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Memorandum**

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subject: Multiple RAB Shares and Subsequent PCTs

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether a taxpayer may determine and apply different reasonably anticipated benefit ("RAB") shares with respect to separate cost pools under a single cost sharing arrangement ("CSA").
2. Whether a taxpayer may determine and apply a RAB share solely for the purpose of calculating platform contribution transaction ("PCT") payments ("PCT Payments") with respect to a particular subsequent PCT that is different from the RAB share used by the taxpayer to calculate cost sharing transaction ("CST") payments ("CST Payments") under the CSA (or the same cost pool under a single CSA) that includes such PCT.

CONCLUSIONS

1. It may be appropriate in certain situations for controlled participants to use two or more RAB shares with respect to two or more discrete lines of research and development (“R&D”) under a single CSA. For this purpose, key considerations include whether R&D projects within the scope of the CSA Activity are, in fact, sufficiently different such that the anticipated benefits, cost pools, and platform contributions within each project can be collectively and accurately accounted for (separate from those of the other projects), and whether determination and application of multiple RAB shares is a more reliable basis for determining RAB shares than using a single RAB share for all projects.

2. It may be appropriate in certain situations for controlled participants to use a separate RAB share to determine PCT Payments with respect to a subsequent PCT that is different from a RAB share that had been applied to calculate the CST Payments under the CSA (or the same cost pool under a single CSA) that includes that subsequent PCT. For this purpose, key considerations include whether determination and application of such separate RAB share is a more reliable basis for determining RAB shares than using the same RAB share for the subsequent PCT and the CST Payments under such CSA or cost pool. However, going forward, it must also be determined whether it would be more reliable to determine a blended RAB share (taking into account the impact of the subsequent PCT on the existing RAB share) to be applied to the CST Payments, or to establish a separate cost pool that includes only the IDCs related to the R&D project that includes the subsequently contributed platform contribution to which the separate RAB share will also be applied.

FACTS

You requested legal advice regarding the recurring issue of whether the cost sharing regulations in § 1.482-7 prohibit the use of multiple RAB shares within a single CSA. Your request arose specifically in response to a case in which a taxpayer determined an arm’s length price for a subsequent PCT¹ that was a different percentage (of an acquisition price) than the RAB share used to determine current CSTs.

LAW AND ANALYSIS

I. The cost sharing regulations – RAB Shares and PCTs

Under a CSA, cost sharing participants share the costs and risks of developing

¹ A subsequent PCT is a PCT that occurs subsequent to the inception of the CSA. See generally Treas. Reg. § 1.482-7(b)(1)(ii) and (g)(2)(viii)(A).

intangibles by engaging in CSTs, resulting in CST Payments that are required to be determined by reference to RAB shares. Treas. Reg. § 1.482-7(a)(1), (b) (first sentence), and (g)(1). For this purpose, “reasonably anticipated benefits” are defined as:

the benefits that reasonably may be anticipated to be derived from exploiting cost shared intangibles. For purposes of this definition, benefits mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.

Treas. Reg. § 1.482-7(j)(1)(i).

“RAB share” is defined as follows:

A controlled participant’s share of reasonably anticipated benefits is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits, as defined in paragraph (j)(1)(i) of this section, of all the controlled participants. 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 reliable data regarding past and projected future results available at such time. RAB shares determined for a particular purpose shall not be further updated for that purpose based on information not available at the time that determination needed to be made. For example, RAB shares determined in order to determine IDC shares for a particular taxable year (as set forth in paragraphs (b)(1)(i) and (d)(4) of this section) shall not be recomputed based on information not available at that time. Similarly, RAB shares determined for the purpose of using a particular method such as the acquisition price method (as set forth in paragraph (g)(5)(ii) of this section) to evaluate the arm’s length amount charged in a PCT shall not be recomputed based on information not available at the date of that PCT. However, nothing in this paragraph (e)(1)(i) shall limit the Commissioner’s use of subsequently available information for purposes of its allocation determinations in accordance with the provisions of paragraph (i) (Allocations by the Commissioner in connection with a CSA) of this section.

Treas. Reg. § 1.482-7(e)(1)(i).

The regulations further explain:

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 between the estimates. 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)(ii) of this section.

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

Treas. Reg. § 1.482-7(e)(1)(ii).

