DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG–144615–02]

RIN 1545–BB26

Section 482: Methods To Determine Taxable Income in Connection With a Cost Sharing Arrangement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding methods under section 482 to determine taxable income in connection with a cost sharing arrangement. These proposed regulations potentially affect controlled taxpayers within the meaning of section 482 that enter into cost sharing arrangements as defined herein. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received November 28, 2005. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 16, 2005, at 10:00 a.m. must be received by October 26, 2005.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–144615–02), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–144615–02), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20044, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–144615–02). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jeffrey L. Parry or Christopher J. Bello, (202) 435–5265; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The collection of information requirements are in proposed § 1.482–7(b)(1)(iv)–(vii) and (k). Responses to the collections of information are required by the IRS to monitor compliance of controlled taxpayers with the provisions applicable to cost sharing arrangements.

Estimated total annual reporting and/or recordkeeping burden: 1250 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 2.5 hours.

Estimated number of respondents and/or recordkeepers: 500.

Estimated frequency of responses: Annually.

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 28, 2005.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information-technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 482 of the Internal Revenue Code generally provides that the Secretary may allocate gross income, deductions, credits, and allowances between or among two or more taxpayers that are owned or controlled by the same interests in order to prevent evasion of taxes or clearly to reflect income of a controlled taxpayer. The second sentence of section 482 added by the Tax Reform Act of 1986 enunciates the ''commensurate with income'' standard that in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. Public Law 99–5143, 1231(e)(1), *reprinted in* 1986–3 C.B. (Vol. 1) 1, 479–80.

Comprehensive regulations under section 482 were published in the **Federal Register** (33 FR 5849) on April 16, 1968, and were revised and updated by transfer pricing regulations in the **Federal Register** (59 FR 34971, 60 FR 65553, 61 FR 21955, and 68 FR 51171) on July 8, 1994, December 20, 1995, May 13, 1996, and August 26, 2003, respectively.

The 1968 regulations contained guidance regarding the sharing of costs and risks. See § 1.482–2A(d)(4). The 1968 regulations were replaced in 1996 by § 1.482–7 regarding the sharing of costs and risks (the 1996 regulations were further modified in 2003 with respect to stock-based compensation).

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 to entering into a cost sharing arrangement. The consideration for this type of external contributions is referred to in the existing regulations as the *buy-in.* Furthermore, additional guidance is needed on methods for valuing these external contributions. The proposed regulations also provide the opportunity to address other technical and procedural issues that have arisen in the course of the administration of the cost sharing rules.

Explanation of Provisions

A. Overview

Under a cost sharing arrangement, related parties agree to share the costs and risks of intangible development in proportion to their reasonable expectations of the extent to which they will relatively benefit from their separate exploitation of the developed intangibles. The existing § 1.482–7 regulations and these proposed regulations provide rules governing cost sharing arrangements consistent with the commensurate income standard under the statute and the general arm's length standard under the section 482 regulations.

Comment letters and other information available to the Treasury Department and IRS have provided limited information on third-party arrangements that are asserted to be similar to cost sharing arrangements. Typically, in the context of discussion concerning the current § 1.482–7 regulations, information has been provided on certain arrangements involving cost plus research and development or government contracts, which, while no doubt arm's length transactions, are not viewed by the Treasury Department and IRS as analogous to cost sharing arrangements.

Thus, in accordance with § 1.482–1(b)(1), the task is to provide guidance relative to cost sharing arrangements regarding ''the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances.'' (Emphasis added.) This guidance 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.

For purposes of determining the results that would have been realized under an arm's length cost sharing arrangement, the proposed regulations adopt as a fundamental concept an *investor model* for addressing the relationships and contributions of controlled participants in a cost sharing arrangement. Under 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), 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 return is less than the total anticipated return that could have been achieved through an alternative investment that is realistically available to it.

The investor model is grounded in the legislative history of the Tax Reform Act of 1986 which provided in pertinent part as follows:

> In revising section 482, the conferees do not intend to preclude the use of certain bona fide cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a bona fide cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within an appropriate product area, and the cost of research and development at all relevant developmental stages would be included. In order for cost-sharing arrangements to produce results consistent with the changes made by the Act to royalty arrangements, it is envisioned that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development. *In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment.*

H.R. Conf. Rep. No. 99–841 at II–638 (1986)(emphasis supplied).

There are special implications that are derived from determining the arm's length compensation for external contributions in line with the investor model. In evaluating that arm's length compensation, it is appropriate, consistent with the investor model, to determine (1) what an investor would pay at the outset of a cost sharing arrangement for an opportunity to invest in that arrangement, and (2) what a participant with external contributions would require as compensation at the outset of a cost sharing arrangement to allow an investor to join in the investment. The appropriate ''price'' of undertaking a risky investment is typically determined at the time the investment is undertaken, based on the ex ante expectations of the investors. Given the uncertainty about whether and to what extent intangibles will be successfully developed under a cost sharing arrangement, ex post interpretations of ex ante expectations are inherently unreliable and susceptible to abuse. Accordingly, an important implication of determining the arm's length result under the investor model, reflected in the methods, is that compensation for external contributions is analyzed and valued ex ante. The ex ante perspective is fundamental to achieving arm's length results.

Accordingly, the proposed regulations provide guidance under section 482 that would replace the existing regulations under § 1.482–7 relating to cost sharing arrangements. They revise § 1.482–7 in light of the experience of both the IRS and taxpayers with the existing regulations. The proposed regulations also restructure the format of the existing regulations to be more consistent with that of the 1994 regulations (for example, §§ 1.482–3 and 1.482–4) and to add organizational clarity.

The proposed regulations begin by specifying the transactions relevant to a cost sharing arrangement. Importantly, the proposed regulations acknowledge that in a typical cost sharing arrangement, at least one controlled participant provides resources or capabilities developed, maintained, or acquired externally to the arrangement that are reasonably anticipated to contribute to the development of intangibles under the arrangement, namely what are referred to as external contributions. Thus, the proposed regulations integrate into the definition of a cost sharing arrangement both ''cost sharing transactions'' regarding the ongoing sharing of intangible development costs as well as ''preliminary or contemporaneous transactions'' by which the controlled participants compensate each other for their external contributions to the arrangement (that is, what the existing regulations refer to as the ''buy-in''). The proposed regulations provide that § 1.482–7 only governs arrangements that are within (or which the controlled taxpayers reasonably concluded to be within) the definition of a cost sharing arrangement. Arrangements outside that definition must be analyzed under the other sections of the section 482 regulations to determine whether they achieve arm's length results.

The proposed regulations provide supplemental guidance on the valuation of the arm's length amount to be charged in a preliminary or contemporaneous transaction. The proposed regulations clarify that the valuation of the rights associated with the external contribution that is compensated in a preliminary or contemporaneous transaction cannot be artificially limited by purported conditions or restrictions. Rather, the arm's length compensation, and the applicable method used to determine that compensation, must reflect the type of transaction and contractual terms of a ''reference transaction'' by which the benefit of exclusive and perpetual rights in the relevant resources or capabilities are provided. This compensation will be determined by a method that will yield a value for the obligation of any given controlled participant that is consistent with that participant's share of the combined value of the external contribution to all controlled participants.

The proposed regulations set forth new specified methods and provide rules for application of existing specified methods, for purposes of determining the arm's length compensation due with respect to external contributions in preliminary or contemporaneous transactions. The proposed regulations also enunciate general principles governing all methods, specified and unspecified, for these purposes.

The proposed regulations provide guidance on allocations that the Commissioner may make to more clearly reflect arm's length results for the controlled taxpayers' cost sharing transactions and preliminary or contemporaneous transactions. In particular, building again on the investor model, the proposed regulations provide guidance on the periodic adjustments that the Commissioner may make in situations where the actually experienced results of a controlled participant's investment attributable to cost contributions and external contributions is widely divergent from reasonable expectations at the time of the investment. Exceptions are provided, including one under which the taxpayer may establish that the differential is due to events beyond its control that are extraordinary and not reasonably anticipated (including business growth that was not reasonably anticipated). The proposed regulations provide that periodic adjustments may only be made by the Commissioner.

Finally, the proposed regulations include provisions to facilitate administration of, and compliance with, the cost sharing rules. These include contractual provisions required for cost sharing arrangements, documentation that must be maintained (and produced upon request by the IRS), accounting requirements, and reporting requirements. Transition rules are provided for modified compliance in the case of qualified cost sharing arrangements under existing § 1.482–7, as well as rules for terminating such grandfather status. The proposed regulations also make conforming and other changes to provisions of the current regulations under sections 482 and 6662 that are related to this guidance.

B. Basic Rules Applicable to CSAs

1. General Rule—Proposed § 1.482–7(a)

Consistent with the rules governing other controlled transactions (for example, transfers of tangibles and intangibles under existing §§ 1.482–3 and 1.482–4), proposed § 1.482–7(a) provides that the arm's length amount charged in a controlled transaction reasonably anticipated to contribute to developing intangibles pursuant to a cost sharing arrangement must be determined under a method described in the proposed regulations.

The controlled participants must share intangible development costs of the intangibles developed or to be developed (the cost shared intangibles) in cost sharing transactions in proportion to their shares of reasonably anticipated benefits (RAB shares) from exploiting cost shared intangibles.

The controlled participants must also compensate other controlled participants for their external contributions in preliminary or contemporaneous transactions. The arm's length amount charged in a preliminary or contemporaneous transaction must be determined pursuant to the method or methods under the other provision or provisions of the section 482 regulations, as supplemented by proposed § 1.482–7(g), applicable to the reference transaction reflected by the preliminary or contemporaneous transaction. Such method will yield a value for the obligation of each obligor in the preliminary or contemporaneous transaction that is consistent with the product of the combined value to all controlled participants of the external contribution that is the subject of the preliminary or contemporaneous transaction multiplied by the obligor's RAB share.

Contributions to developing the cost shared intangibles made by a controlled taxpayer that is not a controlled participant in the cost sharing arrangement must be determined pursuant to § 1.482–4(f)(3)(iii) (Allocations with respect to assistance to the owner). Arm's length consideration for the transfer by a controlled participant of an interest in a cost shared intangible at any time (whether during the term, or upon or after the termination of a cost sharing arrangement) must be determined under the rules of §§ 1.482–1 and 1.482–5 through 1.482–6.

The proposed regulations provide that if an arrangement comes within the definition of a cost sharing arrangement, it is subject to § 1.482–7 (see next section of this Preamble for discussion of the definition of a cost sharing arrangement). Other arrangements that are not cost sharing arrangements (or are not treated as such) must be analyzed under the other provisions of the section 482 regulations to determine whether they achieve arm's length results.

2. Definition of a CSA—Proposed § 1.482–7(b)

a. CSA Transactions in General

Under § 1.482–1(b)(1), a ''controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances.'' (Emphasis added.) Thus, it is important to define with reasonable precision the category of arrangements treated as cost sharing arrangements, their terms, and the functions and risks assumed by the participants in such arrangements. The determination of what ''would have been'' the arm's length results of such transactions is based on those definitions.

Proposed § 1.482–7(b) identifies two groups of transactions that are integral to a cost sharing arrangement—cost sharing transactions and preliminary or contemporaneous transactions. A cost sharing transaction or *CST* is a transaction in which the controlled participants share the intangible development costs of one or more cost shared intangibles in proportion to their respective shares of reasonably anticipated benefits from their individual exploitation of their interests in the cost shared intangibles that they obtain under the arrangement. CSTs reflect the results that would have been expected in a cost sharing agreement between uncontrolled taxpayers that did not bring any external contributions to the arrangement. In other words, if uncontrolled taxpayers started in a true ''green field,'' they would be expected to agree to split ongoing costs of the research in proportion to the relative value of their respective reasonably anticipated benefits from the arrangement.

The proposed regulations are premised in part, however, on the fact that at least one controlled participant typically provides external contributions to a cost sharing arrangement. Thus, the proposed regulations integrate into the definition of a cost sharing arrangement not only the CSTs for the ongoing sharing of intangible development costs, but also the preliminary or contemporaneous transactions or *PCTs* by which the controlled participants compensate one another for their respective external contributions. The necessity of PCTs in connection with cost sharing arrangements was anticipated in the legislative history of the Tax Reform Act of 1986:

> In addition, to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment.

H.R. Conf. Rep. No. 99–841 at II–638 (1986).

b. Constituent Elements of a CSA—Proposed § 1.482–7(b)(1)

The proposed regulations define a cost sharing arrangement or *CSA* as a contractual agreement to share the costs of one or more intangibles that meet three substantive and four administrative requirements. The term *CSA*, as defined, would replace the term *qualified cost sharing arrangement* employed in the existing regulations. The substantive requirements are that the controlled participants (1) divide all interests in cost shared intangibles on a territorial basis, (2) enter into and effect all CSTs and all PCTs, and (3) as a result, individually own and exploit their respective interests in the cost shared intangibles without any further obligation to compensate one another for such interests. The administrative requirements are that the controlled participants substantially comply with (1) the CSA contractual requirements, (2) the CSA documentation requirements, (3) the CSA accounting requirements, and (4) the CSA reporting requirements.

The Treasury Department and the IRS recognize that a CSA, as defined, represents one possible arrangement by which parties may choose to share the costs, risks, and benefits of intangible development. Other arrangements, however, may involve a materially different division of costs, risks, and benefits in contrast to a CSA. 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), rather than divide contributions in accordance with reasonably anticipated benefits from separate exploitation. Given such differences, the guidance under § 1.482–7, as applicable to CSAs, is not appropriate to evaluate what would have been the arm's length results of these other arrangements that do not constitute CSAs when they are undertaken among controlled taxpayers. In such cases the proposed regulations direct taxpayers to guidance under other provisions of the section 482 regulations to determine whether such arrangements achieve arm's length results.

c. External Contributions and PCTs—Proposed § 1.482–7(b)(3)(i) Through (iv)

PCTs are the transactions by which the controlled participants compensate one another for their external contributions to the CSA. External contributions are any resources or capabilities which one or more controlled participants bring to a CSA that were developed, maintained, or acquired externally to the CSA (whether prior to or during the course of the CSA), and that are reasonably anticipated to contribute to developing cost shared intangibles. For example, one controlled participant may have promising in-process technology, or a developed and successful first generation technology, that may reasonably be anticipated to provide a platform for future generation technology to be developed under the CSA. As another example, one controlled participant may have an experienced research team that could reasonably be anticipated to be particularly suited to carrying out the development contemplated under the CSA. The proposed regulations exclude land, depreciable tangible property, and other resources acquired by intangible development costs, since they are compensated by CSTs. See discussion of proposed § 1.482–7(d).

The Treasury Department and the IRS believe that uncontrolled parties entering into a long term commitment to share intangible development costs would require an agreement upfront that all external contributions be made available to the fullest extent for the full period over which they are reasonably anticipated to be needed. Accordingly, the proposed regulations introduce the concept of the reference transaction or *RT* in order to ensure that compensation for external contributions to the CSA reflects the full economic value of resources or capabilities that a participant brings to the CSA. The RT is a transaction providing the benefit of all rights, exclusively and perpetually, in a resource or capability described above, apart from the rights to exploit an existing intangible without further development (see section of Preamble below regarding § 1.482–7(c) (Make-or-sell rights excluded)). The arm's length compensation pursuant to the PCT, and the applicable method used to determine such compensation, must reflect the type of transaction and contractual terms of the RT. The controlled participants must enter into a PCT as of the earliest date (whether on or after the date the CSA is entered into) on which the external contribution is reasonably anticipated to contribute to developing cost shared intangibles (the date of a PCT). The controlled participants are not required to actually enter into the RT and the compensation due from any controlled participant will be limited to its RAB share of the total value of the external contribution, the scope of which is defined by the RT.

The concept of the RT was developed in response to arguments that have been encountered in the examination experience of the IRS under the existing regulations. In numerous situations taxpayers have purported to convey 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. See § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms). In addition, even if the short-term license 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 in administering such approaches more directly by requiring an upfront valuation of all external contributions which would be much 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. No inference is intended concerning the outcome of such limitations under the existing regulations.

Thus, for example, consider a CSA for the development of future generations of an existing technology owned by one controlled participant. The PCT compensation obligation of the other controlled participant or participants would be determined by reference to the RT consisting of the transfer of all rights to the existing technology apart from the rights to exploit the existing technology without further development (see section of Preamble below regarding § 1.482–7(c) (Make-or-sell rights excluded)). The rights transferred in the RT would include the exclusive right to use the technology for purposes of research. They would also include the right to exploit any resulting products that incorporated the technology and any resulting products the development of which is otherwise assisted by the technology. Moreover, the rights transferred in the RT would cover a term extending as long as the exploitation of future generations of the technology continued. The RT provides the basis for selection and application of the method used to value the compensation owed under the PCT by each other controlled participant. The compensation obligation is limited to each such other controlled participant's RAB share of the total value of the rights in the existing technology that would have been transferred in the RT.

Issues have arisen regarding whether an existing research team in place constitutes intangible property for which compensation is due, in addition to sharing the ongoing compensation and other costs of maintaining such team, for purposes of the buy-in provisions under the existing regulations. The Treasury Department and the IRS believe that the proper arm's length treatment is to include the obligation to compensate such external contributions of in-place research capabilities in PCTs. At arm's length, an uncontrolled taxpayer seeking to invest in a research project involving the experienced in-place researchers would require a commitment of the experienced team in place for purposes of the project, rather than assuming the risks presented by an inexperienced team. The Treasury Department and the IRS believe that a contribution of such an experienced team in place would result in the contribution of intangible property within the meaning of § 1.482–4(b) and section 936(h)(3)(B).

The proposed regulations, however, do not restrict the type of transaction that may be the subject of the RT. An RT may consist of the provision of services as well as the transfer of intangible property. For example, in the case of an experienced research team in place, therefore, the RT could be the services agreement to commit the team to the research project under the CSA.

Under the proposed regulations, the controlled participants may designate the type of transaction involved in the RT, if different economically equivalent types of RTs are possible with respect to the relevant resource or capability. If the controlled participants fail to make such a designation, the Commissioner may do so.

Exacting compensation for an external contribution pursuant to a PCT is distinguishable from charging for another's business opportunity. Any taxpayer, controlled or uncontrolled, is free to undertake the business opportunity of trying to develop an intangible on its own. In that case, the taxpayer is bearing all costs and risks, and has no obligation to compensate anyone for taking free advantage of the opportunity. Where, however, the benefit of existing resources or capabilities belonging to another are desired that are reasonably anticipated to contribute to the development effort, then, at arm's length, the supplier of such resources or capabilities would not contribute them absent appropriate compensation.

d. Form of PCT Payment and Post Formation Acquisitions—Proposed § 1.482–7(b)(3)(v) and (vi)

Under the proposed regulations, the general rule is that the consideration owing pursuant to a PCT for an external contribution, referred to as the *PCT Payments*, may take the form of fixed payments, payments contingent on the exploitation of the cost shared intangibles, or a combination of both. The selected payment form must be specified no later than the date of the PCT. The payor of PCT Payments is referred to as the *PCT Payor*, and the payee is referred to as the *PCT Payee*.

In the case of resources or capabilities developed, maintained, or acquired prior to the time they are reasonably concluded to contribute to developing cost shared intangibles (for example, resources or capabilities that predate the CSA), the controlled participants have the flexibility to structure PCT Payments in any of the available forms, subject to conforming to contractual terms, economic substance, and the parties' conduct. See § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms). A CSA generally contemplates that the participants undertake costs and risks in parallel and in proportion to their RAB shares, but this result cannot be achieved in the case of external contributions that are the product of previously incurred costs and risks. So, for such resources or capabilities, the proposed regulations allow the controlled participants to provide for the applicable payment form by the date of the PCT.

A post formation acquisition (PFA) is an external contribution representing resources or capabilities acquired by a controlled participant in an uncontrolled transaction that takes place after formation of the CSA and that, as of the date of the acquisition, are reasonably anticipated to contribute to developing cost shared intangibles. Resources or capabilities may be acquired in a PFA either directly or indirectly through the acquisition of an interest in an entity or tier of entities.

The Treasury Department and the IRS believe that the form of PCT Payments for PFAs must be consistent with the principle that allocations of cost and risk among controlled participants after a CSA has commenced should be in proportion to their respective RAB shares. Accordingly, the proposed regulations provide that the consideration under a PCT for a PFA must follow the form of payment in the uncontrolled transaction in which the PFA was acquired. For example, if subsequent to the formation of a CSA one controlled participant makes a stock acquisition of a target the assets of which consist of resources and capabilities reasonably anticipated as of the date of the acquisition to contribute to developing cost shared intangibles, the PCT Payment by each other controlled participant must be in a lump sum. To avoid the possibility that any payments are inappropriately characterized by the participants, neither PCT Payments, nor cost sharing payments, may be paid in shares of stock in the payor.

e. Territorial Division of Interests—Proposed § 1.482–7(b)(4)

Controlled participants in a CSA own interests in the cost shared intangibles and are able to exploit those intangibles without any obligation to compensate other participants (other than pursuant to CSTs or PCTs). Controlled participants must share intangible development costs in proportion to their reasonably anticipated benefits from their individual exploitation of such interests. Taxpayers have entered into cost sharing arrangements in which the controlled participants receive nonexclusive, indivisible worldwide interests in cost shared intangibles. Taxpayers have taken the position under the existing regulations that such interests are susceptible to being individually exploited, and that the participants' respective shares of benefits from such exploitation are susceptible to being reasonably estimated.

