplement and support, not supplant, the arm's length standard".[13]

The *Xilinx* case reappeared in 2008 when the IRS appealed the Tax Court's 2005 ruling.[14] On 27 May 2009, a three-judge panel of the United States Court of Appeals for the Ninth Circuit ruled that the Tax Court's original decision should be overturned. The two judges who represented the

6. *Seagate* (1994).
7. Seagate claimed a royalty of 1%, using comparable transactions that established a range of royalty rates between 1% and 3%. The IRS claimed that a 6% royalty rate was more appropriate.
8. While the buy-in payment was not explicitly required under prior regulations, many US taxpayers made such a payment because it was consistent with the arm's length standard.
9. Facts taken from H.A. Keates, R. Muylle and D.R. Wright, *Temporary Cost Sharing Regulations: A Comment*, 16 Intl. Transfer Pricing J. 3 (2009), Journals IBFD.
10. *Xilinx Inc. v. Commissioner*, 102 T.C.149 (1994).
11. Facts taken from Z. Gul, R. Muylle, H.A. Keates, D.R. Wright, *R&D Cost Sharing: The Xilinx Appeal*, 16 Intl. Transfer Pricing J. 5 (2009), Journals IBFD; D.R. Wright, *Withdrawal of Court of Appeals Decision in Xilinx*, 17 Intl. Transfer Pricing J. 3 (2010), Journals IBFD; and D.R. Wright, *Xilinx: The Saga Continues*, 17 Intl. Transfer Pricing J. 3 (2010), Journals IBFD.
12. According to the Tax Court: "Section 1.482-1(b)(2), Income Tax Regs., does not require [IRS] to have actual knowledge of an arm's-length transaction as a prerequisite to determining that an allocation should be made. See *Seagate Technology, Inc. v. Commissioner*, T.C. Memo. 2000-388. If, however, it is established that uncontrolled parties would not share the spread, we may conclude that respondent's determination is arbitrary, capricious, or unreasonable. * * * neither party has presented sufficient evidence or established facts adequately addressing whether the arm's-length standard has been met".
13. *Supra* n. 12.
14. US: AC 9th Cir., 27 May 2009, *Xilinx Inc. v. Commissioner*, Tax Treaty Case Law IBFD.

majority opinion determined that employee stock options are to be included in the shared costs under a CSA. They based their decision on a legal canon that requires the specific to prevail over the general, i.e. the specific requirement in the cost sharing regulations that "all" costs be shared trumps the general arm's length requirement in the section 482 regulations. The Court ruled, "[...] related companies in a cost sharing arrangement to develop intangibles must share all costs related to the joint venture, even if unrelated companies would not do so".[15]

Xilinx petitioned for a rehearing, and on 13 January 2010 the Ninth Circuit withdrew its 2009 opinion. In withdrawing its decision, the Appellate Court stated that the regulations are contradictory in nature and affirmed the Tax Court's conclusion that the arm's length requirement takes precedence over the specific cost sharing rules. As a result, the Appellate Court reissued its decision, this time affirming the Tax Court decision.

The *Xilinx* case focused on one aspect of the cost sharing regulations, namely the R&D costs that were required to be included in the cost pool. After the 2003 Regulations were issued and specifically addressed the employee stock option issue, the IRS focused less on the R&D cost allocations in CSAs and allocated more of its efforts into auditing the buy-in payments for transfers of pre-existing intangibles.

7. The 2003 Regulations

As stated above, the IRS believed that the exclusion of employee stock option costs in the shared R&D cost pool distorted the actual costs borne by each party. Employee stock option costs were typically borne solely by the parent company in a CSA, and, in the IRS's view, this produced non-arm's length results. As a result, in 2003 the IRS issued new cost sharing regulations (the 2003 Regulations) that required the inclusion of employee stock options in the cost sharing pool.[16]

This inclusion was met with significant resistance from taxpayers. Many taxpayers continued to maintain that employee stock option costs are not included in arm's length agreements, and therefore the 2003 Regulations violated the arm's length standard. As will be seen in the *Amazon v. Commissioner* case discussed below, inclusion of employee stock options in a cost sharing arrangement continues to be a source of conflict between the IRS and taxpayers.