For this purpose, RAB "must be measured on a basis that is consistent for all" cost sharing participants. Treas. Reg. § 1.482-7(e)(2)(i). Such basis may be either "direct" or "indirect." Id. Examples of indirect bases include, but are not limited to, (1) units used, produced, or sold; (2) sales; and (3) operating profit. Treas. Reg. § 1.482-7(e)(2)(ii).

Units used, produced or sold will generally provide a more reliable measure of anticipated benefit 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 covered intangibles per unit of the item or items used, produced, or sold. Similarly, sales by each controlled participant in the business activities in which covered intangibles are exploited will generally provide a more reliable measure to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. Further, operating profit of each controlled participant from the activities in which covered intangibles are exploited will generally provide a more reliable measure to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant.

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 covered intangibles. The regulations do not describe direct bases for measuring RAB.

RAB shares are, inherently, a forward-looking, projections-based concept:

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 value of the projected benefits to reliably determine RAB shares. . . .

Treas. Reg. § 1.482-7(e)(2)(iii)(A).

If a controlled participant makes a platform contribution to a CSA, arm's length compensation must be paid to that controlled participant. The regulations define "platform contribution" as follows:

A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. The determination whether a resource, capability, or right is reasonably anticipated to contribute to developing cost shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right reasonably determined not to be a platform contribution as of an earlier point in time, may be reasonably determined to be a platform contribution at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles. Notwithstanding the other provisions of this paragraph (c), platform

contributions do not include rights in land or depreciable tangible property, and do not include rights in other resources acquired by IDCs. See paragraph (d)(1) of this section.

Treas. Reg. § 1.482-7(c)(1).

The arm's length amount due for PCTs is "determined under the method or methods applicable under the other section or sections of the section 482 regulations, as supplemented by paragraph (g) of this section." Treas. Reg. § 1.482-7(a)(2). CSA participants "must enter into a PCT as of the earliest date on or after the CSA is entered into on which a platform contribution is reasonably anticipated to contribute to developing cost shared intangibles." Treas. Reg. § 1.482-7(b)(3). Treas. Reg. § 1.482-7(g) provides guidance regarding transfer pricing methods applicable to PCTs. Each such method

will yield a value for the compensation obligation of each PCT Payor consistent with the product of the combined pre-tax value to all controlled participants of the platform contribution that is the subject of the PCT and the PCT Payor's RAB share.

Treas. Reg. § 1.482-7(g)(1).

Cost sharing participants generally may choose the form of PCT Payments as fixed (including spread over a period of time), contingent, or a combination of both, "provided that such form and period of payment are consistent with an arm's length charge as of the date of the PCT." Treas. Reg. § 1.482-7(h)(2)(i).

The regulations contain specific guidance with respect to PCTs that occur after a CSA has gone into effect ("subsequent PCTs"):

The date of a PCT may occur subsequent to the inception of the CSA. For example, an intangible initially developed outside the IDA may only subsequently become a platform contribution because that later time is the earliest date on which it is reasonably anticipated to contribute to developing cost shared intangibles within the IDA. In such case, the date of the PCT, and the analysis of the arm's length amount charged in the subsequent PCT, is as of such later time.

Treas. Reg. § 1.482-7(g)(2)(viii)(A). For this purpose,

the determination of the arm's length amount charged, respectively, in the prior and subsequent PCTs must be coordinated in a manner that provides the most reliable measure of an arm's length result.

In some circumstances, a subsequent PCT may be reliably evaluated independently of other PCTs, as may be possible for example, under the acquisition price method. In other circumstances, the results of prior and subsequent PCTs may be interrelated and so a subsequent PCT may be most reliably evaluated under the residual profit split method of paragraph (g)(7) of this section.

Treas. Reg. § 1.482-7(g)(2)(viii)(B).

II. Discussion

A. Issue 1

As the name suggests, RAB shares are based on future benefits expected to result from the activity of developing and exploiting cost shared intangibles (“CSA Activity”). Treas. Reg. § 1.482-7(e)(1)(i) and (j)(1)(i). For this purpose, future 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 reliable data regarding past and projected future results available at such time.” Treas. Reg. § 1.482-7(e)(1)(i). Accordingly, when controlled participants determine their RAB shares upon the formation of a CSA, they must estimate their RAB into the future over the entire expected duration of the CSA Activity (i.e., the period of developing and exploiting cost shared intangibles) and they must periodically review and update those RAB shares to reflect new information, changing conditions, and actual past results. Such updates by controlled participants apply prospectively. Treas. Reg. § 1.482-7(e)(1)(i).²