The proposed regulations require that controlled participants receive non-overlapping territorial interests in the cost shared intangibles that in the aggregate utilize all the available territories worldwide. The proposed regulations also require that a controlled participant be entitled to the perpetual and exclusive right to cost shared intangible profits of any other controlled taxpayer in the same controlled group as the participant from transactions with uncontrolled taxpayers regarding property or services for use, consumption, or disposition within the participant's territory or territories. For example, where one controlled participant sells part of its output into a territory belonging to another controlled participant, the former must pay the latter participant arm's length compensation to ensure that the intangible profit on the sale is realized by the latter participant. These territoriality requirements facilitate the ability to individually exploit, and estimate the reasonably anticipated benefits from individual exploitation of, interests in cost shared intangibles. No inference is intended as to the permissibility of nonexclusive interests under the existing regulations.

Comments are requested concerning whether alternatives should be provided to territorial division of interests in cost shared intangibles. Proposed alternatives should further the goal of dividing the universe of interests into exclusive, non-overlapping segments to promote measurability of anticipated benefits and administrability both by taxpayers and the IRS. Comments are also requested about how to facilitate attribution of sales to territories, or other non-overlapping divisions of interests, such as in the case of sales via electronic commerce. Comments are also requested on the division, territorially or otherwise, of interests in exploiting cost shared intangibles in space.

f. CSAs in Substance or Form—Proposed § 1.482–7(b)(5)

Pursuant to proposed § 1.482–7(b)(5)(i), as under the existing regulations, the Commissioner may, consistently with § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms), apply the § 1.482–7 rules to any arrangement that in substance constitutes a CSA in accordance with the three substantive requirements enumerated in proposed § 1.482–7(b)(1)(i) through (iii), notwithstanding a failure otherwise to meet the § 1.482–7 requirements.

Provided a taxpayer has followed the formal requirements enumerated in proposed § 1.482–7(b)(1)(iv) through (vii), the Commissioner must treat the arrangement as a CSA if the taxpayer reasonably concluded the arrangement to be a CSA. The Commissioner may also treat any other arrangement as a CSA, if the taxpayer has followed such formal requirements.

3. Exclusion of Make-or-Sell Rights—Proposed § 1.482–7(c)

Disputes have arisen under the existing regulations regarding the buy-in related to a CSA to develop future generations of an intangible that is being exploited in its then current version by the PCT Payee. For example, there may be licenses of the current generation intangible to uncontrolled taxpayers, perhaps with certain rights to make adaptations for their customers. Taxpayers have asserted that a make-and-sell license of this type satisfies the requirement for a buy-in in the CSA under the current regulations. Such a position misconstrues the existing regulations, which focus the buy-in on the availability of the pre-existing intangibles ''for purposes of research in the intangible development area'' under the CSA. See § 1.482–7(g)(2).

The proposed regulations expressly exclude from the scope of a CSA any provision to the extent it relates to exploiting an existing intangible without further development, such as the right to make or sell existing products. The proposed regulations do, however, allow the aggregate valuation of controlled transactions relating to make-or-sell rights with PCT Payments, where such aggregate evaluation provides a more reliable measure of an arm's length result than a separate valuation of the transactions. See proposed § 1.482–7(g)(2)(v).

4. Intangible Development Costs—Proposed § 1.482–7(d)

The proposed regulations restate the provisions defining intangible development costs or *IDCs* that are shared pursuant to CSTs under a CSA to coordinate with the conceptual framework of the proposed regulations and with the stock-based compensation provisions added in 2003.

As discussed, CSTs and PCTs are the two major groupings of transactions entered into pursuant to a CSA. In CSTs, the controlled participants share *all* ongoing costs of developing intangibles. In contrast, in PCTs they compensate one another for resources or capabilities developed, maintained, or acquired externally to the CSA (whether prior to or during the course of the CSA). It is necessary to define IDCs shared in CSTs in a comprehensive manner that does not overlap with the definition of external contributions compensated in PCTs.

The proposed regulations, accordingly, define IDCs as all costs, in cash or in kind (including stock-based compensation), but excluding costs for land and depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. The IDA replaces the concept of the *intangible development area* under the existing regulations. The self-contained IDC definition eliminates the need for the cross-reference to operating expenses as defined in § 1.482–5(d)(3) of the existing regulations and thus eliminates potential disputes over the interaction of these sections.

The proposed regulations also avoid overlapping definitions of IDCs and external contributions. IDCs are limited to costs in the ordinary course of business incurred after the formation of a CSA and that are directly identified with, or reasonably allocable to, the IDA. Thus, for example, the expected value over and above ongoing compensation and other costs of an experienced research team would be compensated by PCTs, but the ongoing compensation and other costs of the team attributable to the IDA would be

IDCs shared in CSTs. Moreover, costs for depreciable property, which under section 197(f)(7) would include amortization of any amortizable section 197 intangible, are carved out from IDCs. Instead, to the extent such intangibles are reasonably anticipated to contribute to developing cost shared intangibles, they would be compensated in PCTs.

Land and depreciable tangible property (for example, use of a laboratory facility) would represent an external contribution. The proposed regulations, however, continue the practical approach of the existing regulations of treating the arm's length rental charge under § 1.482–2(c) (Use of tangible property) for such land and depreciable tangible property as IDCs, since typically these items can be readily valued.

In line with the direction in the 1986 legislative history to reflect ''the actual economic activity'' undertaken pursuant to a CSA, the proposed regulations expressly provide that generally accepted accounting principles or federal income tax accounting rules may provide a useful starting point, but will not be conclusive regarding inclusion of costs in IDCs. As under the existing regulations, IDCs exclude interest expense, foreign income taxes, and domestic income taxes.

The balance of the proposed regulations restate the existing regulations with conforming changes in light of the new terminology and framework. Technical amendments were made to the special transition rule on time and manner of making the election with respect to certain stock-based compensation and the consistency rules for measurement and timing with respect to such stock-based compensation.

Except for such technical amendments, these proposed regulations incorporate the existing provisions relating to the elective method of measurement and timing permitted with respect to certain options on publicly traded stock. However, the Treasury Department and the IRS are considering extending availability of the elective method to other forms of publicly traded stock-based compensation. The Treasury Department and the IRS request comments on which forms of publicly traded stock-based compensation should be eligible for the elective method.

5. Reasonably Anticipated Benefits Share (RAB Share)—Proposed § 1.482–7(e)

Proposed § 1.482–7(e) restates existing § 1.482–7(f)(3)(i) through (iv)(A) with some technical clarifications and changes to conform to the new terminology and framework. The proposed regulations provide, as is implicit in existing § 1.482–7(b)(3), (e)(2), and (f)(3), that for purposes of determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most current reliable data regarding past and projected future results as is available at such time.

6. Changes in Participation Under a CSA—Proposed § 1.482–7(f)

Proposed § 1.482–7(f) replaces existing § 1.482–7(g)(3) and (4), as well as the third and fourth sentences of existing § 1.482–7(g)(1). This provision clarifies the application of the rules of § 1.482–7 in the event of a change in participation under a CSA. A change in participation includes the transfer between controlled participants of all or part of a participant's territorial rights coupled with the assumption by the transferee of the associated obligations under the CSA, the entry into a CSA of a new controlled participant that acquires any territorial rights and associated obligations under the CSA, and the withdrawal of a controlled participant or other relinquishment or abandonment of territorial rights and associated obligations under the CSA. In the event of a change in participation, the transferee of the territorial rights and associated obligations under the CSA succeeds to the transferor's prior history under the CSA, including IDCs borne, benefits derived, and compensation expenditures pursuant to any PCTs. The transferor must receive an arm's length amount of consideration from the transferee under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6.

Proposed § 1.482–7(e)(2)(i) provides that in the case of transfers of cost shared intangibles between controlled participants, other than by way of a change in participation described in proposed § 1.482–7(f), the transferor's benefits for purposes of RAB share determination are measured on a look-through basis with reference to the transferee's benefits, disregarding any consideration paid by the transferee (such as a royalty pursuant to a license agreement).

C. Supplemental Guidance on Methods Applicable to PCTs

The Treasury Department and the IRS recognize that taxpayers and the IRS need additional guidance on the appropriate methods for valuation of external contributions to a CSA. A typical challenge to valuing nonroutine intangibles is the uncertainty as to the profitability of their exploitation. In the case of a CSA, however, there is also the uncertainty whether and to what extent any intangible will be successfully developed under the CSA. Accordingly, proposed § 1.482–7(g) provides supplemental guidance on evaluating external contributions compensated by PCTs, including general principles for specified and unspecified methods, guidance on the application of existing specified methods, and new specified methods.

The investor model informs the guidance on valuation. The guidance generally aims at valuation of the amount charged in a PCT such that a controlled participant's aggregate net investment in a CSA attributable to cost contributions and external contributions may be expected to earn a return appropriate to the riskiness of the CSA.

1. General Rule—Proposed § 1.482–7(g)(1)

As discussed, PCTs are one of two major categories of transactions (the other being CSTs) entered into pursuant to a CSA. In PCTs, the controlled participants compensate one another for their respective external contributions that they bring into a CSA, that is, the resources or capabilities they have developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA that are reasonably anticipated to contribute to developing cost shared intangibles.

Pursuant to § 1.482–1(b)(2), different sections of the section 482 regulations apply to different types of transactions, such as transfers of tangible and intangible property, services, loans or advances, and rentals. The method or methods most appropriate to the calculation of arm's length results for controlled transactions in each category must be selected. When interrelated controlled transactions are of different types, the participants, depending on what produces the most reliable means of measuring arm's length results, may either (1) apply different methods to the different transactions or (2) aggregate the transactions for valuation purposes. See also § 1.482–1(f)(2)(i) and proposed § 1.482–7(g)(2)(v) regarding aggregation of transactions.

A key concept in valuing PCTs is the RT. The RT is a transaction providing the benefit of all rights, exclusively and perpetually, in a resource or capability that is the subject of the external contribution, apart from the rights to exploit an existing intangible without further development. If in fact, the resource or capability is reasonably anticipated to contribute both to developing or exploiting cost shared intangibles and to other business activities of a PCT Payee, the proposed regulations provide that the otherwise applicable value of the relevant PCT Payments may need to be prorated between the CSA and any other business activities on a reasonable basis that reflects the relative economic values of the different business activities.

For purposes of the selection of the category of method applicable to a controlled transaction pursuant to § 1.482–1(b)(2)(ii), proposed § 1.482–7(b)(3)(iii) provides that the applicable method used to determine the compensation for a PCT shall reflect the type of transaction of the RT. For example, in the case of an external contribution consisting of an in-process intangible, the RT could be a transfer of intangibles generally to be evaluated pursuant to §§ 1.482–1 and 1.482–4 through 1.482–6. As a further example, in the case of an external contribution consisting of an experienced research team in place, the RT could be the provision of services generally to be evaluated pursuant to § 1.482–2(b). If different economically equivalent types of RTs are possible with respect to the relevant resource or capability, the controlled participants may designate the type of transaction involved in the RT.

Proposed § 1.482–7(a)(2) provides that the arm's length amount charged in a PCT must be determined pursuant to the method or methods applicable to the RT under the relevant provision or provisions of the section 482 regulations (as those methods are supplemented by proposed § 1.482–7(g)). Such method will yield a value for the obligation of each obligor in the PCT (PCT Payor) consistent with the product of the combined value to all controlled participants of the external contribution that is the subject of the PCT multiplied by the PCT Payor's RAB share. Although some specified and unspecified methods may involve measuring PCT Payments with reference to the value of exploiting cost shared intangibles in one or more controlled participants' territories, the application of such methods must still yield a value that is consistent with the foregoing RAB share of the total value of the external contribution to all controlled participants.

Proposed § 1.482–7(g) sets forth new specified methods for purposes of determining the arm's length compensation due under a PCT, namely, the income method, the acquisition price method, and the market capitalization method. The proposed regulations also provide rules for application of existing specified methods, such as the comparable uncontrolled transaction method and the residual profit method. The proposed regulations also enunciate general principles governing all methods, specified and unspecified, for these purposes. Proposed § 1.482–7(g)(1) provides that each method must be applied in accordance with the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e), except as those provisions are modified in § 1.482–7(g).

2. General Principles—Proposed § 1.482–7(g)(2)

a. In General—Proposed § 1.482–7(g)(2)(i)

The proposed regulations provide general principles for valuing PCT Payments, applicable for both specified and unspecified methods.

b. Valuation Consistent With Upfront Contractual Terms and Risk Allocations—Proposed § 1.482–7(g)(2)(ii)

Existing § 1.482–1(d)(3)(ii) and (iii) generally provide that contractual terms and risk allocations are significant factors in evaluating the most reliable measure of arm's length results. The proposed regulations provide for particular contractual terms and allocations of risk with regard to PCTs determined no later than the date of the PCT. See, for example, proposed § 1.482–7(b)(1)(ii), (b)(3), and (k)(1). Proposed § 1.482–7(g)(ii) accordingly reiterates the requirement that any method applied at any time for purposes of valuing PCT Payments must be consistent with the applicable contractual terms and allocation of risk under the CSA and proposed § 1.482–7 as of the date of a PCT, unless there has been a change in such terms or allocation made in return for arm's length consideration.

It may be particularly important to maintain consistency with upfront contractual terms and allocation of risk for CSAs, since PCT Payments may extend over a period of years. Thus, for example, PCT Payments may become due in subsequent years when actual economic results may have departed from those reasonably anticipated as of the date of the PCT. Subject to the Commissioner's ability to make periodic adjustments (see proposed § 1.482–7(i)(6)), the method for determining the PCT Payments due in the subsequent year must remain consistent with the contractual terms and allocation of risks as of the date of the PCT. Cost sharing participants, like unrelated investors, are held to the terms of their deal at the outset of the investment. For example, under the proposed income method, this upfront contractual-risk consistency principle is illustrated by the use of the applicable rate on sales or profits determined as of the date of the PCT. Thus, while actual sales or profits may depart from projections, the upfront risk allocation continues to be respected by use of the applicable rate determined as of the date of the PCT. Note, while a taxpayer may defend the amount of its PCT Payment in a subsequent year as arm's length based on a different method than that applied in earlier years, it may only do so to the extent the other method also satisfies the upfront contractual-risk consistency principle.

Proposed § 1.482–7(b)(3)(vi) provides that the form of payment for a PCT must be specified no later than the date of the PCT. The form of payment of a PCT, that is, fixed and/or contingent payments, involves an allocation of risk among the controlled participants. In the case of PCT Payments regarding a PFA, the form of payment in the uncontrolled acquisition must be followed. However, in the case of other PCT Payments, the taxpayer has flexibility in the choice of form, subject to economic substance and the parties' conduct.

As the result of the upfront contractual-risk consistency principle, it will be possible for the taxpayer to compute a present value, as of the date of the PCT, of the total arm's length amount of all PCT Payments. Under the CSA documentation requirements in proposed § 1.482–7(k)(2)(ii)(J)(*6*) and (k)(2)(iii)(B), the taxpayer is required to maintain documentation of such upfront valuation and produce it to the IRS within 30 days of a request.

c. Projections—Proposed § 1.482–7(g)(2)(iii)

Since PCT Payments often extend over a period of years and may be contingent on items (for example, sales, costs, and operating profit) in such future periods, the valuation method, specified or unspecified, may rely on projections of such items. The reliability of the valuation method will in such cases depend on the reliability of such projections. The proposed regulations provide that, for these purposes, projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of PCT Payment valuations.

d. Realistic Alternatives—Proposed § 1.482–7(g)(2)(iv)

Regardless of the method or methods used, evaluation of the arm's length charge for a PCT should take into account the general principle that uncontrolled taxpayers dealing at arm's length would evaluate the terms of a transaction, and would enter into a particular transaction only if none of the alternatives is preferable. See § 1.482–1(d)(3)(iv)(H) (The alternatives realistically available to the buyer and seller). Based on that principle, PCT valuations would not meet the foregoing condition where, for any controlled participant, the total anticipated value, as of the date of the PCT, is less than the total anticipated value that could have been achieved through a realistically available alternative investment (whether it is an alternative arrangement for the development of the cost shared intangibles or an alternative with a similar risk profile to the CSA). In other words, a controlled participant, like any rational investor, would not enter into an investment when a better alternative investment is available. Examples are provided illustrating the application of the realistic alternatives principle in the CSA context.

e. Aggregation of Transactions—Proposed § 1.482–7(g)(2)(v)

The proposed regulations provide that multiple PCTs, or one or more PCTs and one or more transactions not governed by proposed § 1.482–7 (such as a make-or-sell license excluded from CSA coverage by proposed § 1.482–7(c)), may be aggregated for purposes of valuation, subject to consideration of whether such aggregate valuation yields a more reliable measure of an arm's length result than would separate valuations. See also § 1.482–1(f)(2)(i) (Aggregation of transactions). For example, assume the CSA involves a PCT for an external contribution of an existing intangible for purposes of developing future generations of the intangible. Also assume that there is a license to the other controlled participants of make-and-sell rights with respect to the current generation of the intangible. The reliability of an aggregate analysis of the PCT and the license will be affected by the degree to which the relative current exploitation benefits from the existing intangible of the controlled participants may be expected to match up with the RAB shares regarding exploitation of the future generations of the intangible. Though it will not generally be necessary to allocate a reliable aggregate arm's length charge as between the various transactions, in certain cases such an allocation may be necessary, for example, in applying the periodic adjustment rules in proposed § 1.482–7(i)(6).

f. Discount Rate—Proposed § 1.482–7(g)(2)(vi)

Specified and unspecified methods for valuing PCT Payments may involve converting future or past monetary sums into a present value as of the date of a PCT. The proposed regulations recognize that there may be different risks and, hence, different discount rates associated with different activities undertaken by a taxpayer. Consistent with the investor model, for items relating to a CSA, 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. In other words, this follows the approach that unrelated investors would take to making an ex ante evaluation of a prospective investment. Namely, the expected value of the investment would equal the projected future cash flows discounted using a discount rate that appropriately reflects the anticipated level of risk being undertaken.

The proposed regulations enumerate several possibilities for choosing an appropriate discount rate. Where there are publicly traded entities that would be comparables dedicated to similar development and exploitation activities, their weighted average cost of capital (WACC) may provide a reliable basis for derivation of an appropriate discount rate. Or, if the taxpayer's group's activities are dedicated to development and exploitation of the contemplated cost shared intangibles, then the taxpayer's own WACC may provide a reliable basis for derivation of an appropriate discount rate. In other cases, depending upon the facts and circumstances, a taxpayer's internal hurdle rate for investments having a comparable risk profile may provide a reliable basis for derivation of an appropriate discount rate.

g. Accounting Principles—Proposed § 1.482–7(g)(2)(vii)

The proposed regulations provide that, while allocations and valuations for accounting purposes may provide a useful starting point, they will not be determinative of PCT Payments to the extent that the accounting treatment is not consistent with economic value. For example, with respect to an acquisition of a target business consisting of wanted assets (that are reasonably anticipated to contribute to developing cost shared intangibles) and of unwanted assets (that will be abandoned immediately after the acquisition), an allocation of a portion of the acquisition price to the abandoned assets done for accounting purposes, under the proposed regulations, would not prevent the proper allocation of the entire acquisition price, in line with economic reality, to the wanted assets for purposes of PCT Payment valuation. Similarly, with respect to an acquisition of a target business consisting only of an in-process intangible and an experienced research team in place, an allocation of a portion of the acquisition price to ''goodwill'' for accounting purposes would not, under the proposed regulations, prevent the proper allocation of the entire acquisition price, in line with the economic reality, to the in-process intangible and experienced research team in place for purposes of PCT Payment valuation. On the other hand, if the target conducts an operating business with exploitation already at an advanced stage of the current generation of the intangible to be further developed under the CSA, then an accounting allocation to goodwill may suggest the need for further consideration of the reliability of an acquisition price method for valuing an external contribution whose value excluded the value of such existing goodwill.

h. Valuation Consistent With the Investor Model—Proposed § 1.482–7(g)(2)(viii)

As has been discussed, the proposed regulations require that PCT valuations be consistent with an investor model for cost sharing. Under the investor model, the amount charged in a PCT must be consistent with the assumption that each controlled participant is making a net aggregate investment, as of the date of a PCT, attributable to both external contributions and cost contributions, for purposes of achieving an anticipated return appropriate to the risks of the CSA over the entire term of development and exploitation of the intangibles resulting from the CSA.