8. The 2005 Proposed Regulations

As discussed previously, under both the 1995 Regulations and the 2003 Regulations, taxpayers typically relied on royalty agreements or the residual profit split to compute the CSA's buy-in payment. By 2005, the IRS had concluded that these methods were allowing US companies to export valuable pre-existing intangibles for a fraction of their long-term value. It contended that the intangibles developed in the United States provided the basis of the business opportunity that was to be developed by the participants in the CSA, and that this basis, also referred to as a "platform", was essential to all further development that would take place under the CSA. Thus, the IRS contended that these underlying intangibles have an ongoing lifespan that should continue to earn a return for the lifetime of the newly developed intangibles' business opportunity. In essence, it was the IRS's opinion that the participant was not merely contributing intangibles to the CSA, but was actually transferring or selling the rights to a business. This distinction is paramount in determining the appropriate method of compensation, the life of the intangibles and the split of profits between the parties.

In 2005, the IRS released proposed regulations that were intended to revolutionize the approach of taxpayers to cost sharing arrangements. The 2005 Proposed Regulations reiterated the IRS's previous belief that R&D costs were to be allocated between the parties in a CSA based upon each party's expected benefits. However, the 2005 Proposed Regulations established two important concepts. First, they introduced the idea of "platform contributions" to the taxpayer; platform contributions were designed to fully account for all transferred intangibles. Second, these regulations introduced so-called income methods for use in valuing the platform contributions, and they encouraged taxpayers to use these methods in place of licence agreements. In doing so, the IRS argued that licence agreements were not comparable to the platform rights that were contributed under the CSA, and therefore could not be used to compute buy-in payments.

The IRS introduced these concepts to discourage taxpayers' use of comparable uncontrolled transactions as a means to establish arm's length prices. These changes were significant, as they laid the foundation for the eventual conflict between the IRS's approach of valuing a buy-in as the sale of a business and the belief of taxpayers that the buy-in is a licence of intangible property which is used to develop future intangible property. Incidentally, there is a proposal contained with the President's budget[17] to change the definition of intangible property to recognize workforce in place, goodwill and going-concern value as intangible property, even though these items do not meet the current definition of intangible property.[18] The authors believe that the purpose of this proposal is to provide additional support to the IRS theory that intercompany transfers of intangible property should be valued as sales of a business opportunity.

In short, platform contributions are designed to account for all inputs that lead to the development of cost-shared intangibles, including "resources, capabilities, or rights, such as expertise in decision-making concerning research and product development, manufacturing or marketing intangibles or services, and management oversight and

15. Id.
16. These costs were also required when applying the comparable profits method to all other types of transactions.
17. This provision is in the current budget proposal as well as proposals beginning in 2010.
18. Currently, an item is not intangible property if it cannot be separated from the services of an individual or is not commercially transferrable.

direction".[19] The IRS created the concept of platform contributions, in part, to provide itself the opportunity to incorporate a wider array of inputs (general know-how, goodwill, etc.) into the cost sharing pool than were previously required by the regulations. The notion of the platform contribution also allowed the IRS to argue that the lifespan of the pre-existing intangible is perpetual, as it is incorporated in all future intangible development by the CSA, and should not expire when new intangibles are developed.

As previously stated, the 2005 Proposed Regulations redefined the IRS approach to CSAs by explicitly advocating application of the income method to value each party's contribution to a CSA. One such income method, the "investor model", invalidated the notion that CSA participants jointly develop an intangible. Under the investor model, participants invest their own pre-existing intangibles or other contributions to the development process and receive a return that is commensurate with their contributions. Income methods, such as the investor model, were categorized as unspecified methods under prior regulations; however in the 2005 Regulations, the IRS identified the investor model as the primary method for evaluating CSAs. It is important to note that the 2005 Proposed Regulations were just that – proposed regulations – and therefore the 2003 Regulations continued as the governing transfer pricing rules at that time.