The investor model is based on two key principles regarding PCT valuations. The first principle is that, ex ante, the aggregate investment in an IDA would be expected to yield a rate return equal to the appropriate discount rate for the CSA. If the anticipated rate of return exceeds the appropriate discount rate for the CSA, either anticipated profits have been overstated or the amount of investment has been understated. If the projections of IDCs and profits are reliable, then the implication could be that the portion of the investment attributable to external contributions has been undervalued. Thus, a valuation method for PCTs is less likely to be reliable if it results in a rate of return to any controlled participant's aggregate investment that is not equal to the appropriate discount rate for the CSA.

The second principle is that, ex ante, the appropriate return to the aggregate investment in an IDA is measured over the entire period of development and exploitation of cost shared intangibles. Included in this principle is the concept that no part of the investment should be viewed as separately earning a return over a more limited period. As a general matter, successful completion of each step in a research program is a necessary condition for the completion of the program as a whole and its contribution continues over the entire life of the project. As an example, a project to develop a new commercial aircraft would not be considered successfully completed if all parts of the aircraft had been designed except the tail assembly. Neither does the fact that the tail assembly is completed last imply that its usefulness in the manufacture and sale of aircraft extends beyond the usefulness of any components completed earlier in the design process. Each step of the project continues to have value as long as the aircraft continues to be built and used. For this reason, each aspect of the research program must be viewed as contributing to the success of the program as a whole (and not just its success for some limited period of time). Thus, a valuation method for PCTs is likely to be less reliable if it assumes a useful life for any contribution to the CSA that does not extend through the entire anticipated period of development and exploitation.

The IRS has examined cases in which CSAs were entered into to utilize current generation intangibles as the base or platform for future generation intangibles, with buy-ins structured as declining royalties over the limited useful life of the current generation intangible. The structure of these buy-ins effectively diminish the value of the buy-in payments, such that the return to a controlled participant making the depressed buy-in payments has an expected return significantly in excess of the appropriate discount rate for the CSA. Furthermore, a buy-in based on declining royalties over a shortened useful life for the contributed intangibles, on its face, is not consistent with the principle that the return to the aggregate investment in an IDA should be measured over the entire period of development and exploitation of cost shared intangibles.

i. Coordination of Best Method Rule and Form of Payment—Proposed § 1.482–7(g)(2)(ix)

Any method for valuing the amount charged in a PCT under the proposed regulations, whether specified or unspecified, will assume a particular form of payment (method payment form) for PCT Payments. For example, as will be discussed, the proposed income method assumes contingent payments in the form of an applicable rate on sales or profits, and the market capitalization method assumes a lump sum method payment form. Except for PCT Payments in respect of PFAs, the proposed regulations allow taxpayers to convert the reasonably anticipated present value, as of the date of the PCT, of the total arm's length amount of all PCT Payments determined under the method payment form into another form of payment (specified payment form). For purposes of the best method rule of § 1.482–1(c), the analysis among competing methods will be undertaken without regard to whether their method payment forms corresponds to the taxpayer's specified payment form for PCT Payments. A best method analysis determines which valuation method is most reliable from the perspective of comparability, completeness and accuracy of the data, and reliability of the underlying assumptions. If the method payment form of the best method determined under this analysis differs from the taxpayer's specified payment form, then the Commissioner will effect a conversion of the best method results into the specified payment form on a reasonable basis, giving due regard to the taxpayer's conversion basis if the taxpayer's method was determined to be the best method as to its method payment form.

j. Coordination of the Valuations of Prior and Subsequent PCTs—Proposed § 1.482–7(g)(2)(x)

Cases may arise where, after the date of one PCT, another PCT is required for other resources or capabilities of a controlled participant which only as of a subsequent date are reasonably anticipated to contribute to the development of cost shared intangibles and therefore are external contributions only as of such subsequent date. In such cases where there are PCTs with different dates, coordination of the valuations of the prior and subsequent PCTs must be effected pursuant to a method that provides the most reliable measure of an arm's length result.

In some instances the coordination will be straightforward. As an example, in the case of a subsequent PCT entered into with respect to a PFA, the PCT Payments are determined based on the related acquisition, independent of any prior PCT. For purposes of determining PCT Payments under a prior PCT, the proposed regulations provide that the PCT Payments with respect to the subsequent PCT in this case are treated the same as unanticipated IDCs. A divergence between actual IDCs and IDCs anticipated on the date of a PCT does not change the method for determining PCT Payments with respect to that PCT. Accordingly, unanticipated payments under a subsequent PCT entered into with respect to a PFA will not affect the method for determining PCT Payments in respect of a prior PCT.

The coordination in other cases will depend on the facts and circumstances. If the external contributions that were the subjects of the respective prior and subsequent PCTs were nonroutine contributions, an approach which may be appropriate would be to determine PCT Payments both for the prior and subsequent PCTs going forward from the date of the subsequent PCT pursuant to a residual profit split method, as described in proposed § 1.482–7(g)(7). Such application of the residual profit split method would include as nonroutine contributions all of the following: the external contribution(s) that were the subject of the prior PCT(s), the external contribution that is the subject of the subsequent PCT, and the interests of the controlled participants in the portion of cost shared intangibles in process of development under the CSA that does not reflect any external contributions.

k. Proration of PCT Payments to the Extent Allocable to Other Business Activities—Proposed § 1.482–7(g)(2)(xi)

The proposed regulations provide that the otherwise applicable value of PCT Payments may need to be prorated between the CSA and any other business activities (other than current make-or-sell activities) to which the resource or capability that is the subject of the PCT is reasonably anticipated to contribute as of the date of the PCT. A proration will only be necessary if the method used for valuing the PCT Payment includes the value of the contribution of the resource or capability to the other business activities. For example, an application of the acquisition price method is based on the full value of a resource or capability and therefore includes the value of any contributions to other business activities, whereas the CUT and CPM applications of the income method are based only on the sales or profits of exploiting cost shared intangibles, and therefore do not include any value of contributions to other business activities. For purposes of the best method rule under § 1.482–1(c), the reliability of the analysis under a method that requires proration is reduced relative to the reliability of an analysis under a method that does not require proration. Any proration must be done on a reasonable basis that reflects the relative economic values of the different business activities.

3. Comparable Uncontrolled Transaction (CUT) Method—Proposed § 1.482–7(g)(3)

The comparable uncontrolled transaction (CUT) method described in § 1.482–4(c), and the arm's length charge described in § 1.482–2(b)(3)(first sentence) based on a comparable uncontrolled transaction, may be applied to evaluate whether the amount charged in a PCT is arm's length by reference to the amount charged in a comparable uncontrolled transaction. When applied in the manner described in § 1.482–4(c), or where a comparable uncontrolled transaction provides the most reliable measure of the arm's length charge described in § 1.482–2(b)(3)(first sentence), the CUT method, or the arm's length charge in the comparable uncontrolled transaction, will typically yield an arm's length total value for the external contribution that is the subject of the PCT. That value must then be multiplied by each PCT Payor's respective RAB share in order to determine the arm's length PCT Payment due from each PCT Payor. A territorial CUT may also be reliably used to the extent the value of the PCT Payment under the territorial CUT is consistent with the RAB share of the worldwide external contribution value.

4. Income Method—Proposed § 1.482–7(g)(4)

The income method, a new specified method under the proposed regulations, follows from the realistic alternatives principle. The income method determines PCT Payments in amounts such that the present value, as of the date of the PCT, to a controlled participant of entering into a CSA equals the present value of the PCT Payee's best realistic alternative.

The proposed regulations provide two specific (but nonexclusive) applications of the income method, one based on the comparable uncontrolled transaction (CUT) method of § 1.482–4(c), and the other based on the comparable profit method (CPM) of § 1.482–5. These applications may include certain simplifying assumptions and are meant to provide examples of possible applications of the general income method, not to exclude other possible applications of this method. Both applications compute the arm's length PCT Payment for each year as the product of an applicable rate on sales or profit. The *applicable rate* is equal to the *alternative rate* less the *cost contribution adjustment.* The alternative rate represents the rate on sales or profit which the PCT Payee could have earned by exploiting cost shared intangibles in the PCT Payor's territory if the PCT Payee alone had borne the risks and costs of developing the cost share intangibles. The CUT application determines the alternative rate from the perspective of a licensor as the royalty rate it would have charged under a license to exploit the cost shared intangibles in the territory, based on comparable third party license arrangements. The CPM application determines the alternative rate from the perspective of a licensee as the royalty rate it would have paid such that it earned only a market return for its routine contributions to the exploitation of the cost shared intangibles, based on comparable returns earned by uncontrolled taxpayers engaged in similar routine activities. The cost contribution adjustment is the reduction of the alternative rate to reflect the anticipated costs and risks the PCT Payor will take on by entering into the CSA.

The income method is typically used in cases where only one controlled participant, namely the PCT Payee, brings nonroutine contributions into the CSA. In such circumstances, the other controlled participant or participants, that is, the PCT Payors, essentially only commit to bearing their respective shares of anticipated IDCs and bring only routine contributions for purposes of exploiting cost shared intangibles. Under the investor model, what is essentially a routine financing investment by the PCT Payors in the development of intangibles, represented by bearing their share of anticipated IDCs, would be expected to earn an ex ante rate of return appropriate to the risks associated with the CSA and reflected in the discount rate. The cost contribution adjustment effectively represents the appropriate return to that routine financing investment, as of the date of the PCT, expressed as a rate on sales or profit.

The use of the applicable rate on sales or profit, determined as of the date of the PCT under the income method, also reflects the principle of consistency with the original contractual allocation of risk. Thus, while actual sales may depart from projections, the upfront risk allocation continues to be respected by use of the applicable rate determined as of the date of the PCT.

Under the CUT and CPM applications of the income method, any routine contributions that are external contributions (routine external contributions) are treated similarly to cost contributions.

The reliability of the income method may decrease if more than one controlled participant brings nonroutine contributions into the CSA.

5. Acquisition Price Method—Proposed § 1.482–7(g)(5)

The acquisition price method is an application of the CUT method pursuant to § 1.482–4(c) and the arm's length charge pursuant to § 1.482–2(b)(3). This method ordinarily applies only when substantially all of the nonroutine resources and capabilities of a recently acquired target's business constitute external contributions, that is, they are reasonably anticipated to contribute to developing cost shared intangibles. Thus, when these circumstances are present, this method may be expected to be appropriate for valuing PCT Payments for PFAs.

Under the acquisition price method, the arm's length charge to each PCT Payor is the product of the adjusted acquisition price, multiplied by such PCT Payor's RAB share. The adjusted acquisition price seeks to isolate that portion of the acquisition price of the target business attributable to the external contributions. The adjusted acquisition price is equal to the acquisition price of the target, increased by relevant liabilities, and decreased by the value of tangible property (separately accounted for under proposed § 1.482–7(d)) and by the value of any other resources and capabilities not covered by PCTs. The reliability of this method is reduced to the extent the acquisition price must be adjusted to take into account significant difficult-to-value tangible property or resources or capabilities of the target not covered by a PCT.

6. Market Capitalization Method—Proposed § 1.482–7(g)(6)

The market capitalization method is also an application of the CUT method pursuant to § 1.482–4(c) and the arm's length charge pursuant to § 1.482–2(b)(3). This method ordinarily applies only when substantially all of the nonroutine resources and capabilities of the PCT Payee's business constitute external contributions, that is, they are reasonably anticipated to contribute to developing cost shared intangibles.

Under the market capitalization method, the arm's length charge to each PCT Payor is the product of the adjusted average market capitalization, multiplied by such PCT Payor's RAB share. The adjusted average market capitalization seeks to determine that portion of the market capitalization of the PCT Payee's business attributable to the external contributions. The adjusted average market capitalization is equal to the 60-day (ending on the date of the PCT) average of the daily market capitalizations of the PCT Payee, increased by liabilities, and decreased by the value of tangible property separately accounted for under proposed § 1.482–7(d) and by the value of any other resources and capabilities not covered by PCTs. The daily market capitalization is calculated on each day the PCT Payee's stock is actively traded as the total number of shares outstanding multiplied by the stock's closing price on that day (as adjusted, for example, for dividends, stock splits, and restructurings to the extent such adjustment can be done reliably). The reliability of this method is reduced to the extent the market capitalization must be adjusted to take into account significant difficult to value tangible property or resources or capabilities of the target not covered by a PCT. The reliability of this method is also reduced to the extent the facts and circumstances demonstrate the likelihood of a material divergence between the average market capitalization of the PCT Payee and the value of its resources and capabilities for which reliable adjustments cannot be made.

7. Residual Profit Split Method—Proposed § 1.482–7(g)(7)

The proposed regulations provide needed guidance on the proper application of the residual profit split method (RPSM) of § 1.482–6 in the context of the development and exploitation of intangibles pursuant to a CSA. The guidance is necessary in order to implement the general principles of proposed § 1.482–7(g)(2), such as consistency with the upfront contractual terms and risk allocation under the CSA and with the investor model. A purported application of RPSM not in accordance with this guidance would constitute an unspecified method for purposes of the sections 482 and 6662(e) and (h) regulations.

Under the proposed regulations, the RPSM may not be applied where only one controlled participant makes significant nonroutine contributions to the development and exploitation of cost shared intangibles. (An RPSM in such a situation would be logically equivalent to the income method using an applicable rate on profit, and is best considered under that method.) The RPSM divides operating profit or loss before any expense or amortization on account of IDCs, routine external contributions, and nonroutine contributions, from developing and exploiting cost shared intangibles in a controlled participant's territory (territorial operating profit or loss) in three steps.

In the first step of the RPSM, each controlled participant is allocated an amount of income that is subtracted from its territorial operating profit or loss to provide a market return to its routine contributions, other than cost contributions (that is, a controlled participant's IDCs borne, gross of cost sharing payments made, and net of cost sharing payments received).

In the second step of the RPSM, each controlled participant is allocated a portion of the residual of its territorial profit or loss, after the first step allocation, attributable to its cost contributions. The second step cost contribution share is a fraction of such residual operating profit or loss. The numerator is the present value, determined as of the date of the PCTs, of the summation, over the entire period of developing and exploiting cost shared intangibles, of the total value of the territorial owner's total anticipated cost contributions. The denominator of the territorial owner's cost contribution fraction is the present value, determined as of the date of the PCTs, of the summation, over the same period, of the territorial owner's total anticipated territorial operating profits, reduced by a market return for routine contributions (other than cost contributions) to the relevant business activity in the territory.

The cost contribution share under the second step of the RPSM corresponds to the cost contribution adjustment under the income method. The cost contribution share under the RPSM, similar to the cost contribution adjustment under the income method, is a reflection of the investor model. What is essentially a routine financing investment in the development of intangibles by the controlled participants, represented by bearing their share of anticipated IDCs, would be expected to earn a return appropriate to the risks associated with the CSA. The cost contribution share effectively represents the appropriate return to that financing investment, as of the date of the PCTs, expressed as a share of territorial operating profit or loss.

In the third step of the RPSM, the residual territorial profit or loss remaining after the first and second step allocations is divided among all the controlled participants based on the relative value, as of the date of the PCTs, of their nonroutine contributions. The relative value of the nonroutine contributions may be measured with reference to external benchmarks that reflect their fair market value, or with reference to estimated capitalized development costs as appropriately grown or discounted so that all contributions may be valued on a comparable dollar base as of the date of the PCTs.

Any amount of a controlled participant's territorial operating profit that is allocated to another controlled participant's nonroutine external contributions under the third step of the RPSM represents the amount of the PCT Payment due to that other controlled participant for its external contributions.

Under the RPSM, the determinations as of the date of the PCT of the second step cost contribution share and the third step relative nonroutine contribution values reflect the principle of consistency with the original contractual allocation of risk. Thus, while actual territorial operating profit or loss may depart from projections, the upfront risk allocation continues to be respected through the use of the cost contribution shares and relative nonroutine contribution values determined as of the date of the PCTs.

In applying the RPSM, any routine contributions that are external contributions (routine external contributions) are treated similarly to cost contributions.

The proposed regulations set forth comparability and reliability considerations appropriate for application of the RPSM in the CSA context.

8. Unspecified Methods—Proposed § 1.482–7(g)(8)

The proposed regulations also provide general rules applicable for methods not specified in proposed § 1.482–7(g)(3) through (7).

D. Coordination With the Arm's Length Standard—Proposed § 1.482–7(h)

Transactions in connection with a CSA must produce results consistent with the arm's length standard. The proposed regulations, therefore, dispel the misconception that cost sharing is a safe harbor.

In accordance with § 1.482–1(b)(1), the proposed regulations provide guidance appropriate in the context of a CSA regarding ''the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances.'' (Emphasis added.) In a CSA where the resulting intangibles may only be exploited in a controlled participant's territory, the arm's length result would require a participant to bear IDCs only in proportion to the expected relative values of its territory, that is, in proportion to its respective RAB shares. The same is true for PCTs. Where a controlled participant brings external contributions into the arrangement, at arm's length that participant would only agree to make the external contributions if it received compensation from the other participants for the anticipated benefits to their respective territories attributable to the external contributions.

Therefore, the proposed regulations provide that a CSA, and the CSTs and PCTs required in connection with a CSA, produce results that are consistent with an arm's length result within the meaning of § 1.482–1(b) if, and only if, each controlled participant's IDC share equals its RAB share, and all other requirements are satisfied, including those with respect to PCT Payments.

The Treasury Department and IRS recognize that a CSA, as defined, represents only one possible arrangement pursuant to which parties may choose to share the costs, risks, and benefits of intangible development. Other arrangements, however, may involve a different division of costs, risks, and benefits than those arising pursuant to a CSA. Given such differences, the guidance under § 1.482–7 is not appropriate to evaluate what would have been arm's length results of those other arrangements when undertaken among controlled taxpayers. As discussed, in such cases the proposed regulations instead would point taxpayers to the guidance under the other provisions of the section 482 regulations to determine whether such arrangements achieve arm's length results.

E. Allocations by the Commissioner in Connection With CSAs—Proposed § 1.482–7(i)

1. Consolidation of Existing Allocation Provisions—Proposed § 1.482–7(i)(1) Through (4)

Proposed § 1.482–7(i) assembles in one section, provisions regarding allocations by the Commissioner that currently are spread throughout existing § 1.482–7, with conforming changes to reflect the terminology and framework of the proposed regulations. Thus, under § 1.482–7(i)(1), the Commissioner is generally authorized to make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result.

Under proposed § 1.482–7(i)(2), the Commissioner may make appropriate adjustments to CSTs to bring IDC shares in line with RAB shares. Such adjustments include adding or removing costs from IDCs, allocating costs between the IDA and other business activities, improving the reliability of the benefits measurement basis used or the projections used to estimate RAB shares, and allocating among the controlled participants any unallocated territorial interests in cost shared intangibles. CST adjustments must be reflected in the year in which the IDCs are incurred, along with any appropriate allocation of arm's length interest to the date of payment.

Under proposed § 1.482–7(i)(3), the Commissioner may make appropriate allocations to adjust PCT Payments in accordance with the proposed regulations. Thus, the Commissioner may examine the taxpayer's method for determining the amount charged in a PCT in accordance with the provisions of the section 482 regulations as supplemented by proposed § 1.482–7(g). The Commissioner may either propose adjustments to the taxpayer's method or apply another method to adjust the results reported by the taxpayer consistent with an arm's length result.

Under proposed § 1.482–7(i)(4), the Commissioner may make appropriate allocations regarding changes in participation in accordance with proposed § 1.482–7(f).

2. Allocations When CSTs Are Consistently and Materially Disproportionate to RAB Shares—Proposed § 1.482–7(i)(5)

The fundamental requirement of a CSA with regard to CSTs is for the controlled participants to share IDCs in proportion to their respective RAB shares. Under proposed § 1.482–7(e)(1), RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants and the ongoing development of intangibles. Such updates must reflect a comprehensive revision over the entire past and projected future period of intangible exploitation in light of the most current reliable data.

To the extent the controlled participants consistently and materially fail to bear IDC shares equal to their respective RAB shares, the Commissioner would be able to exercise its authority pursuant to existing § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms) to impute an agreement that is consistent with the controlled participants' course of conduct. Thus, a participant that bears a disproportionately greater IDC share may be allocated an undivided interest in another territory or territories of exploitation of the cost shared intangibles, and would be allocated arm's length consideration from any other controlled participant whose IDC share is less than its RAB share over time.

Current § 1.482–7(g)(5) provides that these allocations be ''after any cost allocations authorized by [§ 1.482–7(a)(2)]'' is eliminated. Some have interpreted this reference to mean that the Commissioner must make cost allocations, and failure to do so would bar the Commissioner from making an allocation pursuant to existing § 1.482–7(g)(5). This interpretation, if accepted, defeats the expectation that controlled participants must themselves act consistently with their CST deal and maintain their RAB shares current for that purpose. No inference is intended regarding the outcome under the existing regulations.

3. Periodic Adjustments—Proposed § 1.482–7(i)(6)

In 1986, Congress indicated a significant degree of skepticism about related-party transfers of high-profit potential intangibles for relatively insignificant lump sum or royalty consideration that effectively place all the intangible development downside risk in one controlled taxpayer and all the upside profit potential in another. See H.R. Rep. 99–426, at 424–25 (1985). See also Notice 88–123 (the White Paper), 1988–2 C.B. 458, 472–74, 477–480. The legislative history also notes that it is especially difficult to obtain realistic comparables with respect to such intangibles because they seldom if ever are transferred to unrelated parties. See id.

The Commissioner's ability to evaluate controlled participants' deals with regard to high-profit potential intangibles is hampered, not only by the absence of comparables, but by an asymmetry of information vis-a-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. While risk and uncertain outcomes are typically the hallmarks of high-profit potential intangibles, significantly different results raise concerns whether the form of the initial arrangement matches its substance. These concerns are particularly problematic given the information asymmetry between taxpayers and the IRS. Periodic adjustments effectively permit the IRS to impute an arm's length arrangement that appropriately reflects the profit potential of transferred intangibles where the IRS believes that the taxpayers' arrangement does not appropriately reflect such profit potential. Because the guidance on periodic adjustments is intended to address the problem of information asymmetry, and because it is exceedingly 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.

Accordingly, taxpayers cannot exercise periodic adjustments of this type. This prohibition is necessary for proper administration of these rules. Moreover, taxpayers are not inappropriately disadvantaged by this rule because they have the ability to structure their related-party arrangements in line with the economic prospects of their business. A taxpayer can always protect itself against periodic adjustments by adopting 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. There are various forms of consideration that taxpayers at arm's length might adopt in the face of uncertainty and risk. In some cases, uncontrolled taxpayers might find that projections of anticipated profits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections. In other cases 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. This does not mean that the taxpayer must adopt an arrangement that tilts the risks in a way that necessarily always involves reporting income without regard to later actual results. For example, contingent arrangements may appropriately reflect profit potential and yet appropriately tie in with later outcomes. In such arrangements, less income may properly result if the outcomes are less successful than reasonably anticipated, or greater income will result if the outcomes are more successful. Taxpayers simply are in the best position to structure their arrangements upfront to accommodate a range of potential outcomes.

Proposed § 1.482–7(j)(6) provides guidance on how periodic adjustments may be made in the context of a CSA. The goal is to conform the results of CSTs and PCTs to the arm's length standard. In accordance with the 1986 legislative history, achieving that goal requires that the ''income allocated among the parties reasonably reflect the actual economic activity undertaken by each'' and that ''to the extent, if any, that one party is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, *it would be expected that an appropriate return would be provided to such party to reflect its investment.*'' H.R. Conf. Rep. No. 99–841 at II–638 (1986). (Emphasis supplied.)

The proposed regulations build the CSA periodic adjustment provisions upon the previously discussed investor model. The taxpayer's arrangement will be respected so long as a controlled participant's actually experienced return ratio (AERR), equal to the present value of its actually experienced operating profits from exploiting cost shared intangibles divided by its investment in the CSA (consisting of the present value sum of its cost contributions and PCT Payments), is within a specified periodic return ratio range (PRRR). The PRRR provides a band of comfort for actual return ratios of no more than 2 and no less than ½ (unless there is a failure to substantially comply with the administrative requirements of proposed § 1.482–7(k), in which case the comfort band consists of actual return ratios of no more than 1.5 and no less than .67). Results above or below these respective thresholds typically warrant a more thorough and detailed examination of the arm's length nature of the initial taxpayer arrangement, as well as a means to impute an alternative arrangement that more reliably reflects an arm's length result, as described below.

In determining a controlled participant's AERR, the present values of its operating profits and CSA investments are measured from the period beginning on the commencement of the CSA through the end of the year of adjustment. For these purposes, present values are determined using an applicable discount rate (ADR) appropriate to the risks associated with the given CSA, as the Commissioner may determine under the guidance of proposed § 1.482–7(g)(2)(vi). Where the stock of the PCT Payor, or another company that owns stock in the PCT Payor and is in a consolidated group with the PCT Payor for financial accounting purposes is publicly traded, the Commissioner may treat the ADR as equal to the publicly traded company's weighted average cost of capital, as determined pursuant to the capital asset pricing model, subject to the taxpayer's ability to show another discount rate is more appropriate in the facts and circumstances to the satisfaction of the Commissioner. Where there is no publicly traded company in the PCT Payor group, the ADR will be determined under the general principles applicable for discount rates, subject to such adjustments as the Commissioner determines is appropriate.

In determining the AERR and, thus, whether the AERR is within or without the PRRR, it is intended that the items entering into the computation (*e.g.*, operating profits, cost contributions, and PCT Payments) are those items as adjusted (including as the result of any prior IRS adjustments).

The guidance on periodic adjustments is not intended, for example, to systematically reallocate above-market returns after-the-fact, since such returns may in whole or in part reward legitimate ex ante risk-taking by CSA investors. Accordingly, an AERR outside the PRRR does not necessarily mean that adjustments will ultimately be warranted. Rather, the PRRR provides comfort to taxpayers that within the PRRR they will not be subject to periodic adjustments. If the AERR is outside the PRRR, the proposed regulations provide exceptions pursuant to which periodic adjustments will not be made where a taxpayer can demonstrate that its deal was nevertheless arm's length. These exceptions adapt the exceptions in existing § 1.482–4(f)(2)(ii), along with three additional exceptions appropriate in the CSA context. One exception effectively would avoid ''start up'' triggers from return ratios below the low end of the PRRR by delaying low end trigger testing until after the first five years of substantial exploitation of cost shared intangibles resulting from the CSA. A similar exception would enable a taxpayer to avoid a low end trigger that it can establish to the satisfaction of the Commissioner results from the ''cut off'' from consideration of anticipated profits, cost contributions, or PCT Payments beyond the end of the year of adjustment. For purposes of the foregoing exception, the taxpayer may assume that the yearly average of past operating profits for the years up through the year of adjustment in which there has been substantial exploitation of cost shared intangibles will continue into the future. The third additional exception would enable a taxpayer to avoid a high end trigger that it can establish to the satisfaction of the Commissioner results from routine contributions to its profitability, or from nonroutine contributions, including its own external contributions.

In the event that the AERR is outside the PRRR, and no exception applies, then the Commissioner may adjust the taxpayer's PCT Payments to the level of an equivalent stream of contingent royalties as would be determined under a modified RPSM. The modified RPSM would vary depending on whether the periodic adjustment was triggered by an AERR above the high end or below the low end of the PRRR.

In the event of a trigger above the high end of the PRRR, the arrangement going forward beginning with the year of adjustment would effectively treat the past cost contribution shares of all controlled participants as bought out and would determine new fractions for cost contribution shares as of the start of the year of adjustment (if development activity is then continuing under the CSA). Prior cost contributions and operating profits, therefore, would not be taken into account in the second step of the modified RPSM. The relative valuation of nonroutine contributions, including external contributions, in the third step of the modified RPSM would still be determined as of the original date of the PCTs, but taking into account any data relevant to such relative valuation as may be available up through the date of the periodic adjustment.

In the event of a trigger below the low end of the PRRR, the arrangement going forward beginning with the year of adjustment would effectively recompute the original cost contribution share fractions by substituting projections as revised in light of actual experience up through the date of the periodic adjustment.

For these purposes only, the residual profit split method may be used even where only one controlled participant makes significant nonroutine contributions to the CSA Activity. (As mentioned above in the discussion of the residual profit split method, applying the residual profit split method in such a situation is logically equivalent to applying the income method using an applicable rate on profit. For convenience, the proposed regulations apply the residual profit split method to all periodic adjustments rather than separately describing an equivalent modified income method for the situation in which only one controlled participant makes significant nonroutine contributions to the CSA Activity.) If only one controlled participant provides all the external contributions and other nonroutine contributions, then the third step residual profit or loss belongs entirely to such controlled participant.

It should be emphasized that the Commissioner's determination whether or not to make periodic adjustments would be informed by whether the outcome as adjusted more reliably reflects an arm's length result.

F. Definitions and Special Rules—Proposed § 1.482–7(j)

Proposed § 1.482–7(j) provides definitions and special rules relevant to CSAs.

1. Controlled Participant—Proposed § 1.482–7(j)(1)(i)

The proposed regulations incorporate the existing definitions and examples with regard to a controlled participant with conforming changes to reflect the new framework and terminology. Thus, a controlled participant is a controlled taxpayer that is a party to the CSA contractual agreement that reasonably anticipates that it will derive benefits from exploiting one or more cost shared intangibles.

The proposed regulations dispense with the possibility of an uncontrolled participant in a CSA. The Treasury Department and the IRS are not aware of any uncontrolled participants in any CSAs. The elimination of uncontrolled participants simplified various provisions of the proposed regulations. The Treasury Department and the IRS request comments in this regard.

2. Cost Shared Intangible—Proposed § 1.482–7(j)(1)(ii)

The term *cost shared intangible* replaces the term *covered intangible* from existing § 1.482–7(b)(4)(iv). A cost shared intangible means any intangible developed or to be developed as a result of the IDA. Thus, cost shared intangibles include both the intangibles that are contemplated to result from the IDA as well as any which serendipitously may result from the IDA.

Cost shared intangibles include any portion thereof that may be attributable to an external contribution and, therefore, do not simply represent the incremental results of the IDA. For example, if a new generation software resulting from the IDA incorporates elements of the prior generation software, the cost shared intangible is the total result of the prior and subsequent contributions. No inference is intended as to the outcome under the existing regulations.

3. Interest In An Intangible—Proposed § 1.482–7(j)(1)(iii)

The proposed regulations employ the same general definition of an *interest in an intangible* found in existing § 1.482–7(a)(2). It should be noted, however, that the proposed regulations provide that the interests in cost shared intangibles must be divided among the controlled participants on a territorial basis. See proposed § 1.482–7(b)(1)(i) and (b)(4).

4. Benefits—Proposed § 1.482–7(j)(1)(iv)

The proposed regulations clarify the definition of *benefits* found in existing § 1.482–7(e)(1). Benefits means the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.

5. Reasonably Anticipated Benefits—Proposed § 1.482–7(j)(1)(v)

The proposed regulations effectively employ the same definition of *reasonably anticipated benefits* found in existing § 1.482–7(e)(2).

6. Territorial Operating Profit or Loss—Proposed § 1.482–7(j)(1)(vi)

The proposed regulations define *territorial operating profit or loss* as the operating profit or loss as separately earned by each controlled participant in its geographic territory from the CSA Activity, determined before an expense (including amortization) on account of IDCs, routine external contributions, and nonroutine contributions.

7. CSA Activity—Proposed § 1.482–7(j)(1)(vii)

The proposed regulations define *CSA Activity* as the activity of developing and exploiting cost shared intangibles.

8. Consolidated Group—Proposed § 1.482–7(j)(2)(i)

In line with existing § 1.482–7(c)(3), the proposed regulations treat all members of a U.S. group filing consolidated income tax returns as one taxpayer for purposes of the CSA provisions. The proposed regulations would also treat all members of a foreign fiscal unity as one taxpayer for these purposes.

9. No Trade or Business and Partnership—Proposed § 1.482–7(j)(2)(ii) and (iii)

In line with existing §§ 1.482–7(a)(1) and 301.7701–1(c), the proposed regulations provide that participation in a CSA, of itself, does not constitute a U.S. trade or business or result in the creation of a partnership for federal income tax purposes.

10. Character of Payments—Proposed § 1.482–7(j)(3)

In line with existing § 1.482–7(h), the proposed regulations provide ordering rules for characterizing cost sharing payments with regard to the items they reimburse. PCT Payments will be characterized consistently with the designation of the type of transaction involved in the RT. The proposed regulations continue to provide for the netting of PCT Payments made to, and received by, a controlled participant.

G. Administrative Provisions—Proposed § 1.482–7(k)

The proposed regulations include provisions to facilitate administration of, and compliance with, the cost sharing rules. Thus, under a CSA, the controlled participants must substantially comply with certain contractual, documentation, accounting, and reporting requirements. Similar requirements are spread throughout the existing regulations in § 1.482–7(b), (c)(1), (i), and (j). In the proposed regulations, the substantial compliance standard is included in proposed § 1.482–7(b)(1)(iv) through (vii), and the specific requirements are assembled together in § 1.482–7(k).

1. CSA Contractual Requirements—Proposed § 1.482–7(k)(1)

Under proposed § 1.482–7(k)(1)(i), a CSA must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the CSA. The written CSA must incorporate the contractual provisions set forth in proposed § 1.482–7(k)(1)(ii). Proposed § 1.482–7(k)(1)(iii) provides that a written contractual agreement is contemporaneous with the formation (or revision) of a CSA if, and only if, the controlled participants record the CSA, in its entirety, in a document that they sign and date no later than 60 days after the first occurrence of any IDC to which such agreement (or revision) is to apply. By requiring that CSAs be memorialized contemporaneously with formation (or revision), the CSA contractual provisions are more likely to reliably reflect (without hindsight) the relative risks of the controlled participants.

2. CSA Documentation Requirements—Proposed § 1.482–7(k)(2)

Under proposed § 1.482–7(k)(2)(i), the controlled participants must timely update and maintain sufficient documentation to establish that the participants have met the contractual requirements of proposed § 1.482–7(k)(1). In addition, the controlled participants must timely update and maintain documentation sufficient to establish and support the items listed in proposed § 1.482–7(k)(2)(ii) regarding the ongoing implementation of the CSA, CSTs, and PCTs. Thus, each controlled participant must at timely intervals update and maintain the documentation required by proposed § 1.482–7(k)(2)(i) and (ii) on an ongoing basis from the outset of the formation of the CSA. To the extent that additional documentation is required by the new availability of information or the occurrence of post-formation events, each controlled participant must maintain such documentation in a manner such that the controlled participant retains and supplements (but does not replace) the documentation maintained from the outset.

Proposed § 1.482–7(k)(2)(iii), which replaces existing § 1.482–7(j)(2)(ii), cross-references proposed § 1.6662–6(d)(2)(iii)(D) for the coordination of the CSA documentation rules with the specified method documentation rules under the section 6662 transfer pricing penalty regulations. Proposed § 1.6662–6(d)(2)(iii)(D) provides that satisfaction of the CSA documentation requirements satisfies the specified method principal documentation requirements with respect to the CSTs and PCTs, other than the requirements to provide a description of the relevant organizational structure and an index of principal and background documents, provided that such documentation is sufficient to establish that the taxpayer reasonably concluded that its method and application provided the most reliable measure of an arm's length result. Each controlled participant must provide such documentation to the IRS within 30 days of a request, subject to extension in the Commissioner's discretion.

3. CSA Accounting Requirements—Proposed § 1.482–7(k)(3)

Proposed § 1.482–7(k)(3)(i) tracks the existing regulations in requiring that the controlled participants establish a consistent method of accounting, translate foreign currencies on a consistent basis, and explain any material differences from U.S. generally accepted accounting principles. Under proposed § 1.482–7(k)(3)(ii), controlled participants may not rely solely upon financial accounting rules to establish satisfaction of the accounting requirements. Rather, the method of accounting must clearly reflect income.

4. CSA Reporting Requirements—Proposed § 1.482–7(k)(4)

Proposed § 1.482–(7)(k)(4)(i) requires that each controlled participant must file with the Ogden Campus a statement regarding its participation in a CSA (CSA Statement). The CSA Statement must provide the information enumerated in proposed § 1.482–7(k)(4)(ii), including the earliest date that any IDC occurred, the date on which the controlled participants formed (or revised) the CSA, and (if different from the immediately preceding date) the date on which the controlled participants recorded the CSA (or revision) in accordance with the contemporaneous recordation requirement.

Pursuant to proposed § 1.482–7(k)(4)(iii)(A), each controlled participant must file an original CSA Statement with the IRS no later than 90 days after the first occurrence of an IDC to which the newly-formed CSA applies or, in the case of a taxpayer that became a controlled participant after the formation of the CSA, no later than 90 days after such taxpayer became a controlled participant. The CSA Statement must be dated and signed, under penalties of perjury, by an officer of the controlled participant who is duly authorized (under local law) to sign the statement on behalf of the controlled participant.

In addition to the 90-day rule described above, proposed § 1.482–7(k)(4)(iii)(B) contains an annual reporting requirement. Each controlled participant must attach to its U.S. income tax return, for each taxable year for the duration of the CSA, a copy of the original CSA Statement that the controlled participant filed in accordance with the 90-day rule. Further, the annual reporting by the controlled participant must update the information reflected on the original CSA Statement by attaching a schedule that documents changes in such information over time. If a controlled participant does not file a U.S. income tax return, then it must ensure that the foregoing CSA Statement and updated schedule are attached to any Schedule M of Form 5471, to any Form 5472, or to any Form 8865 with respect to that participant.

H. Effective Date and Transition Rule—Proposed §§ 1.482–7(l) and (m)

The proposed regulations are proposed to be applicable on the date of publication of the proposed regulations as a final regulation in the **Federal Register**. Thus, CSAs commencing on or after such date, and CSTs and PCTs occurring after such date with respect to CSAs existing as of the effective date, will be subject to § 1.482–7, as then finally revised. Conversely, other transactions not reasonably anticipated to contribute to developing intangibles pursuant to an arrangement constituting a CSA described in § 1.482–7(b)(1) or (5) will be subject to other applicable section 482 regulations. See proposed § 1.482–7(a)(3)(iii).

The proposed regulations provide transition rules under which an existing arrangement that constituted a qualified cost sharing arrangement under the regulations before the effective date will be considered a CSA and will be allowed an additional period to conform to the new rules with certain modifications. Although certain documentation requirements are delayed and certain substantive requirements concerning pre-effective date matters are relaxed for a grandfathered CSA described in the previous sentence, the controlled participants' CSTs and PCTs that occur after the effective date would have to comply with the substantive requirements of these regulations beginning immediately after such date. CSTs and PCTs occurring prior to the effective date are subject to these regulations only in the event that PCT Payments become subject to periodic adjustment under paragraph (i)(6) as a result of a subsequent PCT occurring on or after the effective date.

The proposed regulations specify circumstances under which the grandfathered status of pre-effective date arrangements would terminate. Accordingly, an otherwise grandfathered arrangement would cease to be so grandfathered from the earliest of a failure of the controlled participants to substantially comply with the regulations as transitionally modified, a material change in the scope of the CSA as contemplated in the underlying contractual arrangement (such as a material expansion of the activities undertaken in the CSA beyond those undertaken as of the effective date), or a 50 percent change in the beneficial ownership of the interests in cost shared intangibles.

I. Changes to Other Provisions

The proposed regulations make conforming changes to § 1.367(a)–1T, § 1.861–17, and §§ 1.482–1 *et seq.* of the section 482 regulations to reflect the new terminology and framework of the CSA provisions.

The proposed regulations redesignate current § 1.482–7 as § 1.482–7A which would continue to apply for dates prior to the publication of this document as a final regulation in the **Federal Register** and to the extent applicable under the transition rule of proposed § 1.482–7(m).

The proposed regulations add examples to § 1.482–8 to illustrate the application of the best method rule in connection with the new specified methods under proposed § 1.482–7(g).

As previously stated, proposed § 1.6662–6(d)(2)(iii)(D) coordinates the CSA documentation requirements of proposed § 1.482–7(k)(2) with the specified method documentation requirements of the section 6662 transfer pricing penalty regulations.

In line with the penultimate sentence of existing § 1.482–7(a)(1) and proposed § 1.482–7(j)(2)(iii), proposed § 301.7701–1(c) provides that participation in a CSA, of itself, does not give rise to a separate entity.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined also that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that few small entities are expected to enter into cost sharing agreements, as defined herein, and that for those that do, the burdens imposed under proposed § 1.482–7(b)(1)(iv) through (vii) and (k) would be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 16, 2005, at 10 a.m., in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 26, 2005. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.482–7A also issued under 26 U.S.C. 482. * * *

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

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

* * * * *

(d) * * *

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

* * * * *

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

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

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

§ 1.482–0 Outline of regulations under section 482.