9. The 2007 Coordinated Issue Paper

To further clarify its position with respect to the investor model, the IRS issued a Coordinated Issue Paper (CIP) on CSA Buy-in Adjustments in September of 2007. The CIP stipulated that the income method is generally the best method for valuing the initial buy-in because the IRS believes that CUTs are typically not comparable. This means that the data used to apply the comparable profits method do not reflect similar risks and the residual profit split method does not properly equate past and future risks. The CIP claimed that CUTs applied by taxpayers were not comparable because they lacked similar profit potential and incorporated different risk and economic conditions. This lack of comparability stemmed primarily from the distinction between the licensing of technology and the sale of a business opportunity. The CIP presented a similar argument against the use of the residual profit split method by suggesting that it valued fundamentally different past and future risks than are appropriate for a CSA. The conclusion of the CIP was that the investor model, under which the useful life is not limited and the full expected net residual profit is attributed to the original contribution of the intangibles, should be adopted to appropriately value buy-in payments under CSAs.

After the issuance of the Coordinated Issue Paper in 2007, IRS field level audit staff began applying the investor model as a "cookie cutter" approach, i.e. without regard to the facts and circumstances of each particular case. This led to a large number of contested audits in which the IRS rejected the taxpayer's valuation method and applied the investor model. To illustrate the approach that the IRS would often take at the field level, consider an example of a taxpayer that provided process technology to a CSA: This technology was useful for the current production of a US company's products. The CSA was established to develop new manufacturing technology and new products. The CSA partner, an established European entity, had already developed a market for other products made by the company in Europe and Asia, and was in a unique position to develop new products and establish new manufacturing technology based on this experience. The process intangibles that were transferred did not represent the full package of intangibles used in the manufacturing and sale of the products, nor were they core to the development of the new intangibles created by the CSA. Additionally, the lifespan of the transferred technology was estimated to be five years by the business people within the company. All other intangible rights to the products sold by the company were maintained by the US entity, and the US entity received the intangible income for the remainder of its rights outside of the CSA.

During the audit process, which began in 2006, the IRS contested the taxpayer's use of the CUT method, supported by a residual profit split method to determine buy-in payments. As the process moved forward, an IRS economist was consulted. The IRS economist applied the investor model wherein he asserted that the lifespan of the intangibles should be perpetual, i.e., for the full life of the product line, and that the residual profit should not be split based on the licence agreements, but be awarded in full to the US entity. Further, the field team included not just the sales of the existing products, but also the expected sales of the new products developed by the CSA.

The taxpayer refuted the assessment; it argued that the investor model was not a primary method when the CSA was instituted in 2002, and thus did not take precedence over the CUT or the profit split method, and it also provided scientific evidence of the useful life of the intangibles. With disregard to the arguments made by the taxpayer, in 2010, more than eight years after the cost sharing arrangement was put in place, the IRS issued its assessment based on a full-scale application of the investor model.

This has not been an uncommon occurrence for taxpayers that are involved in audits with the IRS for tax years between 2000 and 2008. It is also notable that this application of the income method effectively leaves the offshore entity with a contract manufacturer's rate of return. Readers who have followed the IRS's auditing positions from the early 1980s recognize the various attempts that IRS has used to force offshore manufacturers to this very low rate of return. This is yet the latest iteration of that approach.

19. Internal Revenue Service Bulletin 2012-12, TD9568, 19 March 2012, Part A Explanation of Provisions.

10. The 2008 Temporary Regulations

The IRS issued its 2008 Temporary Regulations on 31 December 2008, and according to the regulations, they "[...] are generally applicable for [cost sharing arrangements] commencing on or after January 5, 2009, with transition rules for certain pre-existing arrangements".[20] These regulations elucidated and directed taxpayers' efforts to identify taxable income arising out of cost sharing arrangements.[21] The 2008 Temporary Regulations supported the efforts of the 2005 Proposed Regulations, and as a result the idea of platform contributions and application of the investor model became part of US transfer pricing regulations.

According to the US Treasury, the 2008 Temporary Regulations were a "clarification" of law; however these regulations also reformed the approach to CSAs by eroding the strength of taxpayer CUTs and in its place suggesting the use of the income method. The 2008 Temporary Regulations lessened the flexibility of taxpayers in employing the CUT method by including tougher rules to determine comparability. If, under the 2008 Temporary Regulations, the taxpayer was unable to appropriately apply the CUT method to its CSA, it was expected to rely on a secondary method (in the view of the IRS, an income method) to perform its analysis.