* * * * *

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

(C) Allocate residual profit.
(*1*) In general.
(*2*) Cost contribution share of residual profit or loss.
(*3*) Nonroutine contribution share of residual profit or loss.
(*4*) Determination of PCT Payments.
(*5*) Routine external contributions.
(iv) Comparability and reliability considerations.
(A) In general.
(B) Comparability.
(C) Data and assumptions.
(D) Other factors affecting reliability.
(v) Example.
(8) Unspecified methods.
(h) Coordination with the arm's length standard.
(i) Allocations by the Commissioner in connection with a CSA.
(1) In general.
(2) CST allocations.
(i) In general.
(ii) Adjustments to improve the reliability of projections used to RAB shares.
(A) Unreliable projections.
(B) Foreign-to-foreign adjustments.
(C) Correlative adjustments to PCTs.
(D) Examples.
(iii) Timing of CST allocations.
(3) PCT allocations.
(4) Allocations regarding changes in participation under a CSA.
(5) Allocations when CSTs are consistently and materially disproportionate to RAB shares.
(6) Periodic adjustments.
(i) In general.
(ii) PRRR.
(iii) AERR.
(A) In general.
(B) PVTP.
(C) PVI.
(iv) ADR.
(A) In general.
(B) Publicly traded companies.
(C) Publicly traded.
(D) PCT Payor WACC.
(E) Generally accepted accounting principles.
(v) Determination of periodic adjustments.
(vi) Exceptions to periodic adjustments.
(A) Transactions involving the same external contributions as in the PCT.
(B) Results not reasonably anticipated.
(C) Reduced AERR does not cause Periodic Trigger.
(D) Increased AERR does not cause Periodic Trigger.
(E) 10-year period.
(F) 5-year period.
(vii) Examples.
(viii) Documentation.
(j) Definitions and special rules.
(1) Definitions.
(2) Special rules.
(i) Consolidated group.
(ii) Trade or business.
(iii) Partnership.
(3) Character.
(i) In general.
(ii) PCT Payments.
(iii) Examples.
(k) CSA contractual, documentation, accounting, and reporting requirements.
(1) CSA contractual requirements.
(i) In general.
(ii) Contractual provisions.
(iii) Meaning of contemporaneous.
(A) In general.
(B) Example.
(2) CSA documentation requirements.
(i) In general.
(ii) Additional CSA documentation requirements.
(iii) Coordination rules and production of documents.
(A) Coordination with penalty regulations.
(B) Production of documentation.
(3) CSA accounting requirements.
(i) In general.
(ii) Reliance on financial accounting.
(4) CSA reporting requirements.
(i) CSA Statement.
(ii) Content of CSA Statement.
(iii) Time for filing CSA Statement.
(A) 90-day rule.
(B) Annual return requirement.
(*1*) In general.
(*2*) Special filing rule for annual return requirement.
(iv) Examples.
(l) Effective date.
(m) Transition rule.
(1) In general.
(2) Termination of grandfather status.
(3) Transitional modification of applicable provisions.

* * * * *

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

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

The revisions read as follows:

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

* * * * *

(b) * * *
(2) * * *
(i) * * * Section 1.482–7 provides the methods to be used to evaluate whether a cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

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

* * * * *

Par. 6. Section 1.482–4 is amended by

1. Redesignating paragraph (f)(3)(iv) as paragraph (f)(3)(v).
2. Adding a new paragraph (f)(3)(iv).

The addition reads as follows:

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

* * * * *

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

* * * * *

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

§ 1.482–5 Comparable profits method.

* * * * *

(c) * * *
(2) * * *
(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by § 1.482–7(d)(3)(i)) among the tested party and comparable parties.

* * * * *

Par. 8. Section 1.482–7 is revised to read as follows:

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

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

(1) *RAB share method for cost sharing transactions (CSTs).* The controlled participants that are parties to a cost sharing transaction (CST), as described in paragraph (b)(2) of this section, must share the intangible development costs (IDCs) of the cost shared intangibles in proportion to their shares of reasonably anticipated benefits (RAB shares). See paragraph (j)(1) of this section for the definitions of controlled participant, cost shared intangible, benefits, and reasonably anticipated benefits, and paragraphs (d) and (e) of this section regarding IDCs and RAB shares, respectively.

(2) *Methods for preliminary or contemporaneous transactions (PCTs).* The arm's length amount charged in a preliminary or contemporaneous transaction (PCT), as described in paragraph (b)(3) of this section, must be determined under the method or methods under the other section or sections of the section 482 regulations, as supplemented by paragraph (g) of this section, applicable to the reference transaction (RT) reflected by the PCT. See § 1.482–1(b)(2)(ii) (Selection of category of method applicable to

transaction), paragraph (b)(3)(iv) of this section (Reference transaction), and paragraph (g) of this section (Supplemental guidance on methods applicable to PCTs).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) *PCTs*—(i) *In general.* A PCT is a controlled transaction in which each other controlled participant (PCT Payor) is obligated to compensate a controlled participant (PCT Payee) for an external contribution of the PCT Payee.

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

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

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

(v) *PFAs.* A post formation acquisition (PFA) is an external contribution that is acquired by a controlled participant in an uncontrolled transaction that takes place after the formation of the CSA and that as of the date of acquisition is reasonably anticipated to contribute to developing cost shared intangibles. Resources or capabilities may be acquired in a PFA either directly, or indirectly through the acquisition of an interest in an entity or tier of entities.

(vi) *Form of payment*—(A) *In general.* The consideration under a PCT for an external contribution other than a PFA may take one or a combination of both of the following forms—

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

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

(B) *PFAs.* The consideration under a PCT for a PFA must be paid in the same form as the uncontrolled transaction in which the PFA was acquired.

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

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

(viii) *Examples.* The following examples illustrate the principles of this paragraph (b)(3). In each example, Companies P and S are members of the same controlled group, and execute a CSA that is described in paragraph (b)(1) of this section. The examples are as follows:

Example 1. Company P has developed and currently markets version 1.0 of a new software application XYZ. Company P and Company S execute a CSA under which they will share the IDCs for developing future versions of XYZ. Version 1.0 is reasonably anticipated to contribute to the development of future versions of XYZ and therefore the RT rights in version 1.0 constitute an external contribution of Company P for which compensation is due from Company S pursuant to a PCT. The applicable method and determination of the arm's length compensation due pursuant to the PCT will be based on the RT. The controlled participants designate the RT as a transfer of intangibles that would otherwise be governed by § 1.482–4, if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482–4 as supplemented by paragraph (g) of this section. The RT in this case is the perpetual and exclusive provision of the benefit of all rights in version 1.0, other than the rights described in paragraph (c) of this section (Make-or-sell rights excluded). This includes the exclusive right to use version 1.0 for purposes of research and the right to exploit any products that incorporated the platform technology of version 1.0, and would cover a term extending as long as the uncontrolled taxpayer were to continue to exploit future versions of XYZ or any other product based on the version 1.0 platform. Though Company P and Company S are not required to actually enter into the transaction described by the RT, the value of the compensation obligation of Company S for the PCT will reflect the full value of the external contribution defined by the RT, as limited by Company S's RAB share.

Example 2. Company P and Company S execute a CSA under which they will share the IDCs for developing Vaccine Z. Company P will commit its research team that has successfully developed a number of other vaccines to the project. The expertise and existing integration of the research team is a unique resource or capability of Company P which is reasonably anticipated to contribute to the development of Vaccine Z and therefore the RT Rights in the research team constitute an external contribution for which compensation is due from Company S as part of a PCT. The applicable method and determination of the arm's length compensation due pursuant to the PCT will be based on the RT. The controlled parties designate the RT as a provision of services that would otherwise be governed by § 1.482–2(b)(3)(first sentence) if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482–2(b)(3)(first sentence) as supplemented by paragraph (g) of this section. The RT in this case is the perpetual and exclusive provision of the benefits by Company P of its research team to the development of Vaccine Z by the uncontrolled party. Because the IDCs include the ongoing compensation of the researchers, the compensation obligation under the PCT is only for the value of the commitment of the research team by Company P to the CSA's development efforts net of such researcher compensation. Though Company P and Company S are not required to actually enter into the transaction described by the RT, the value of the compensation obligation of Company S for the PCT will reflect the full value of provision of services described in the RT, as limited by Company S's RAB share.

Example 3. In Year 1, Company P and Company S execute a CSA under which they will share the IDCs for developing Product X. In Year 3, Company P acquires technology intangibles that it anticipates will contribute to the development of Product X from an uncontrolled party for a lump sum consideration. Because the technology intangibles are reasonably anticipated to contribute to the development on the date of the acquisition and the acquisition is an uncontrolled transaction that takes place after the formation of the CSA, the RT Rights in the technology intangibles are an external contribution acquired as part of a PFA. Accordingly, Company P and Company S must enter into a PCT in which Company S compensates Company P for the RT Rights in the technology intangibles and pursuant to paragraph (b)(3)(vi)(B) of this section, the form of payment of the PCT must mirror the lump sum form of payment of the PFA.

Example 4. Assume the same facts as in *Example 3.* In Year 4 Company P acquires Company X in a tax-free stock-for-stock acquisition. Company X is a start-up technology company with negligible amounts of tangible property and liabilities. Company X joins in the filing of a U.S. consolidated income tax return with USP and is treated as one taxpayer with Company P under paragraph (j)(2)(i) of this section. Accordingly, under paragraph (b)(3)(v) of this section, Company P's acquisition of the stock of Company X will be treated as an indirect acquisition of the resources and capabilities of Company X. The in-process technology and workforce of Company X acquired by Company P are reasonably anticipated to contribute to the development of product Z and therefore the RT Rights in the in-process technology and workforce of Company X are external contributions for which compensation is due to Company P from Company S under a PCT. Furthermore, because these external contributions were acquired by Company P in an uncontrolled transaction that took place after the formation of the CSA, they are also PFAs. Accordingly, the consideration due from S under the PCT must be paid in the same form of payment as Company's P acquisition of Company X, which was done in a lump sum payment.

Therefore, consideration for the PCT must be paid in a lump sum.

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

(ii) *Example.* The following example illustrates the principles of this paragraph (b)(4):

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(3)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

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

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

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

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

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

Example 1. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a better mousetrap. USS and FP share the costs of FP's R&D facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company. Based on the facts and circumstances, the cost of the conference facility cannot be directly identified with, and is not reasonably allocable to, the IDA. In this case, the cost of the conference facility must be excluded from the amount of IDCs.

Example 2. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop intangibles for producing a new device. USP and FS share the costs of an R&D facility, the salaries of the facility's researchers, and reasonable overhead costs attributable to the project. Although USP also incurs costs related to field testing of the device, USP does not include those costs in the IDCs that USP and FS will share under the CSA. The Commissioner may determine, based on the facts and circumstances, that the costs of field testing are IDCs that the participants must share.

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

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

(e) *Reasonably anticipated benefits share (RAB share)*—(1) *In general.* A controlled participant's share of reasonably anticipated benefits (RAB share) is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits of all the controlled participants. See paragraph (j)(1)(v) of this section (defining reasonably anticipated benefits). RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the CSA. For purposes of determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most current reliable data regarding past and projected future results as is available at such time. A controlled participant's RAB share must be determined by using the most reliable estimate. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with § 1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of RAB shares—

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

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

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

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

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

(B) *Sales.* Sales by each controlled participant in the business activities in which cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to cost shared intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting cost shared intangibles are not substantial relative to the revenues generated, or if the principal effect of using cost shared intangibles is to increase the controlled participants' revenues (for example, through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring RAB shares unless each controlled participant operates at the same market level (for example, manufacturing, distribution, etc.).

(C) *Operating profit.* Operating profit of each controlled participant from the activities in which cost shared intangibles are exploited, as determined before any expense (including amortization) on account of IDCS, may be used as an indirect basis for measuring anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that such profit is largely attributable to the use of cost shared intangibles, or if the share of profits attributable to the use of cost shared intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when cost shared intangibles are closely associated with the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop a new car model. The controlled participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66⅔% of each year's IDCs and FP bears 33⅓% of such costs.

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

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

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

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

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

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

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

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

(g) *Supplemental guidance on methods applicable to PCTs*—(1) *In general.* This subsection provides supplemental guidance on applying the methods listed below for purposes of evaluating the arm's length amount charged in a PCT. Each method must be applied in accordance with the provisions of § 1.482–1, including best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e), except as those provisions are modified in this subsection. The methods are—

(i) The comparable uncontrolled transaction method described in § 1.482–4(c), or the arm's length charge described in § 1.482–2(b)(3)(first sentence) based on a comparable uncontrolled transaction, further described in paragraph (g)(3) of this section;

(ii) The income method, described in paragraph (g)(4) of this section;

(iii) The acquisition price method, described in paragraph (g)(5) of this section;

(iv) The market capitalization method, described in paragraph (g)(6) of this section;

(v) The residual profit split method, described in paragraph (g)(7) of this section; and

(vi) Unspecified methods, described in paragraph (g)(8) of this section.

(2) *General principles*—(i) *In general.* The principles set forth in this paragraph (g)(2) apply, as appropriate, to the use of any of the methods set forth in this section to determine the arm's length charge for a PCT.

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

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

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

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

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

(ii) S's manufacturing and distribution activities under the CSA will be routine in nature, and identical to the activities it would undertake if it alternatively licensed the product from P.

(iii) Reasonably reliable estimates indicate that P could self-develop and license the product outside of the Country X for a royalty of 20% of sales. Based on reliable financial projections that include all future development costs and licensing revenue, the net present value of this licensing alternative to P for the non-Country X market (measured as of the date of the PCT) would be $500 million of operating income. Thus, based on this realistic alternative, the anticipated net present value under the CSA to P in the non-Country X market (measured as of the date of the PCT), including R&D reimbursement and PCT Payments from S, should not be less than $500 million.

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

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

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

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

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

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

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

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

(v) *Aggregation of transactions.* In some cases, controlled participants are required to determine arm's length payments for multiple PCTs covering various external contributions or, in addition to one or more PCTs, for transactions covering resources or capabilities that are not governed by this section, such as the transfer of make-or-sell rights as described in paragraph (c) of this section. Following the principles of aggregation described in § 1.482–1(f)(2)(i), a best method analysis under § 1.482–1(c) may determine that the method that provides the most reliable measure of an arm's length charge for the multiple PCTs and other transactions not governed by this section, if any, is a method that determines the arm's length charge for the multiple transactions on an aggregate basis under this section. A section 482 adjustment may be made by comparing the aggregate arm's length charge so determined to the aggregate payments actually made for the multiple transactions. In such a case, it generally will not be necessary to allocate separately the aggregate arm's length charge as between various PCTs or as between PCTs and transactions governed by other regulations under section 482. However, such an allocation may be necessary for other purposes, such as applying paragraph (i)(6) (Periodic adjustments) of this section. An aggregate determination of the arm's length charge for multiple transactions will generally yield a payment for a controlled participant that is equal to the aggregate value of the external contributions and other resources and capabilities covered by the multiple transactions multiplied by that controlled participant's RAB share. Because RAB shares only include benefits from cost shared intangibles, the reliability of an aggregate determination of payments for multiple transactions may be reduced to the extent that it includes transactions not governed by this section covering resources and capabilities for which the controlled participants' expected benefit shares differ substantially from their RAB shares.

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

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

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

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

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

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

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

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

(ii) The in-process technology and workforce of Company X acquired by USP are reasonably anticipated to contribute to developing cost shared intangibles and therefore the RT Rights in the in-process technology and workforce of Company X external contributions for which FSub must compensate USP as part of a PCT. In determining whether to apply the acquisition price or another method for purposes of evaluating the arm's length charge in the PCT, relevant comparability and reliability considerations must be weighed in light of the general principles of paragraph (g)(2) of this section. The allocation for accounting purposes raises an issue as to the reliability of using the acquisition price method in this case because it indicates that a significant portion of the value of Company X's assets is allocable to goodwill, which is often difficult to value reliably and which, depending on the facts and circumstances, might not be attributable to external contributions that are to be compensated by PCTs. See paragraph (g)(5)(iv(A) of this section.

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

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

(ii) In this case an analysis of the facts indicates a likelihood, consistent with the allocation under the accounting treatment (although not necessarily in the same amount), of goodwill and going concern value economically attributable to the existing U.S. software business rather than to the external contributions consisting of the

RT Rights in the in-process technology and research workforce. Accordingly, further consideration must be given to the extent to which these circumstances reduce the relative reliability of the acquisition price method in comparison to other potentially applicable methods for evaluating the PCT Payment.

Example 3. (i) USP, a U.S. corporation and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop Product A. Company Y is an uncontrolled corporation that owns Technology X that is critical to the development of Product A. Company Y currently markets Product B, which is dependent on Technology X. USP is solely interested in acquiring Technology X, but is only able to do so through the acquisition of Company Y in its entirety for $200 million in an uncontrolled transaction in Year 2. For accounting purposes, the acquisition price is allocated as follows: $120 million to Product B and the underlying Technology X, $30 million to trademark and other marketing intangibles, and the residual $50 million to goodwill and going concern. After the acquisition of Company Y, Technology X is used to develop Product A. No other part of Company Y is utilized in any manner. Product B is discontinued and accordingly, the accompanying marketing intangibles become worthless. None of the previous employees of Company Y are retained.

(ii) The Technology X of Company Y acquired by USP is reasonably anticipated to contribute to developing cost shared intangibles and is therefore an external contribution for which FSub must compensate USP as part of a PCT. Although for accounting purposes a significant portion of the acquisition price of Company Y was allocated to items other than Technology X, the facts demonstrate that USP had no intention of using and therefore placed no economic value on any part of Company Y other than Technology X. If USP was willing to pay $200 million for Company Y solely for purposes of acquiring Technology X, then assuming the acquisition price method is otherwise the most reliable method, the value of Technology X is the full $200 million acquisition price. Accordingly, the value of the arm's length PCT Payment due from FSub to USP for the external contribution consisting of the RT Rights in Technology X will equal $200 million multiplied by FSub's RAB share.

(viii) *Valuation consistent with the investor model*—(A) *In general*. The valuation of the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in developing cost shared intangibles pursuant to the CSA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate, determined following the principles set forth in paragraph (g)(2)(vi) of this section, over the entire period of developing and exploiting the cost shared intangibles. If the cost shared intangibles themselves are reasonably anticipated to contribute to developing other intangibles, then the period in the preceding sentence includes the period of developing and exploiting such indirectly benefited intangibles.

(B) *Example*. The following example illustrates the principles of this paragraph (g)(2)(viii):

Example. (i) P, a U.S. corporation, has developed a software program, DEF, which applies certain algorithms to reconstruct complete DNA sequences from partially-observed DNA sequences. S is a wholly-owned foreign subsidiary of P. P and S enter into a CSA to develop a new generation of genetic tests, GHI, based in part on the use of DEF which is therefore an external contribution of P for which compensation is due from S pursuant to a PCT. S makes no external contributions to the CSA. GHI sales are projected to commence two years after the inception of the CSA, which is on the first day of Year 1, and then to continue for eight more years. P and S project that GHI will be replaced by a new generation of genetic testing based on technology unrelated to DEF or GHI at the end of Year 10.

(ii) For purposes of valuing the PCT for P's external contribution of DEF to the CSA, P and S apply a type of residual profit split method that is not described in paragraph (g)(7) of this section and which, accordingly, constitutes an unspecified method. See paragraph (g)(7)(i) (last sentence) of this section. The principles of this paragraph (g)(2) apply to any method for valuing a PCT, including the unspecified method used by P and S.

(iii) Under the method employed by P and S, in each Year, a portion of the income from sales of GHI in S's territory is allocated to certain routine contributions made by S. The residual of the profit or loss from GHI sales in S's territory after the routine allocation step is divided between the controlled participants pro rata to their capital stocks allocable to S's territory. Each controlled participant's capital stock is computed by growing and amortizing (in the case of P) its historical expenditures regarding DEF allocable to S's territory and (in the case of S) its ongoing cost contributions towards developing GHI. The amortization of the capital stocks is effected on a straight-line basis over an assumed four-year life for the relevant expenditures. The capital stocks are grown using an assumed growth factor which P and S consider to be appropriate. Thus, the residual profit or loss from sales of GHI in S's territory is divided between P and S pro rata to P's capital stock in DEF attributable to S's territory and to S's capital stock from its cost contributions.

(iv) The assumption that all expenditures amortize on a straight-line basis over four years does not appropriately reflect the principle that as of the date of the PCT regarding DEF, every contribution to the development of GHI, including DEF is reasonably anticipated to have value throughout the entire period of exploitation of GHI as projected to continue through Year 10. Under this method as applied by P and S, P's capital stock in DEF, and therefore the amount of profit in S's territory allocated to P as a PCT Payment from S, will decrease every year. After Year 4, P's capital stock in DEF will necessarily be $0. Thus, under this method, P will receive none of the residual profit or loss from GHI sales in S's territory after Year 4 as a PCT Payment. As a result of this limitation of the PCT Payments to be made by S, the return to S's aggregate investment in the CSA is anticipated to be significantly higher than the appropriate discount rate for the CSA. This is not consistent with the investor model principle that S should anticipate a return to its aggregate investment in the CSA equal to the appropriate discount rate over the entire period of developing and exploiting GHI. The inconsistency of the method with the investor model materially lessens its reliability for purposes of a best method analysis. See § 1.482–1(c)(2)(ii)(B).

(ix) *Coordination of best method rule and form of payment*. A method described in paragraph (g)(1) of this section evaluates the arm's length amount charged in a PCT in terms of a form of payment (method payment form). For example, the method payment form for the income method described in paragraph (g)(4)(iii) or (iv) of this section is payment contingent on the exploitation of cost shared intangibles by the PCT Payor, and the method payment form for the market capitalization method is lump sum payment. The method payment form may not necessarily correspond to the form of payment specified pursuant to paragraphs (b)(3)(vi)(A) and (k)(2)(ii)(l) of this section (specified payment form). The determination under § 1.482–1(c) of the method that provides the most reliable measure of an arm's length result is to be made without regard to whether the respective method payment forms under the competing methods correspond to the specified payment form. If the method payment form of the method determined under § 1.482–1(c) to provide the most reliable measure of an arm's length result differs from the specified payment form, then the conversion from such method payment form to such specified payment form will be made on a reasonable basis to the satisfaction of the Commissioner. For purposes of the preceding sentence, if the method described in the documentation by the controlled participants pursuant to paragraph (k)(2)(ii)(J) of this section is determined under § 1.482–1(c) to provide the most reliable measure of an arm's length result, then the Commissioner will give due consideration whether the conversion from the method payment form to the specified payment form was made by the controlled participants on a reasonable basis.

(x) *Coordination of the valuations of prior and subsequent PCTs*—(A) *In general*. In cases where PCTs are required on different dates, coordination of the valuations of the prior and subsequent PCTs must be effected pursuant to a method that provides the most reliable measure of an arm's length result. Depending on the facts and circumstances, such as whether the external contributions that were the subject of the prior and subsequent PCTs were nonroutine contributions, an approach which may be appropriate would be to determine PCT Payments both for the prior and subsequent PCTs going forward from the date of the subsequent PCT pursuant to a residual profit split method, as described in paragraph (g)(7) of this section. Such application of the residual profit split method would include as nonroutine contributions all of the following: The external contribution(s) that were the subject of the prior PCT(s), the external contribution that is the subject of the subsequent PCT, and the interests of the controlled participants in the incremental cost shared intangible development resulting from the development activities under the CSA. Paragraph (g)(2)(x)(B) of this section specifies the appropriate coordination with a prior PCT in the case of a subsequent PCT the subject of which is a PFA.

(B) *Coordination with regard to PFAs*. PCT Payments for a subsequent PCT that is derived from a PFA are determined independently of any prior PCTs. Such PCT Payments will be treated, for purposes of the application of the method used for evaluating a prior PCT, the same as IDCs, the actual amounts of which may not correspond to those projected on the date of the prior PCT. A divergence between actual and anticipated IDCs does not require alteration in the application of the method used to value PCT Payments. Similarly, a subsequent PCT derived from a PFA will not require alteration in the application of the method used to value PCT Payments for a prior PCT.

(xi) *Proration of PCT Payments to the extent allocable to other business activities*. If a resource or capability that is the subject of a PCT is reasonably anticipated to contribute both to developing or exploiting cost shared intangibles and to other business activities of the PCT Payee (other than exploiting an existing intangible without further development), then to the extent it can be demonstrated that a portion of the value of the relevant PCT Payments otherwise determined under this section is attributable to such other business activities, the PCT Payments must be prorated. Such proration will be done on a reasonable basis in proportion to the relative economic value, as of the date of the PCT, reasonably anticipated to be derived from the resource or capability by the CSA Activity as compared to such other business activities of the PCT Payee. In the case of an aggregate valuation done under the principles of paragraph (g)(2)(v) of this section that includes payment for rights to exploit an existing intangible without further development, the prorated aggregate payments must take into account the economic value attributable to such exploitation rights as well. For purposes of the best method rule under § 1.482–1(c), the reliability of the analysis under a method that requires proration pursuant to this paragraph is reduced relative to the reliability of an analysis under a method that does not require proration.

(3) *Comparable uncontrolled transaction method*. The comparable uncontrolled transaction (CUT) method described in § 1.482–4(c), and the arm's length charge described in § 1.482–2(b)(3) (first sentence) based on a comparable uncontrolled transaction, may be applied to evaluate whether the amount charged in a PCT is arm's length by reference to the amount charged in a comparable uncontrolled transaction. When applied in the manner described in § 1.482–4(c), or where a comparable uncontrolled transaction provides the most reliable measure of the arm's length charge described in § 1.482–2(b)(3) (first sentence), the CUT method, or the arm's length charge in the comparable uncontrolled transaction, will typically yield an arm's length total value for the external contribution that is the subject of the PCT. That value must then be multiplied by each PCT Payor's respective RAB share in order to determine the arm's length PCT Payment due from each PCT Payor. The reliability of a CUT that yields a value for the external contribution only in the PCT Payor's territory will be reduced to the extent that value is not consistent with the total worldwide value of the external contribution multiplied by the PCT Payor's RAB share.

(4) *Income method*—(i) *In general*. The income method evaluates whether the amount charged in a PCT is arm's length by reference to the controlled participants' realistic alternatives to entering into a CSA.

(ii) *Determination of arm's length charge*—(A) *In general*. Under this method, 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. Paragraphs (g)(4)(iii) and (iv) of this section describe two specific applications of the income method, but do not exclude other possible applications of this method.

(B) *Example*. The following example illustrates the principles of this paragraph (g)(4)(ii):

Example. (i) USP, a U.S. manufacturer, has developed a new, lightweight fabric for sleeping bags. In Year 1 USP enters into a CSA with its wholly-owned foreign subsidiary, FSub, to develop an improved version of this fabric. Under the CSA, USP will own the rights to exploit improved versions of the fabric in the United States and FSub will own the rights to exploit improvements in the rest of the world (ROW). The rights to further develop the fabric are reasonably anticipated to contribute to the development of future improved versions and therefore the RT Rights in the fabric are external contributions for which compensation is due pursuant to a PCT. USP does not transfer the right to exploit its current fabric to FSub. FSub does not furnish any external contributions. If USP did not participate in the CSA, its next best realistic alternative would be to develop future versions of the fabric on its own, exploit those versions in the United States and license such versions for exploitation outside the United States to FSub. In Year 1, USP estimates that its present value of this alternative (including arm's length royalties on sales in the ROW) is $100 million. Under the CSA, USP projects U.S. sleeping bag sales with improved versions of the fabric to amount to $80 million (present value in Year 1). The costs (other than IDCs) plus the routine return to such costs associated with the U.S. sales are anticipated to be $10 million. USP's anticipated cost contributions under the CSA are $10 million (present value in Year 1). FSub projects that in the ROW, future sales should amount to $100 million (present value in Year 1).

(ii) An arm's length contingent PCT Payment under the income method is a sales-based royalty at a rate, p, such that the present value to USP of the next best realistic alternative is equal to the present value to USP of participating in the CSA. In other words, the rate is such that $100 million (value of licensing alternative) = $80 million (anticipated U.S. sales) − $10 million (anticipated costs, other than IDCs, plus routine return) − $10 million (anticipated cost contribution) + (p * $100 million (anticipated ROW sales)), or 40%. Accordingly, FSub should pay USP a royalty of 40% of actual ROW sales annually when the two begin to exploit future generations of the fabric.

(iii) *Application of income method using a CUT*—(A) *In general*. This application of the income method is typically used in cases where only one controlled participant furnishes nonroutine contributions, as described in paragraph (g)(7)(iii)(C)(*1*) of this section. This application assumes that the best reasonable alternative of the PCT Payee to entering into the CSA would be to develop the cost shared intangibles on its own, bearing all the IDCs itself, and then to license the cost shared intangibles to the other controlled participants.

(B) *Determination of arm's length charge*—(*1*) *In general*. An arm's length PCT Payment under this application of the income method is represented as an applicable rate on sales from exploiting the cost shared intangibles, determined as of the date of the PCT.

(*2*) *Applicable rate*. The applicable rate is equal to the alternative rate less the cost contribution adjustment.

(*3*) *Alternative rate*. The alternative rate is the constant rate the PCT Payee would charge an uncontrolled licensee over the period the cost shared intangibles are anticipated to be exploited if the PCT Payee had developed the cost shared intangibles on its own and licensed them to the uncontrolled licensee. The alternative rate is determined using the comparable uncontrolled transaction method, as described in § 1.482–4(c)(1) and (2).

(*4*) *Cost contribution adjustment*. The cost contribution adjustment is equal to a fraction, the numerator of which is the present value of the PCT Payor's total anticipated cost contributions and the denominator of which is the present value of the PCT Payor's total anticipated sales from exploiting the cost shared intangibles.

(C) *Example*. The following example illustrates the principles of this paragraph (g)(4)(iii):

Example. (i) USP, a software company, has developed version 1.0 of a new software application which it is currently marketing. In Year 1 USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the rights to exploit the future versions in the United States, and FS will have the rights to exploit them in the rest of the world (ROW). The future rights in version 1.0, and USP's development team, are reasonably anticipated to contribute to the development of future versions and therefore the RT Rights in version 1.0 are external contributions for which compensation is due from FS as part of a PCT. USP does not transfer the current exploitation rights in version 1.0 to FS. FS does not furnish any external contributions. FS anticipates sales of $100 million (present value in Year 1) in its territory and anticipates cost contributions of $40 million (present value in Year 1). The arm's length rate USP would have charged an uncontrolled licensee for a license of future versions of the software had USP further developed version 1.0 on its own is 60%, as determined under the comparable uncontrolled transaction method in § 1.482–4(c).

(ii) An arm's length contingent PCT Payment under the income method is an applicable rate equal to the alternative rate less the cost contribution adjustment. In this case the alternative rate is 60%, the arm's length rate determined under § 1.482–4(c). The cost contribution adjustment is 40%, the present value to FS of its anticipated cost contribution over the present value of its anticipated sales of future versions of the software, that is, $40 million / $100 million. The applicable rate, which represents an arm's length contingent PCT Payment, payable by the FS to USP on all actual ROW sales of the future versions of the software therefore is 20%, which is equal to the alternative rate of 60% less the cost contribution adjustment of 40%.

(iv) *Application of income method using CPM*—(A) *In general.* This application of the income method is typically used in cases where only one controlled participant furnishes nonroutine contributions. 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. This PCT Payment ensures that PCT Payors who do not furnish any external contributions subject to a PCT receive an appropriate ex ante risk adjusted return on their investment in the CSA.

(B) *Determination of arm's length charge based on sales*—(*1*) *In general.* An arm's length PCT Payment under this application of the income method is represented as an applicable rate on sales from exploiting the cost shared intangibles, determined as of the date of the PCT.

(*2*) *Applicable rate.* The applicable rate is equal to the alternative rate less the cost contribution adjustment.

(*3*) *Alternative rate.* The alternative rate is determined using the comparable profits method described in § 1.482–5 and is estimated as a fraction. The numerator of the fraction is the present value of the PCT Payor's total anticipated territorial operating profit, as defined in paragraph (j)(1)(vi) of this section, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory. The denominator of the fraction is the discounted present value of the PCT Payor's total anticipated sales from exploiting the cost shared intangibles.

(*4*) *Cost contribution adjustment.* The cost contribution adjustment is equal to a fraction the numerator of which is the present value of the PCT Payor's total anticipated cost contributions and the denominator of which is the present value of the PCT Payor's total anticipated sales from exploiting the cost shared intangibles.

(C) *Determination of arm's length charge based on profit*—(*1*) *In general.* An arm's length PCT Payment under this application of the income method may also be represented as an applicable rate on territorial operating profit, as defined in paragraph (j)(1)(vi) of this section, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory. This is done following the calculations described in paragraph (g)(4)(iv)(B) of this section, substituting anticipated territorial operating profit, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory, wherever anticipated sales appear in the calculations.

(*2*) *Alternative rate.* Substituting territorial operating profits, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory, for sales in the calculation of the alternative rate results in a fraction with both a numerator and denominator equal to the present value of the PCT Payor's total anticipated territorial operating profit, as defined in paragraph (j)(1)(vi) of this section, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory. Therefore the alternative rate under this application is 1, or 100%.

(*3*) *Cost contribution adjustment.* Substituting territorial operating profit, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory, for sales results in a cost contribution adjustment equal to a fraction the numerator of which is the present value of the PCT Payor's total anticipated cost contributions and the denominator of which is the present value of the PCT Payor's total anticipated territorial operating profit, as defined in paragraph (j)(1)(vi) of this section, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory.

(D) *Example.* The following example illustrates the principles of this paragraph (g)(4)(iv):

Example. (i) USP, a U.S. pharmaceutical company, invests in research and development to begin developing a vaccine for disease K. In Year 1, USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to complete the development of the vaccine. Under the CSA, USP will have the rights to exploit the vaccine in the United States, and FS will have the rights to exploit it in the rest of the world. The partially developed vaccine owned by USP, and USP's development team, are reasonably anticipated to contribute to the development of the final vaccine and therefore the RT Rights in the vaccine and the development team are external contributions for which compensation is due from FS as part of a PCT. FS does not furnish any external contributions. The total anticipated IDCs under the CSA are $100 million (in Year 1 dollars). USP and FS each have total projected sales of $100 million (in Year 1 dollars) of the vaccine, which they use as the basis for determining RAB shares. Accordingly, they divide the development costs based on 50/50 RAB shares, $50 million (in Year 1 dollars) paid by each participant. Based on an analysis under the comparable profits method under § 1.482–5, FS's anticipated territorial operating profit, as reduced by a market return for its routine contributions to exploiting the vaccine in its territory, is $80 million (in Year 1 dollars).

(ii) An arm's length contingent PCT Payment under the income method is an applicable rate equal to the alternative rate less the cost contribution adjustment. In this case the alternative rate is 80% (($80 million territorial operating profit/$100 million sales). The cost contribution adjustment is 50%, the present value to FS of its anticipated cost contributions over the present value of its anticipated sales of the vaccine, that is, $50 million/$100 million. The applicable rate, which represents an arm's length contingent PCT Payment, payable by the FS to the USP over the period the vaccine is exploited therefore is 30%, which is equal to the alternative rate of 80% less the cost contribution adjustment of 50%.

(iii) An arm's length contingent PCT Payment based on territorial operating profits under the income method is an applicable rate equal to the alternative rate less the cost contribution adjustment. In this case the alternative rate is 100% (($80 million territorial operating profit /$80 million territorial operating profit). The cost contribution adjustment is 62.5%, the present value to FS of its anticipated cost contributions over the present value of its anticipated territorial profits from sales of the vaccine, that is, $50 million/$80 million. The applicable rate on territorial operating profit, which represents an arm's length contingent PCT Payment, payable by the FS to the USP over the period the vaccine is exploited therefore is 37.5%, which is equal to the alternative rate of 100% less the cost contribution adjustment of 62.5%.

(v) *Routine external contributions.* For purposes of this paragraph (g)(4), any routine contributions that are external contributions (routine external contributions), the valuation and PCT Payments for which are determined and made independently of the income method, are treated similarly to cost contributions. Accordingly, wherever the term cost contributions appears in this paragraph (g)(4) it shall be read to include net routine external contributions. Net routine external contributions are defined as a controlled participant's total anticipated routine external contributions, plus its anticipated PCT Payments to other controlled participants in respect of their routine external contributions, minus the anticipated PCT Payments it is to receive from other controlled participants in respect of its routine external contributions.

(vi) *Comparability and reliability considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result. Consistent with those considerations, the reliability of applying the income method as a measure of the arm's length charge for a PCT Payment is typically less reliable to the extent that more than one controlled participant furnishes nonroutine contributions.

(B) *Application of the income method using a CUT.* If the income method is applied using a CUT, as described in paragraph (g)(4)(iii) of this section, any additional comparability and reliability considerations stated in § 1.482–4(c)(2) may apply.

(C) *Application of the income method using CPM.* If the income method is applied using CPM, as described in paragraph (g)(4)(iv) of this section, any additional comparability and reliability considerations stated in § 1.482–5(c) apply.

(5) *Acquisition price method*—(i) *In general.* The acquisition price method applies the comparable uncontrolled transaction method of § 1.482–4(c), or the arm's length charge described in § 1.482–2(b)(3)(first sentence) based on a comparable uncontrolled transaction, to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction. The acquisition price method is ordinarily used only where substantially all the target's nonroutine contributions (as described in paragraph (g)(7)(iii)(C)(*1*) of this section) to the PCT Payee's business activities are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under this method, the arm's length charge for a PCT or group of PCTs covering resources and capabilities of the target is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares.

(iii) *Adjusted acquisition price.* The adjusted acquisition price 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.

(iv) *Reliability and comparability considerations.* The comparability and reliability considerations stated in § 1.482–4(c)(2) apply. Consistent with those considerations, the reliability of applying the acquisition price method as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the target's nonroutine contributions to the PCT Payee's business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued; or

(B) A substantial portion of the target's assets consists of tangible property that cannot reliably be valued.

(v) *Example.* The following example illustrates the principles of this paragraph (g)(5):

Example. USP, a U.S. corporation, and its newly incorporated, wholly-owned foreign subsidiary (FS) enter into a CSA in Year 1 to develop Group Z products. Under the CSA, USP and FS will have the exclusive rights to exploit the Group Z products in the U.S. and the rest of the world, respectively. Based on RAB shares, USP will bear 60% and FS will bear 40% of the costs incurred during the term of the agreement. USP acquires Company X in Year 2 for cash consideration worth $110 million. Company X joins in the filing of a U.S. consolidated income tax return with USP. Under paragraph (j)(2)(i) of this section, Company X and USP are treated as one taxpayer. Accordingly, the RT Rights in any of Company X's resources and capabilities that are reasonably anticipated to contribute to the development activities of the CSA will be considered external contributions furnished by USP. Company X's resources and capabilities consist of its workforce, certain technology intangibles, $15 million of tangible property and other assets and $5 million in liabilities. The technology intangibles, as well as Company X's workforce, are reasonably anticipated to contribute to the development of the Group Z products under the CSA and therefore the RT Rights in the technology intangibles and the workforce are external contributions by way of a PFA for which FS must make a PCT

Payment to USP. None of Company X's existing intangible assets or any of its workforce are anticipated to contribute to activities outside the CSA. Applying the acquisition price method, the value of USP's external contributions is the adjusted acquisition price $100 million ($110 million acquisition price plus $5 million liabilities less $15 million tangible property and other assets). FS must make a PCT Payment to USP for these external contributions in an amount of $40 million, which is the product of $100 million (the value of the external contributions) and 40% (FS's RAB share).

(6) *Market capitalization method*—(i) *In general.* The market capitalization method applies the comparable uncontrolled transaction method of § 1.482–4(c), or the arm's length charge described in § 1.482–2(b)(3)(first sentence) based on a comparable uncontrolled transaction, to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the average market capitalization of a controlled participant (PCT Payee) whose stock is regularly traded on an established securities market. The market capitalization method is ordinarily used only where substantially all of the PCT Payee's nonroutine contributions (as described in paragraph (g)(7)(iii)(C)(*1*) of this section) to the PCT Payee's business are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* 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.

(iii) *Average market capitalization.* 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. The daily market capitalization of the PCT Payee is calculated on each day its stock is actively traded as the total number of shares outstanding multiplied by the adjusted closing price of the stock on that day. The adjusted closing price is the daily closing price of the stock, after adjustments for stock-based transactions (dividends and stock splits) and other pending corporate (combination and spin-off) restructuring transactions for which reliable arm's length adjustments can be made.

(iv) *Adjusted average market capitalization.* 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 of any other resources and capabilities of the PCT Payee not covered by a PCT or group of PCTs.

(v) *Reliability and comparability considerations.* The comparability and reliability considerations stated in § 1.482–4(c)(2) apply. Consistent with those considerations, the reliability of applying the comparable uncontrolled transaction method using the adjusted market capitalization of a company as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the PCT Payee's nonroutine contributions to its business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued;

(B) A substantial portion of the PCT Payee's assets consists of tangible property that cannot reliably be valued; or

(C) Facts and circumstances demonstrate the likelihood of a material divergence between the average market capitalization of the PCT Payee and the value of its resources and capabilities for which reliable adjustments cannot be made.

(vi) *Examples.* The following examples illustrate the principles of this paragraph (g)(6):

Example 1. (i) USP, a publicly traded U.S. company, and its newly incorporated wholly-owned foreign subsidiary (FS) enter into a CSA on Date 1 to develop software. Under the CSA, USP and FS will have the exclusive rights to exploit all future generations of the software in the United States and the rest of the world, respectively. Based on RAB shares, USP will bear 70% and FS will bear 30% of the costs incurred during the term of the CSA. USP's assembled team of researchers and its entire existing and in-process software are reasonably anticipated to contribute to the development of the software under the CSA and the RT Rights in the research team and existing and in-process software are therefore external contributions for which compensation is due from FS. USP separately enters into a license agreement with FS for make-and-sell rights for all existing software in the rest of the world. This license of current make-and-sell rights is a transaction that is governed by § 1.482–4. However, after analysis, it is determined that the PCT Payments and the arm's length payments for the make-and-sell license may be most reliably determined in the aggregate using the market capitalization method, under principles described in paragraph (g)(2)(v) of this section.