11. The 2011 Regulations

On 16 December 2011, the IRS issued final regulations (the 2011 Regulations). The 2011 Regulations retained the principles explicated in the 2008 Temporary Regulations, including the investor model, and added a "realistic alternative" concept and aggregate valuation. The 2011 Regulations highlight the "realistic alternatives" principle that the CUT method may not be the most reliable way to test arm's length consideration for contributions under CSAs. The 2011 Regulations also reinforce the broader definition of intangibles. They endorse the underlying theory that most, if not all, of the value created by the parties in a CSA is attributable to pre-existing intangibles,[22] which are transferred to a CSA through platform contributions, not by the R&D conducted under a CSA.

Not only is the income method introduced as a specific method, but the CUT method is qualified with a note of caution in its usage as a specified method. The 2011 Regulations also include a clause which implies that the investor model be adopted even if comparable arm's length transactions exist. Accordingly, the Regulations state:

> The reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction and only entered into such transaction if no alternative is preferable. This condition is not met, therefore, where for any controlled participant the total anticipated present value of its income attributable to its entering into the CSA, as of the date of the [platform contribution], is less than the total anticipated present value of its income that could be achieved through an alternative arrangement realistically available to that controlled participant.[23]

By including this clause, the IRS is able to assume the position that a CSA analysis supported by CUT agreements is unacceptable if it produces profits for the US transferor that are less than the amount that would be generated through the sale of the business (measured by the present value of its income stream attributable to the business). The IRS implicitly argues that no such opportunity to sell a business for its present value must have arisen; if an opportunity to sell the business for the present value of its income stream did arise, then the controlled party would have surely chosen that option in lieu of a royalty through which it receives less economic gain. However, when valuing the controlled transaction between two parties, the opportunity to sell a business can and should be exercised by the US taxpayer.

Although the IRS continued to categorize its changes to the Regulations as clarifications and fine-tuning, it is evident that the 2011 Regulations pitted the IRS's income method approach squarely against taxpayers' commonly employed CUT analysis.

The first Tax Court case that tested the IRS's new approach to valuing the buy-in was *Veritas v. Commissioner*.[24] The case was docketed in 2006 and ultimately decided in December 2009. The IRS audited Veritas's CSA for the years 1999-2001 using the income method and the concept of the platform contribution that it introduced in the 2005 Proposed Regulations and further established in the 2008 Temporary Regulations.[25] The income method was not contained in the regulations that applied to the years at issue in the case.

Veritas-US, which was at the time a major developer and manufacturer of computer software, entered into a cost sharing arrangement and a technology licence arrangement with its subsidiary, Veritas-Ireland. Veritas-US granted Veritas-Ireland the right to use intangibles in the development and production of Veritas-Ireland's storage management products in exchange for a lump-sum royalty payment of USD 166 million. Veritas based the USD 166 million lump-sum payment on third-party arrangements established between it and original equipment manufacturers. The IRS did not accept Veritas' CUT approach, and applied the income method to calculate the buy-in; it arrived at a lump-sum payment of USD 1.675 billion.[26] The vast discrepancy in what Veritas and the IRS postulated to be an arm's length buy-in payment rested primarily in the disparity of what each party considered to be intangible property. The IRS augmented Veritas' quantification

20. Treasury Decision 9441, 74 FR340-391, 5 Jan. 2009, "IRS Final and Temporary Rules (T.D. 9441) on Methods to Determine Taxable Income in Connection with Cost-Sharing Arrangement", Background.
21. *Supra* n. 18, Summary.
22. There was a redefinition of intangible property; according to the 2011 Regulations, a piece of intangible property is no longer required to be commercially transferrable.
23. US Treas. Reg. sec. 1.482-7 (g)(2)(B)(iii).
24. *Veritas Software Corporation & Subsidiaries, Symantec Corporation v. Commissioner of Internal Revenue*, 133 TC No. 14 (2009).
25. *Supra* n. 23.
26. Facts taken from A. Lin and D.R. Wright, *The Tax Court Decision in* VERITAS*: A Comment*, 17 Intl. Transfer Pricing J. 2 (2010), Journals IBFD.

of intangible property by adding "platform contributions" such as access to an R&D team, marketing team, distribution channels, customer lists, trademarks, trade names, brand names and sales agreements.