(ii) On Date 1, USP had an average market capitalization of $205 million, tangible property and other assets that can be reliably valued worth $5 million and no liabilities. Applying the market capitalization method, the aggregate value of USP's external contributions and the make-and-sell rights in its existing software is $200 million ($205 million average market capitalization of USP less $5 million of tangible property and other assets). The total arm's length value of the PCT Payments and license payments FS must make to USP for the external contributions and current make-and-sell rights is $60 million, which is the product of $200 million (the value of the external contributions and the make-and-sell rights) and 30% (FS's share of anticipated benefits of 30%).

Example 2. The facts are the same as *Example 1* except that USP also makes significant nonroutine contributions that are difficult to value to several other mature business divisions it operates that are not reasonably anticipated to contribute software development that is the subject of the CSA and are therefore not external contributions and accordingly not required to be covered by a PCT. The reliability of using the market capitalization method to determine the value of USP's external contributions to the CSA is significantly reduced in this case because it would require adjusting USP's average market capitalization to account for the significant nonroutine contributions that are not required to be covered by a PCT.

(7) *Residual profit split method*—(i) *In general.* The residual profit split method evaluates whether the allocation of combined operating profit or loss attributable to one or more external contributions subject to a PCT is arm's length by reference to the relative value of each controlled participant's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled participants for which data are available that include the developing and exploiting of cost shared intangibles (relevant business activity). The residual profit split method may not be used where only one controlled participant makes significant nonroutine contributions to the development and exploitation of the cost shared intangibles. The provisions of § 1.482–6 shall apply to CSAs only to the extent provided and as modified in this paragraph (g)(7). Any other application to a CSA of a residual profit method not described below will constitute an unspecified method for purposes of sections 482 and 6662(e) and the regulations thereunder.

(ii) *Appropriate share of profits and losses.* The relative value of each controlled participant's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of § 1.482–1(d)(3). Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled participants engaged in the relevant business activity. The profit allocated to any particular controlled participant is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one controlled participant may earn a profit while another controlled participant incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion.

(iii) *Profit split*—(A) *In general.* Under the residual profit split method, each controlled participant's territorial operating profit or loss, as defined in paragraph (j)(1)(vi) of this section, is allocated between the controlled participants that each furnish significant nonroutine contributions to the relevant business activity in that territory following the three step process set forth in paragraphs (g)(7)(iii)(B) and (C) of this section.

(B) *Allocate income to routine contributions other than cost contributions.* The first step allocates an amount of income to each controlled participant that is subtracted from its territorial operating profit or loss to provide a market return for the controlled participant's routine contributions (other than cost contributions) to the relevant business activity in its territory. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned or provided by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled participants. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§ 1.482–3, 1.482–4, and1.482–5, or with the arm's length charge described in § 1.482–2(b)(3) (first sentence) based on a comparable uncontrolled transaction.

(C) *Allocate residual profit*—(*1*) *In general.* The allocation of income to each controlled participant's routine contributions in the first step will not reflect profit or loss attributable to that controlled participant's cost contributions, nor reflect the profit or loss attributable to any controlled participant's nonroutine contributions to the relevant business activity. Nonroutine contributions include nonroutine external contributions, and other nonroutine contributions, to the relevant business activity in the relevant territory. The residual territorial profit or loss after the allocation of income in the first step in paragraph (g)(7)(iii)(B) of this section is further allocated under the second and third steps in paragraphs (g)(7)(iii)(C)(*2*) and (*3*) of this section.

(*2*) *Cost contribution share of residual profit or loss.* Under the second step, a portion of each controlled participant's residual territorial profit or loss after the first step allocation is allocated to that controlled participant's cost contributions (cost contribution share). A controlled participant's cost contribution share is equal to the following fraction of such residual territorial profit or loss. The numerator is the present value, determined as of the relevant date, of the summation, over the entire period of developing and exploiting cost shared intangibles, of the total value of such controlled participant's total anticipated cost contributions. The denominator is the present value, determined as of the relevant date, of the summation, over the same period, of such controlled participant's total anticipated territorial operating profits, as defined in paragraph (j)(1)(vi) of this section, reduced by a market return for the routine contributions (other than cost contributions) to the relevant business activity in the relevant territory. For these purposes, the relevant date is the date of the PCTs.

(*3*) *Nonroutine contribution share of residual profit or loss.* Under the third step, the remaining share of each controlled participant's residual territorial profit or loss after the first and second step allocations generally should be divided among all of the controlled participants based upon the relative value, determined as of the date of the PCTs, of their nonroutine contributions to the relevant business activity in the relevant territory. The relative value of the nonroutine contributions of each controlled participant may be measured by external market benchmarks that reflect the fair market value of such nonroutine contributions. Alternatively, the relative value of nonroutine contributions may be estimated by the capitalized cost of developing the nonroutine contributions and updates, as appropriately grown or discounted so that all contributions may be valued on a comparable dollar basis as of the same date. If the nonroutine contributions by a controlled participant are also used in other business activities (such as the exploitation of make-or-sell rights described in paragraph (c) of this section), an allocation of the value of the nonroutine contributions must be made on a reasonable basis among all the business activities in which they are used in proportion to the relative economic value that the relevant business activity and such other business activities are anticipated to derive over time as the result of such nonroutine contributions.

(*4*) *Determination of PCT Payments.* Any amount of a controlled participant's territorial operating profit or loss that is allocated to another controlled participant's external contributions to the relevant business activity in the relevant territory under the third step represents the amount of the PCT Payment due to that other controlled participant for its such external contributions.

(*5*) *Routine external contributions.* For purposes of this paragraph (g)(7), routine external contributions, the valuation and PCT Payments for which are determined and made independently of the residual profit split method, are treated similarly to cost contributions. Accordingly, wherever used in this paragraph (g)(7), the term routine contribution shall not be read to include routine external contributions and the term cost contribution shall be read to include net routine external contributions, as defined in paragraph (g)(4)(v) of this section.

(iv) *Comparability and reliability considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result. The application of these factors to the residual profit split in the context of the relevant business activity of developing and exploiting cost shared intangibles is discussed in paragraphs (g)(7)(iv)(B), (C), and (D) of this section.

(B) *Comparability.* The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions.

(C) *Data and assumptions.* The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets between the relevant business activity and the controlled participants' other activities will affect the reliability of the determination of the territorial operating profit and its allocation among the controlled participants. See § 1.482–6(c)(2)(ii)(C)(*1*);

(*2*) The degree of consistency between the controlled participants and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. See § 1.482–6(c)(2)(ii)(C)(*2*); and

(*3*) The reliability of the data used and the assumptions made in valuing the nonroutine contributions by the controlled participants. In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. In any given case, the costs of developing the intangible may not be related to its market value. In addition, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled participant's other activities, which may affect the reliability of the analysis.

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, and 1.482–5, or with the arm's length charge described in § 1.482–2(b)(3) (first sentence) based on a comparable uncontrolled transaction, the first step of the residual profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled participants and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the third step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all the controlled participants are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all the controlled participants is affected by the reliability of the data and the assumptions pertaining to each controlled participant. Thus, if the data and assumptions are significantly more reliable with respect to one of the controlled participants than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(v) *Example.* The following example illustrates the principles of this paragraph (g)(7):

Example. (i) USP, a U.S. nanotech company, has partially developed technology for nanomotors which are used to provide mobility for nanodevices. At the same time, USP's wholly-owned subsidiary, FS, a foreign nanotech company, has partially developed technology for nanosensors which provide sensing capabilities for nanodevices. At the beginning of Year 1, USP enters into a CSA with FS to develop NanoBuild, a technology which will be used to build a wide range of fully functioning nanodevices. The partially developed nanomotor and nanosensor technologies owned by USP and FS, respectively, are reasonably anticipated to contribute to the development of NanoBuild and therefore the RT Rights in the nanomotor and nanosensor technologies constitute external contributions of USP and FS for which compensation is due under PCTs. Under the CSA, USP will have the right to exploit NanoBuild in the United States, while FS will have the right to exploit NanoBuild in the rest of the world. USP's and FS's RAB shares are 40% and 60% respectively.

(ii) The present value of the total projected IDCs for the CSA is $10 billion (as of the date of the PCTs). Based on RAB shares, USP expects to bear 40%, or $4 billion, of these IDCS and FS expects to bear 60%, or $6 billion. For accounting purposes, USP and FS project a combined operating profit from exploitation of the NanoBuild of $11 billion (in Year 1 dollars), taking into account the $10 billion of projected IDCs. However, for purposes of applying the residual profit split method, combined operating profit is determined without taking into account IDCs. Therefore, USP and FS redetermine their combined operating profits for purposes of the residual profit split method to equal $21 billion (adding $10 billion of IDCs back to the accounting profit of $11 billion). Of this amount, 40% or $8.4 billion is expected to be generated by USP in the U.S. and 60% or $12.6 billion is expected to be generated by FS in the rest of the world.

(iii) USP and FS each undertake routine distribution activities in their respective markets that constitute routine contributions to the relevant business activity of exploiting NanoBuild. They estimate that the total market return (costs plus a market return on those costs) on these routine contributions will amount to $1 billion, (in Year 1 dollars). Of this amount, USP's anticipated routine return is $400 million and FS's anticipated routine return is $600 million. After deducting the routine return, USP's total anticipated residual operating profit is $8 billion ($8.4 billion–$0.4 billion) and FS's total anticipated residual operating profit equals $12 billion ($12.6 billion–$0.6 billion).

(iv) After analysis, USP and FS determine that the relative values of the nanomotor and nanosensor technologies are most reliably measured by their respective capitalized costs of development. Some of the factors considered in this analysis include the similar nature and success, and the relatively contemporaneous timing, of the nanoengineering research done to develop both the nanometer and nanosensor technologies and the lack of external market benchmarks. The capitalized costs of the nanomotor and nonsensor technologies are $3 billion and $5 billion, respectively.

(v) Under the residual profit split method, in each taxable year USP and FS will allocate the operating income they each separately report in their territory (territorial operating income) between their routine contributions, their cost contribution share and their nonroutine contributions, in this case the nanomotor and nanosensor technologies.

(vi) In step one of the residual profit split, USP and FS each allocate an amount of income that is subtracted from their actual territorial operating income for the taxable year to provide a market return for their actual routine contributions in that year.

(vii) In step two, a portion of residual territorial operating profit or loss after accounting for the allocation of income to routine contributions in step one, will be allocated by USP and FS to their cost contribution shares. The percentage allocable to the cost contribution share in this case is equal to the each participant's share of total anticipated IDCs divided by the difference between its total anticipated operating profits in its territory and the total anticipated routine return in its territory. It follows that the cost contribution shares of USP and FS are as follows: USP = 50% ($4 billion/$8 billion) and FS = 50% ($6 billion/$12 billion).

(viii) In step three, USP and FS each allocate a portion of their residual territorial operating income remaining after application of steps one and two between their respective nonroutine contributions. USP and FS have estimated relative values for USP's nanomotor technology at $3 billion and FS's nanosensor technology at $5 billion. The percentage of each participant's residual territorial operating income that is allocated to the nanomotor technology is therefore 37.5% ($3 billion/($3 billion + $5 billion)) and the percentage allocated to the nanosensor technology is 62.5% ($5 billion/($3 billion + $5 billion)).

(ix) USP will owe a PCT Payment to FS equal to the amount of its territorial operating profit or loss that is allocated in step three to FS's nanosensor technology and FS will owe a PCT Payment to USP equal to the amount of its territorial operating iprofit or loss that is allocated in step three to USP's nanomotor technology. The PCT Payments owed each year by USP and FS, respectively, will be netted against each other, so that only one participant will make a net PCT Payment.

(8) *Unspecified methods.* Methods not specified in paragraphs (g)(3) through (7) of this section may be used to evaluate whether the amount charged for a PCT is arm's length. Any method used under this paragraph (g)(8) must be applied in accordance with the provisions of § 1.482–1 and of paragraph (g)(2) of this section. 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 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. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482–1(c). In accordance with § 1.482–1(d) (Comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 2. The facts are the same as in *Example 1,* except that in Year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and adjusted benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the controlled participants. The Commissioner concludes that the projected benefit shares were unreliable, and uses adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 3. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a CSA in Year 1. They project that they will begin to receive benefits from covered intangibles in Years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In Years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the controlled participants' projections, the Commissioner compares the adjusted benefit shares to the projected benefit shares. Although USP's adjusted benefit share (50%) is within 20% of its projected benefit share (60%), FS's adjusted benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the Commissioner may conclude that the controlled participants' projections were not reliable and may use adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

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

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

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

SALES

[In millions of dollars]

Year	USS	FP
1	5	10
2	20	20
3	30	30
4	40	40
5	40	40
6	40	40
7	40	40
8	20	20
9	10	10
10	5	5

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

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

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

SALES

[In millions of dollars]

Year	USS	FP
1	0	17
2	17	35
3	25	41
4	38	41
5	39	41

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

Example 7. (i) The facts are the same as in *Example 6*, except that the actual sales results through Year 5 are as follows:

SALES

[In millions of dollars]

Year	USS	FP
1	0	17
2	17	35
3	25	44
4	34	54
5	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the Commissioner determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

Year	USS	FP
6	36	55
7	36	55
8	18	28
9	9	14
10	4.5	7

(iii) Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and

$229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These adjusted benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were unreliable. The Commissioner adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

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

(3) *PCT allocations.* The Commissioner may make allocations to adjust the results of a PCT so that the results are consistent with an arm's length result in accordance with the provisions of the applicable sections of the section 482 regulations, as determined pursuant to paragraph (a)(2) of this section.

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

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

(6) *Periodic adjustments*—(i) *In general.* Subject to the exceptions in paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments with respect to all PCT Payments for an open taxable year (the Adjustment Year), and for all subsequent taxable years for the duration of the CSA Activity, if the Commissioner determines that, for a particular PCT (the Trigger PCT), a particular controlled participant that owes or owed a PCT Payment relating to that PCT (the PCT Payor) has realized an Actually Experienced Return Ratio (AERR) that is outside the Periodic Return Ratio Range (PRRR). The satisfaction of the condition stated in the preceding sentence is referred to as a Periodic Trigger. See paragraph (i)(6)(ii) through (vi) of this section regarding the PRRR, the AERR, and periodic adjustments. In determining whether to make such adjustments, the Commissioner may consider whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances, including any information known as of the Determination Date. The Determination Date is the date of the relevant determination by the Commissioner. The failure of the Commissioner to determine for an earlier taxable year that a PCT Payment was not arm's length will not preclude the Commissioner from making a periodic adjustment for a subsequent year. A periodic adjustment under this paragraph may be made without regard to whether the taxable year of the Trigger PCT or any other PCT remains open for statute of limitations purposes.

(ii) *PRRR.* Except as provided in the next sentence, the PRRR will consist of return ratios that are not less than ½ nor more than 2. Alternatively, if the controlled participants have not substantially complied with the documentation requirements referenced in paragraph (k) of this section, as modified, if applicable, by paragraph (m)(3) of this section, the PRRR will consist of the return ratios that are not less than .67 nor more than 1.5.

(iii) *AERR.* (A) *In general.* The AERR is the Present Value of Total Profits (PVTP) divided by the Present Value of Investment (PVI). In computing PVTP and PVI, present values are computed using the Applicable Discount Rate (ADR), and all information available as of the Determination Date is taken into account.

(B) *PVTP.* The PVTP is the present value, as of the earliest date that any IDC described in paragraph (d)(1) of this section occurred (the CSA Start Date), of the PCT Payor's actually experienced territorial operating profits, as defined in paragraph (j)(1)(vi) of this section, from the CSA Start Date through the end of the Adjustment Year.

(C) *PVI.* The PVI is the present value, as of the CSA Start Date, of the PCT Payor's investment associated with the CSA Activity, defined as the sum of its cost contributions and its PCT Payments, from the CSA Start Date through the end of the Adjustment Year. For purposes of computing the PVI, PCT Payments means all PCT Payments due from a PCT Payor before netting against PCT Payments due from other controlled participants.

(iv) *ADR*—(A) *In general.* Except as provided in paragraph (i)(6)(iv)(B) of this section, the ADR is the discount rate pursuant to paragraph (g)(2)(vi) of this section, subject to such adjustments as the Commissioner determines appropriate.

(B) *Publicly traded companies.* If the PCT Payor meets the conditions of paragraph (i)(6)(iv)(C) of this section, the ADR is the PCT Payor WACC as of the date of the trigger PCT. However, if the Commissioner determines, or the controlled participants establish to the Commissioner's satisfaction, that a discount rate other than the PCT Payor WACC better reflects the degree of risk of the CSA Activity as of such date, the ADR is such other discount rate.

(C) *Publicly traded.* A PCT Payor meets the conditions of this paragraph (i)(6)(iv)(C) if—

(*1*) Stock of the PCT Payor is publicly traded; or

(*2*) Stock of the PCT Payor is not publicly traded, provided—

(*i*) The PCT Payor is included in a group of companies for which consolidated financial statements are prepared; and

(*ii*) A publicly traded company in such group owns, directly or indirectly, stock in PCT Payor. Stock of a company is publicly traded within the meaning of this paragraph (i)(6)(iv)(C) if such stock is regularly traded on an established United States securities market and the company issues financial statements prepared in accordance with United States generally accepted accounting principles for the taxable year.

(D) *PCT Payor WACC.* The PCT Payor WACC is the WACC of the PCT Payor or the publicly traded company described in paragraph (i)(6)(iv)(C)(*2*) of this section, as the case may be.

(E) *Generally accepted accounting principles.* For purposes of paragraph (i)(6)(iv)(C) of this section, a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that the amounts of debt, equity and interest expense are reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets.

(v) *Determination of periodic adjustments.* In the event of a Periodic Trigger, subject to paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments with respect to all PCT Payments between all PCT Payors and PCT Payees for the Adjustment Year and all subsequent years for the duration of the CSA Activity pursuant to the residual profit split method as provided in paragraph (g)(7) of this section, subject to the further modifications in this paragraph (i)(6)(v).

(A) If the AERR is less than the PRRR, then the cost contribution share of residual profit or loss under paragraph (g)(7)(iii)(C)(*2*) of this section is determined as follows:

(*1*) The relevant date specified in that paragraph is the CSA Start Date. However, the effect of using such relevant date is modified as specified in paragraphs (i)(6)(vi)(A)(*2*) and (i)(6)(vi)(A)(*3*) of this section.

(*2*) The discount rate to be used in paragraph (g)(7)(iii)(C)(*2*) of this section is determined as of the relevant date, but taking into account any data relevant to such determination that may become available up through the Determination Date.

(*3*) The present values of the summations described in paragraph (g)(7)(iii)(C)(*2*) of this section are determined by substituting actual results up through the Determination Date, and future results anticipated on that date, for the results anticipated on the relevant date. It is possible that, because of these substitutions, the resulting fraction determined in that paragraph will be greater than one.

(B) If the AERR is greater than the PRRR, then the cost contribution share of residual profit or loss under paragraph (g)(7)(iii)(C)(*2*) of this section is determined as follows:

(*1*) The relevant date specified in that paragraph is the first day of the Adjustment Year. However, the effect of using such relevant date is modified as specified in paragraphs (i)(6)(vi)(B)(*2*) and (i)(6)(vi)(B)(*3*) of this section.

(*2*) The discount rate to be used in paragraph (g)(7)(iii)(C)(*2*) of this section is determined as of the relevant date, but taking into account any data relevant to such determination that may become available up through the Determination Date.

(*3*) In computing the fraction described in paragraph (g)(7)(iii)(C)(*2*) of this section, the summation period described in that paragraph is modified to start on the first day of the Adjustment Year; thus, the summations described in that paragraph that are used to determine that fraction will not include any items relating to periods before the first day of the Adjustment Year.

(C) The relative value of nonroutine contributions in paragraph (g)(7)(iii)(C)(*3*) of this section are determined as described in that paragraph, but taking into account any data relevant to such determination that may become available up through the Determination Date.

(D) For these purposes, the residual profit split method may be used even where only one controlled participant makes significant nonroutine contributions to the CSA Activity. If only one controlled participant provides all the external contributions and other nonroutine contributions, then the third step residual profit or loss belongs entirely to such controlled participant.

(vi) *Exceptions to periodic adjustments*—(A) *Transactions involving the same external contribution as in the PCT.* If—

(*1*) The same external contribution is furnished to an uncontrolled taxpayer under substantially the same circumstances as those of the relevant RT (as defined in paragraph (b)(3)(iii) of this section) and with a similar form of payment as the PCT;

(*2*) This transaction serves as the basis for the application of the comparable uncontrolled transaction method described in § 1.482–4(c), or the arm's length charge described in § 1.482–2(b)(3)(first sentence) based on a comparable uncontrolled transaction, in the first year in which substantial PCT Payments relating to this PCT were required to be paid; and

(*3*) The amount of those PCT Payments in that year was arm's length; then no periodic adjustment that uses that PCT as the Trigger PCT will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section.