The Tax Court favoured Veritas' CUT method over the IRS's income method, with minor adjustments. The Court outlined several reasons why it rejected the IRS's method. First, the Court found that the IRS failed to differentiate between the value of subsequently developed intangibles and pre-existing intangibles, thus including intangibles beyond what is required for a buy-in payment. Second, the IRS included intangibles such as access to Veritas US's marketing and R&D teams, which were not among the intangibles recognized by the 1996 US transfer pricing regulations. Finally, the Court determined that the IRS incorrectly assigned a perpetual useful life to transferred intangibles, which the Court found to have a useful life of four years.[27]

The Court rejected the IRS's income method, and refuted the IRS's position that intangibles should be valued in perpetuity. Veritas argued that the technology transferred between Veritas-US and Veritas-Ireland was sold in conjunction with software, which evidence has shown to have a finite life. This ruling sent a strong message to the IRS that it could not retroactively apply rules that were not in effect at the time that transactions took place. To this point, the Court stated that "taxpayers are merely required to be compliant, not prescient".[28] Although the IRS strongly opposed the judgment, it did not appeal the case. It did, however, publicly announce its opposition to the ruling in an Action on Decision memo: "The Internal Revenue Service [...] believes the Court's factual findings and legal assertions are erroneous. Therefore, it does not acquiesce in the result or the reasoning of the decision".

Although the Tax Court ruled in favour of the taxpayer, it is important to note that the Court was applying the 1995 Regulations that were in effect for the tax years in question (1999-2001).

12. Fallout from the *Veritas* Decision

In the aftermath of the *Veritas* decision, the IRS has found itself in an uncertain position. While it wants to have a court decision that verifies and substantiates its new regulations, it could experience a significant setback if it were to lose another decision as it did with *Veritas*. The investor model itself was not refuted under the *Veritas* decision; rather, the Court determined that in the specific circumstances of the case, the taxpayer had used an appropriate method of determining the buy-in payment and should not have been expected to apply the investor model.

Three specific factors were significant in this decision. First, the CSA was entered into under the 1995 Regulations, which did not include the income method as a specified method. Second, the taxpayer had used a specified method in applying the CUT method, and third, the Court agreed with the taxpayer that the intangibles had a limited lifespan and did not represent platform contributions with an unlimited life. For the IRS to substantiate the investor model, it would require a case that meets these challenges, particularly the fact that the investor model was not a specified method prior to the 2008 Temporary Regulations taking effect on 5 January 2009.

Within a year of the *Veritas* decision, the IRS began to change its approach to the handling of older CSA cases that were still pending. The cookie cutter use of the investor model was met with resistance from taxpayers and the courts, and, for the IRS to substantiate its positions, it needed to refine its use of the investor method and how it was applied. This sentiment was first expressed in 2011 by the new IRS Director of Transfer Pricing Operations, Large Business and International Division, Samuel M. Maruca, who provided a new direction for the IRS litigation team. He stated:

> In the majority of transfer pricing cases, we need to use more fundamental building blocks that are focused on old-fashioned, rigorous fact development and analysis. Put another way, the methodology comes second – the first priority of the [international examiner] will be to understand the business and its economics. It takes more time and effort, for sure, but it will optimize outcomes.[29]

Mr Maruca took this new approach a step further in an interview in April 2012 when he stated:

> [W]e have been engaged in 'triaging' the inventory of initial buy-in cases that arose under the 1995 regulations, and that process is now well along. We have contacted the relevant Exam teams and we've been working with them to devise the best approach for the particular case in view of its specific fact pattern, the way it has been developed, its maturity in the audit process, and its significance within the context of the inventory as a whole [...]. In some cases this means presenting our own version of the residual profit split method to Appeals. This has been done to good effect in a number of cases already – we are achieving some better results. And the backlog is decreasing.[30]

To further substantiate this change in approach, the IRS withdrew the Coordinated Issue Paper in 2012, reiterating that the IRS should consider the facts and circumstances of the case and not use the Coordinated Issue Paper as a blueprint. These comments are welcome words for many taxpayers, and consequent changes are starting to be seen at all levels of the audit system. For taxpayers such as the one in the example previously discussed, the IRS added new members to the audit teams in 2011 and 2012 and often applied the residual profit split method to determine the buy-in payment, as warranted by the facts and circumstances in the case.

Another case that may shed light on the resolve of the IRS to press forward with investor model cases involves Amazon.com. Although Amazon's CSAs were entered into before the 2008 Temporary Regulations took effect, the IRS audited Amazon.com and used the investor model

27. Id.
28. *Veritas* (2009).
29. *Practitioners Say Recent Comments by Maruca, JCT Could Signal Changes to U.S. Cost Sharing Regime,* Bloomberg BNA, 20 Transfer Pricing Report 219 (30 June 2011).
30. *Maruca Describes Plans for Advisory Group, Reports Success with Cost Sharing Settlements*, Bloomberg BNA, 20 Transfer Pricing Report 1264, (19 Apr. 2012).

in its valuations. The taxpayer is appealing the deficiency notice issued in 2012 that included USD 2.2 billion in transfer pricing adjustments involving the years 2004 to 2006.[31] The Amazon case may provide a clearer picture of the IRS's resolve to go forward with investor model cases, especially ones in which the timing is not in its favour. The really interesting part of the Amazon case, however, is the fact that it is challenging the validity of the regulation which requires that employee stock options be included in the CSA cost sharing pool.

Mr Maruca's comments are aimed at settling older cases, and should not lead taxpayers to believe that the investor model is dead. While Mr Maruca suggests that a rigorous review of the facts and circumstances is needed before determining whether to apply the investor model, he does not back away from it entirely. His comments also indicate that the IRS is specifically targeting pre-2009 cases to clear out the system, but does not expound on cases that take place in 2009 or later (and therefore would fall under the new regulations).

13. Conclusion

If a company wishes to establish a CSA in which one party is located in the United States, it should be aware of a number of issues.

What are the intangibles that are transferred? Intangibles have been defined as intellectual property that is legally transferrable and separable from the services of an individual and derives its value not from its physical attributes, but from its intellectual content or other intangible properties. In order for the IRS to adopt the position that a buy-in covers the sale of a business, it found it necessary to modify the definition of intangibles to include workforce in place, goodwill and going-concern value through the creation of platform contributions. However, neither goodwill nor going-concern value meets the current definition of intangible property in the US section 482 regulations.

There is great controversy regarding whether workforce in place, goodwill and going concern value are really intangible property, as the term is typically understood. Many commentators argue that these items do not comprise intangibles for one of several reasons, namely that they are not transferrable, they result from accounting rules predicated upon spreading the purchase price of an acquisition across the assets comprising the acquisition, etc. However, these terms have been included in the Obama administration's Green Book, which contains the administration's budget:[32]

> The proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the [IRS] may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the [IRS] may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.[33]

To date, no action has been taken on this proposal, although these intangibles are inherently included in the IRS's litigating position regarding cost sharing buy-in payments, and they are implicitly in the cost sharing regulations due to the fact that the income method is implicitly required for computation of buy-in payments.

What rights are transferred? Several issues about the transfer of rights have arisen and have become important. The actual rights transferred have become important, e.g. make and sell rights vs. use rights. In other words, intangible property rights have been parsed into two pieces: the right to use pre-existing intangible property to manufacture and sell products vs. the right to use pre-existing intangible property to conduct future R&D. This issue rests at the heart of the discussion regarding the economic life of the pre-existing intangible property. Make and sell rights can be valued by applying comparable licence arrangements in which royalties are typically paid up to the point that the intangible property becomes public domain, i.e. the patent expires. The IRS position on use rights, however, has been that their economic life is perpetual, presumably because they represent a "platform" of intangible property knowledge that makes future R&D more efficient and effective. This platform exists in perpetuity, and the IRS wants payment in perpetuity for them.

Characterization of the transaction. If one views a cost sharing arrangement as the sale of a business, the "investor model" is typically used to value the payment for that business – in other words, computing the net present value of the stream of revenue associated with the business that could be sold. The IRS has adopted this approach in both its litigation of these issues and the regulations that it has put in place. The issue that must be addressed in this approach concerns the income that is left for the offshore cost sharer. In some of the IRS's analysis, the offshore cost sharer is given a contract manufacturer's rate of return, and nothing more. This means that the subsidiary bears (sometimes significant) costs without any prospect of receiving a benefit from that investment.

Some commentators justify this return by naming the charge a "cost" (i.e. a contractually obligated expense) rather than an "investment". Whatever it is called, there is risk associated with any expenditure, and it is hard to believe that an unrelated third party would have been willing to incur this cost/risk if it knew that it could never receive greater than a contract manufacturer's rate of return. In other cases, the IRS has been a bit less harsh, e.g. allowing the CSA participant to earn a portion of the incremental income attributable to the intangible property.