(B) *Results not reasonably anticipated.* If the controlled participants establish to the satisfaction of the Commissioner that the differential between the AERR and the nearest bound of the PRRR is due to extraordinary events beyond its control and that could not reasonably have been anticipated at the time of the Trigger PCT, then no periodic adjustment will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section.

(C) *Reduced AERR does not cause Periodic Trigger.* If the controlled participants establish to the satisfaction of the Commissioner that the Periodic Trigger would not have occurred had the PCT Payor's operating profits used to calculate its PVTP excluded those operating profits attributable to the PCT Payor's routine contributions to its exploitation of cost shared intangibles, and nonroutine contributions to the CSA Activity, then no periodic adjustment will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section.

(D) *Increased AERR does not cause Periodic Trigger*—(*1*) If the controlled participants establish to the satisfaction of the Commissioner that the Periodic Trigger would not have occurred had the operating profits of the PCT Payor used to calculate its PVTP included its reasonably anticipated operating profits after the Adjustment Year from the CSA Activity, including from routine contributions to that activity, and had the cost contributions and PCT Payments of the PCT Payor used to calculate its PVI included its reasonably anticipated cost contributions and PCT Payments after the Adjustment Year, then no periodic adjustment will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section. The reasonably anticipated amounts in the previous sentence are determined based on all information available as of the Determination Date.

(*2*) For purposes of this paragraph (i)(6)(vii)(D) of this section, the controlled participants may, if they wish, assume that the average yearly operating profits for all taxable years prior to and including the Adjustment Year, in which there has been substantial exploitation of cost shared intangibles resulting from the CSA (exploitation years), will continue to be earned in each year over a period of years equal to 15 minus the number of exploitation years prior to and including the Determination Date.

(E) *10-year period.* If the AERR determined is within the PRRR for each year of the 10-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA is, then no periodic adjustment in a subsequent year will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section.

(F) *5-year period.* For any year of the 5-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, no Periodic Trigger will be considered to occur as a result of a determination that the AERR falls below the lower bound of the PRRR.

(vii) *Examples.* The following examples illustrates the principles of this paragraph (i)(6):

Example 1. (i) At the beginning of Year 1, USP, a publicly traded U.S. company, and FS, its wholly-owned foreign subsidiary, enter into a CSA to develop new technology for wireless cell phones. As part of a PCT, USP furnishes an external contribution, the RT Rights for an in-process technology that when developed will improve the clarity of cell to cell calls, for which compensation is due from FS. FS furnishes no external contributions to the CSA. The weighted average cost of capital of the controlled group that includes USP and FS in Year 1 is 15%. In Year 10, the Commissioner audits Years 1 through 8 of the CSA to determine whether or not any periodic adjustments should be made. USP and FS have substantially complied with the documentation requirements of this section.

(ii) FS derives the following actual cash flow from its participation in the CSA. The cash flows include the lump sum PCT of $100 million made by FS to USP. The derivation of such PCT Payment was based on financial projections undertaken in Year 1 (not shown). (All amounts in this table and the tables that follow are in millions.)

Year	Sales	Non-IDC costs	IDCs	PCT payments	Total inv. costs	Operating profits (accounting)	Exploitation profits	AERR
1	0	0	15	100	115	−115	0	
2	0	0	17	0	17	−17	0	
3	0	0	18	0	18	−18	0	
4	780	562	20	0	20	198	218	
5	936	618	22	0	22	296	318	
6	1,123	680	24	0	24	420	444	
7	1,179	747	27	0	27	405	432	
8	1,238	822	29	0	29	387	416	
NPV through Year 5	1,048	722	69	100	169	157	326	1.9
NPV through Year 6	1,606	1,060	81	100	181	365	546	3.0
NPV through Year 7	2,116	1,383	92	100	192	541	733	3.8

(iii) Because USP is publicly traded in the United States and is a member of the controlled group to which the PCT Payor, FS, belongs, for purposes of calculating the AERR for FS, the present values of its PVTP and PVI are determined using an ADR of 15%, the weighted average cost of capital of the controlled group. At a 15% discount rate, the PVTP, calculated in Year 8 as of Year 1, and based on actual profits realized by FS through Year 7 from exploiting the new wireless cell phone technology developed by the CSA, is $733 million. The PVI, based on FS's IDCs and its compensation expenditures pursuant to the PCT, is $192 million. The AERR for FS is equal to its PVTP divided by its PVI, $733 million/$192 million, or 3.8. There is a Periodic Trigger because FS's AERR of 3.8 falls outside the PRRR of ½ to 2, the applicable PRRR for controlled participants complying with the documentation requirements of this section.

(iv) At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 3.0. It is also determined that none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. It follows that the arm's length PCT Payments made by FS from Year 6 forward shall be determined each taxable year using the residual profit split method described in paragraph (g)(7) of this section as modified by paragraph (i)(6)(v) of this section. Periodic adjustments will be made to the extent the PCT Payments actually made by FS differ from the PCT Payment calculation under the residual profit split.

(v) Actual and projected IDCs, territorial operating profits and returns to routine contributions for the remainder of the exploitation of the cost shared intangibles, determined as of the beginning of Year 6 are as follows:

Year	IDCs	Territorial operating profits	Return to routine contributions	Profits less routine return
6	24	444	68	376
7	27	432	75	357
8	29	416	82	334
9 (Projected)	32	396	90	305
10 (Projected)	35	370	99	271
Total PV as of Year 6	116	1666	326	1340

(vi) Under step one of the residual profit split method, for each taxable year, FS will be allocated a portion of its actual territorial operating income for the taxable year to provide a market return for its actual routine contributions in that year. As a result of a transfer pricing analysis, the Commissioner determines that the return to FS's routine activities, based on the return for comparable routine functions undertaken by comparable unrelated companies, is 10% of non-IDC costs. The allocations of actual territorial profits in Years 6 through 8 are as follows:

Year	Territorial operating profits	Return to routine contributions	Residual profits after step 1
6	444	68	376
7	432	75	357
8	416	82	334

(vii) Under step two, a portion of the residual territorial operating profit or loss after the allocation of profit to routine contributions in step one will be allocated by FS to its cost contribution share. The percentage allocable to the cost contribution share is equal to FS's share of the total anticipated IDCs divided by its total anticipated territorial operating profits reduced by total expected return to its routine contributions to the exploitation of the cost shared technology in its territory. All amounts are determined as present values as of the first day of Year 6, using an appropriate discount rate on that date, and do not include any amounts relating to periods before the first day of Year 6. Following these rules, it is determined that the present value of FS's share of the total anticipated IDCs after the first day of Year 6 is $116 million and its total anticipated territorial operating profits reduced by the return to its routine contributions is $1,340 million. It follows that the percentage of residual territorial operating profit or loss allocated to FS's cost contribution share is 8.6% ($116/$1,340). The allocation of actual residual profits after Step 1 in Years 6 through 8 is as follows:

Year	Residual profits after step 1	Step 2 profits allocated to FS	Residual profits after step 2
6	376	32	344
7	357	31	327
8	334	29	305

(viii) In step three, because USP provided the only nonroutine contributions to the CSA Activity, 100% of FS's residual operating income after steps one and two is allocated to USP's external contributions and therefore represents the amount of the PCT Payment due from FS to USP for the particular taxable year. Also because USP provided the only nonroutine contributions to the CSA Activity, none of its residual territorial operating profit or loss is attributable to FS, therefore no offsetting PCT Payment is due from USP to FS. The PCT Payments due and adjustments made in Years 6 through 8 are as follows:

Year	Residual profits after step 2	PCT payment due from FS to USP	Actual PCT payment made	Adjustment
6	344	344	0	344
7	327	327	0	327
8	305	305	0	305

Example 2. The facts are the same as *Example 1* paragraphs (i) through (iii). At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 3.0. Upon further investigation as to what may have caused the high return in FS's market, the Commissioner learns that, in Year 4, significant health risks were linked to the use of wireless cell phones of USP's leading competitors. No such health risk was linked to the cell phones developed by USP and FS under the CSA. This resulted in a significant increase in USP's and FS's market share for cellular phones. Further analysis determines that it was this unforeseen occurrence that was primarily responsible for the AERR trigger. Based on paragraph (i)(6)(vi)(B) of this section, the Commissioner concludes that no adjustments are warranted, as FS simply has earned the premium return that any such investor would earn under the circumstances.

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

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

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

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

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

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

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

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

(viii) *Examples.* The following examples illustrate the principles of this paragraph (j)(1):

Example 1. Controlled participant. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a CSA with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The CSA provides that USS will receive the rights to exploit the machine in the extraction of the natural resource in the United States, and

FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to exploit this process in the United States, USS is not a controlled participant because it will not derive a benefit from the exploiting the intangible developed under the CSA.

Example 2. Controlled participants. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a CSA to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R+D is not assigned any rights to exploit the intangibles. R+D's activity consists solely in carrying out research for the group. It is reliably projected that the RAB shares of USP and FS will be 66⅔% and 33⅓%, respectively, and the parties' agreement provides that USP and FS will reimburse 66⅔% and 33⅓%, respectively, of the IDCs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (j)(1)(i) of this section, because it will not derive any benefits from exploiting cost shared intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of paragraph (a)(3) of this section and § 1.482–4(f)(3)(iii). Such consideration must be treated as IDCs incurred by USP and FS in proportion to their RAB shares (*i.e.*, 66⅔% and 33⅓%, respectively). R+D will not be considered to bear any share of the IDCs under the arrangement.

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

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

Example 5. Reasonably anticipated benefits. Controlled parties A and B enter into a cost sharing arrangement to develop product and process intangibles for an already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of $100M from sales of Product P until it became obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of $20M in present value revenue from the product intangible, while B reasonably anticipates only an increase of $10M. Further, A and B each reasonably anticipate spending an extra $5M present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving $2M present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($20M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($10M) plus its reasonably anticipated cost savings ($2M) minus its reasonably anticipated increased costs ($5M), which equals $7M. Thus A's reasonably anticipated benefits are $17M and B's reasonably anticipated benefits are $7M.

(2) *Special rules*—(i) *Consolidated group.* For purposes of this section, all members of the same consolidated group shall be treated as one taxpayer. For purposes of this paragraph (j)(2)(i), the term *consolidated group* means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

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

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

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

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

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

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

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

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

[All amounts stated in X's]

	A	B	C	D
Payments	<40>	<21>	<37.5>	<30>
Receipts	48	34	22.5	24
Final	8	13	<15>	<6>

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

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

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

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

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

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

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

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

(F) Enumerate all categories of IDCs to be shared under the CSA;

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

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

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

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

(iii) *Meaning of contemporaneous*—(A) *In general.* For purposes of this paragraph (k)(1), a written contractual agreement is contemporaneous with the formation (or revision) of a CSA if, and only if, the controlled participants record the CSA, in its entirety, in a document that they sign and date no later than 60 days after the first occurrence of any IDC described in paragraph (d) of this section to which such agreement (or revision) is to apply.

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

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

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

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

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

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

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

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

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

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

(*1*) All projections used to estimate benefits;

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

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

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

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

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

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

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

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

(*3*) Each alternative method that was considered, and the reason or reasons that the alternative method was not selected;

(*4*) Any data that the controlled participant obtains, after the CSA takes effect, that would help determine if the controlled participant method selected has been applied in a reasonable manner;

(*5*) The discount rate, where applicable, used to value each payment due under a PCT, and a demonstration that the discount rate used is consistent with the principles of paragraph (g)(2)(vi) of this section;

(*6*) The estimated arm's length values of any external contributions as of the dates of the relevant PCTs, in accordance with paragraph (g)(2)(ii) of this section;

(*7*) A discussion, where applicable, of why transactions were or were not aggregated under the principles of paragraph (g)(2)(v) of this section;

(*8*) The method payment form and any conversion made from the method payment form to the specified payment form, as described in paragraph (g)(2)(ix) of this section; and

(*9*) If applicable under paragraph (i)(6)(iv) of this section, the WACC of the controlled group that includes the controlled participants.

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

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

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

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

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

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

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

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

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

(A) State that the participant is a controlled participant in a CSA;

(B) Provide the controlled participant's taxpayer identification number;

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

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

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

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

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

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

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

Example 1. A and B, both of which file U.S. tax returns, agree to share the costs of developing a new chemical formula in accordance with the provisions of this section. On March 30, Year 1, A and B record their agreement in a written contract styled, ''Cost Sharing Agreement.'' The contract applies by its terms to IDCs occurring after

March 1, Year 1. The first IDCs to which the CSA applies occurred on March 15, Year 1. To comply with paragraph (k)(4)(iii)(A) of this section, A and B individually must file separate CSA Statements no later than 90 days after March 15, Year 1 (June 13, Year 1). Further, to comply with paragraph (k)(4)(iii)(B) of this section, A and B must attach copies of their respective CSA Statements to their respective Year 1 U.S. income tax returns.

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

(l) *Effective date.* This section applies on the date of publication of this document as a final regulation in the **Federal Register**.

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

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

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

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

(iii) The date 50 percent or more of the value of the interests in cost shared intangibles are owned directly or indirectly by a person or persons that were not direct or indirect owners of such interests as of the date of publication of this document as a final regulation in the **Federal Register**.

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

(i) CSTs and PCTs occurring prior to the date of publication of this document as a final regulation in the **Federal Register** shall be subject to the provisions of former § 1.482–7 rather than this section. Notwithstanding the foregoing, PCTs of a CSA will be subject to the provisions of this section if there is a Periodic Trigger for such CSA for which a subsequent PCT, occurring on or after the date of publication of this document as a final regulation in the **Federal Register**, is the Trigger PCT.

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

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

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

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

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

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

(viii) Paragraph (k)(4)(iii)(B) shall be construed as only applying for taxable years ending after the filing of the CSA Statement described in paragraph (m)(3)(vii) of this section.

Par. 9. Section 1.482–8 is amended by adding *Examples 10* through *15* at the end of the section to read as follows:

§ 1.482–8 Examples of the best method rule.

* * * * *

Example 10. Preference for acquisition price method. (i) USP develops, manufacturers, and distributes ethical pharmaceutical products. USP and FS, USP's wholly-owned subsidiary, enter into a CSA to develop a new oncological drug, Oncol. Immediately prior to entering into the CSA, USP acquires Company X, an unrelated U.S. pharmaceutical company. Company X is solely engaged in oncological pharmaceutical research, and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound Y, a promising molecular compound derived from a rare plant, which USP reasonably anticipates will contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol as well. The RT Rights in the Compound X and the commitment of Company X's researchers to the development of Oncol are external contributions for which compensation is due from FS as part of a PCT. Under the terms of the CSA, USP is to be compensated for its external contributions on a lump sum basis.

(ii) In this case, the acquisition price method, based on the lump sum price paid by USP for Company X, is likely to provide a more reliable measure of an arm's length PCT Payment due to USP than the application of any other method.

Example 11. Preference for market capitalization method. (i) Company X is a publicly traded U.S. company solely engaged in oncological pharmaceutical research and its only significant resources and capabilities are its workforce and the its sole patent, which is associated with Compound Y, a promising molecular compound derived from a rare plant. Company X has no marketable products. Company X enters into a CSA with FS, a newly-formed foreign subsidiary, to develop a new oncological drug, Oncol, derived from Compound Y. Compound X is reasonably anticipated to contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to the developing Oncol under the CSA. The RT Rights in Compound Y and the commitment of Company X's researchers are external contributions for which compensation is due from FS as part of a PCT. Under the terms of the CSA, Company X is to be compensated for its external contributions on a lump sum basis.

(ii) In this case, given that Company X's external contributions covered by PCTs relate to its entire economic value, the application of the market capitalization method, based on the market capitalization of Company X, is likely to provide a more reliable measure of an arm's length result for Company X's PCTs to the CSA than the application of any other method.

Example 12. Preference for market capitalization method. (i) MicroDent, Inc. (MDI) is a publicly traded company that developed a new dental surgical microscope ScopeX–1, which drastically shortens many surgical procedures. On January 1 of Year 1, MDI entered into a CSA with a wholly-owned foreign subsidiary (FS) to develop ScopeX–2, the next generation of ScopeX–1. The RT Rights associated with ScopeX–1, as well as MDI's research capabilities are reasonably anticipated to contribute to the development of ScopeX–2 and are therefore external contributions for which compensation is due from FS as part of a PCT. Under the terms of the CSA, MDI is to be compensated for its external contributions on a lump sum basis. At the time of the PCT, MDI's only product was the ScopeX-I microscope, although MDI was in the process of developing ScopeX–2. Concurrent with the CSA, MDI separately transfers exclusive and perpetual exploitation rights associated with ScopeX–1 to FS in the same specified geographic area as assigned to FS in the CSA.

(ii) Although the transactions between MDI and FS under the CSA are distinct from the transactions between MDI and FS relating to the exploitation rights for ScopeX–1, it is likely to be more reliable to evaluate the combined effect of the transactions than to evaluate them in isolation. This is because the combined transactions between MDI and FS relate to all of the economic value of MDI (that is, the exploitation rights and research rights associated with ScopeX–1, as well as the research capabilities of MDI). In this case, application of the market capitalization method, based on the enterprise value of MDI on January 1 of Year 1, is likely to provide a more reliable measure of an arm's length payment for the aggregated transactions than the application of any other method.

(iii) Notwithstanding that the market capitalization method provides the most reliable measure of the aggregated transactions between MDI and FS, see paragraph (g)(2)(v) of this section for further considerations of when further analysis may be required to distinguish between the remuneration to MDI associated with PCTs under the CSA (for research rights and capabilities associated with ScopeX–1) and the remuneration to MDI for the exploitation rights associated with ScopeX–1.

Example 13. Income method (CPM-based) preferred to acquisition price method. The facts are the same as *Example 10*, except that the acquisition occurred significantly in advance of formation of the CSA, and reliable adjustments cannot be made for this time difference. In addition, Company X has other valuable molecular patents and associated research capabilities, apart from Compound Y, that are not reasonably anticipated to contribute to the development of Oncol and that cannot be reliably valued. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its assigned area (the United States). FS will distribute Oncol in its assigned area (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. FS does not furnish any external contributions. At the time of the PCT, reliable (ex ante) financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken. In this case, application of the income method is likely to provide a more reliable measure of an arm's length result than application of the acquisition price method based on the price paid by USP for Company X.

Example 14. Evaluation of alternative methods. (i) The facts are the same as *Example 10*, except that the acquisition occurred sometime prior to the CSA, and Company X has some areas of promising research that are not reasonably anticipated to contribute to developing Oncol. In general, the Commissioner determines that the acquisition price data is useful in informing the arm's length price, but not necessarily determinative. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its assigned area (the United States). FS will distribute Oncol in its assigned area (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. At the time of the PCT, financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken.

(ii) Under the facts, it is possible that the acquisition price method or the CPM-based income method might reasonably be applied. Whether the acquisition price method or the income method provides the most reliable evidence of the arm's length price of USP' contributions depends on a number of factors, including the reliability of the financial projections, the reliability of the discount rate chosen, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the in-process research done by Company X that does not constitute external contributions to the CSA.

Example 15. Evaluation of alternative methods. (i) The facts are the same as *Example 14*, except that FS has a patent on Compound Y, which the parties reasonably anticipate will be useful in mitigating potential side effects associated with Compound X and thereby contribute to the development of Oncol. The RT Rights in Compound Y constitute an external contribution for which compensation is due from USP as part of a PCT. The value of FS's external contribution cannot be reliably measured by market benchmarks.

(ii) Under the facts, it is possible that either the acquisition price method and the income method together or the residual profit split method might reasonably be applied to determine the arm's length PCT Payments due between USP and FS. Under the first option the PCT Payment for the external contributions related to Company X's workforce and Compound X would be determined using the acquisition price method referring to the lump sum price paid by USP for Company X. Because the value of these external contributions can be determined by reference to a market benchmark they are considered routine external contributions. Accordingly, under this option, the external contribution related to Compound Y would be the only nonroutine external contribution and the relevant PCT Payment is determined using the income method. Under the second option, rather than looking to the acquisition price for Company X, all the external contributions are considered nonroutine and the RPSM is applied to determine the PCT Payments for each external contribution. Under either option, the PCT Payments will be netted against each other.

(iii) Whether the acquisition price method together with the income method or the residual profit split method provides the most reliable evidence of the arm's length price of the external contributions of USP and FS depends on a number of factors, including the reliability of the determination of the relative values of the external contributions for purposes of the RPSM, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the RT Rights in the in-process research done by Company X that does not constitute external contributions to the CSA. In these circumstances, it is also relevant to consider whether the results of each method are consistent with each other, or whether one or both methods are consistent with other potential methods that could be applied.

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

§ 1.861–17 Allocation and apportionment of research and experimental expenditures.

* * * * *

(c) * * *

(3) * * *

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

* * * * *

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

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

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

The addition reads as follows:

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

* * * * *

(d) * * *

(2) * * *

(iii) * * *

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

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PART 301—PROCEDURE AND ADMINISTRATION

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

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

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

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

* * * * *

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

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Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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