The key issues in application of the cost sharing model are centred largely on the computation of the buy-in payment

31. A relatively small piece of this USD 2.2 billion deficiency, approximately USD 9 million, is attributable to Amazon's exclusion of employee stock options in its CSA cost sharing pool.
32. General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, commonly called The 2011 Green Book.
33. General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, at 90.

for the use of pre-existing intangible property. At its heart, the differences between the IRS and taxpayers rest on the proper characterization of these transactions.

Life of the pre-existing intangible property. If one views the pre-existing intangible property as a platform upon which the R&D cost sharers develop new technology, then that platform may have a perpetual life, as the IRS contends. One must be cautious with this approach, however. Not every industry has a platform that exists on the day the cost sharing arrangement is established, or a platform that has value into the future. Two examples can be used to illustrate this point. First, in some industries (high tech, for example) foreign operations may be put in place very early in the corporation's life in order for the corporation to remain competitive. As a result, these companies locate in low labour cost areas and/or partner with other companies in its industry to take advantage of the market for highly skilled workers. In these cases, a platform may not be developed when the cost sharing arrangement is put in place. Additionally, the technology in some industries changes frequently and in a revolutionary manner, rather than incrementally (or evolutionarily). In these industries, the value of the platform may be relatively minimal, as the nature of the technology changes dramatically over time. In other words, one cannot simply accept the conclusion that a platform has significant value into perpetuity without verifying that the conclusion is correct. As in all transfer pricing cases, the facts drive the answer.

A related issue concerns the rights that are typically provided in a third-party licence arrangement. Typically, the rights transferred in such a contract are "make, use and sell" rights, which give the licensee the right to use the pre-existing intangible property to both manufacture the product and use the technology to further develop the product before and after commercialization of the product. To understand this point, consider the following discussion of typical licensing arrangements. In many third-party transactions, a patent is licensed before it has been used as an input in the development of a commercially viable product. In such cases, the licensee must perform further R&D to commercialize the intangible property, and it does so at its own cost and risk; however the licensor typically owns the intangible property that results even though the licensee is the entity that manufactures and sells the product. In these cases, the licensee pays royalties only for the agreed upon term (typically until the patent expires), even though the use rights have arguably been transferred to the licensee through the licence arrangement.

This logic can, and should, be used in the context of an R&D cost sharing arrangement. There are circumstances in which the IRS's position may be correct, but there are other circumstances where the position of taxpayers may be the better argument of the two. Again, the facts drive the answer, and it is likely that the "right" answer varies from one case to the next.

Contribution of the offshore subsidiary to the transaction. Part of the IRS position seems to be that the offshore subsidiary contributes nothing other than its labour to the overall transaction at issue. In the authors' experience, this comes out in the form of an underlying assumption that the "licensee" brings no intangible property or other valuable assets to the table – all the valuable contributions are made by the US licensor. This approach can be debated based on the facts. For example, suppose that the offshore subsidiary existed prior to the establishment of a CSA. In that case, it may have a well-developed management team, an existing production plant and manufacturing process know-how that will be valuable to the manufacturing effort associated with the products developed under the cost sharing arrangement, to name just a few of the valuable assets that the subsidiary brings to the cost sharing arrangement. In this scenario, the facts would lead one to the conclusion that the offshore subsidiary should receive a return greater than that of a contract manufacturer.

Even in the case of brand new subsidiaries, the management team may be in existence and may provide valuable local relationships that are important to the success of the enterprise. The authors could continue with more examples, but the point is made. It would be a unique situation in which the subsidiary brought absolutely nothing to the cost sharing arrangement – at the very least, it is bringing its willingness to take on the risk associated with the investments that it must make to bear its share of the R&D cost, to build and maintain the manufacturing plant, etc. The contribution made by the offshore subsidiary must be carefully determined, and appropriate compensation given to the subsidiary for its contribution. There is no "one size fits all" to this analysis.

In conclusion, CSAs remain a hotly contested part of US transfer pricing practice, and are likely to remain so for the foreseeable future. Given the current emphasis on base erosion and profit shifting, it is likely that this will continue to be a focus of IRS audit activity.