A controlled participant’s RAB share must be determined by using the most reliable estimate of RAB. Treas. Reg. § 1.482-7(e)(1)(ii). This rule is consistent with the arm’s length standard, which requires use of the best method – “the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.” Treas. Reg. § 1.482-1(c)(1). Whether that requires the use of a single RAB share for all costs covered by a single CSA, or instead requires two or more RAB shares applicable to two or more discrete cost pools covered by a single CSA, will depend on the facts and circumstances. Specifically, there should be a single RAB share if RAB are most reliably estimated on the basis of a single RAB share, and there should be two or more RAB shares if RAB are most reliably estimated with respect to separate cost pools (and their associated platform contributions) on different bases. Accordingly, the Internal Revenue Service may determine in a particular situation that a

² We note that the requirement that taxpayers apply RAB share updates prospectively does not prevent the Internal Revenue Service from making adjustments to correct unreliably determined RAB shares retroactively. Treas. Reg. § 1.482-7(e)(1)(i) (“However, nothing in this paragraph (e)(1)(i) shall limit the Commissioner’s use of subsequently available information for purposes of its allocation determinations in accordance with the provisions of paragraph (i) (Allocations by the Commissioner in connection with a CSA) of this section.”).

taxpayer that used a single RAB share for all costs under a single CSA should have used more than one RAB share for separate cost pools, and may determine in another situation that a taxpayer that used more than one RAB share for separate cost pools under a single CSA should have used a single RAB share for those pools collectively.

B. Issue 2

The regulations regarding subsequent PCTs explain that whether a subsequent PCT should be evaluated separately or in combination with prior PCTs depends on which approach provides the most reliable measure of an arm's length result. Treas. Reg. § 1.482-7(g)(2)(viii)(B). That guidance does not specifically address the inter-relationship of RAB shares and subsequent PCTs.

When a platform contribution is made to an existing CSA (for example, intangible property is acquired by a controlled participant after the inception of the CSA and is required to be contributed in a PCT to the CSA for further development), an arm's length amount must be paid to the contributing controlled participant by the other controlled participant(s). The platform contribution may relate to the current CSA Activity or expand the scope of that activity. The RAB expected to be derived from the platform contribution may come from existing product lines covered by the current CSA Activity, or from new product lines that do not currently exist (in which case there would be no correlation between existing RAB shares and the arm's length price for the subsequent PCT), or both. Accordingly, a separate determination must be made in each case as to whether the method used to determine the arm's length amount to be paid for a subsequent PCT should take into account the method used to determine current RAB shares. In addition, after a subsequent PCT has been entered into, the determination of appropriate RAB shares for intangible development costs that will be incurred going forward must be determined for the IDA connected with each PCT upon which a separate RAB share was determined. As in the case of Issue 1, above, a key consideration is whether the use of one (or more) RAB shares within a single CSA will provide a more (or less) reliable result under the facts and circumstances.

III. Illustrative examples

Example 1. USP, a US company, wholly owns foreign subsidiary, FS. USP and FS are participants in a CSA ("CSA 1") under which they share IDCs based on their respective RAB, using projected revenues as a measure of benefit. After the CSA Start Date, USP acquires a new product line as a result of a corporate acquisition. The corporation (a US corporation with a wholly owned foreign subsidiary) acquired by USP had an existing CSA ("CSA 2"). CSA 2 also uses projected revenues as the most reliable measure of benefits. The new consolidated group retains both CSAs. No new platform contribution is made to either CSA, and the CSA participants remain the same. The RAB measure of revenues is unchanged, with each separate CSA retaining the same RABs as before the acquisition.

Example 2. Assume the same facts as in Example 1, except that CSA 2 is merged into CSA 1. Two separate RAB shares are retained, such that segmented financial data for IDCs related to the separate product lines is required for each separate RAB share calculation. The participants stay the same as under the original CSAs, so there is no change in participation requiring compensation under Treas. Reg. § 1.482-7(f). Projected revenues, separately estimated for each product line, continue to be used as the most reliable measure of reasonably anticipated benefit for each product line.

Example 3. Assume the same facts as in Example 1, except that RAB shares for CSA 2 are calculated using operating profit as the most reliable measure of reasonably anticipated benefits. Accordingly, projected revenues will be used as the most reliable measure of RAB for CSA 1, and projected operating profits will be used as the most reliable measure of RAB for CSA 2, and these measures will be applied to segmented IDCs for each CSA to calculate separate RAB shares.

Example 4. The facts are the same as in Example 1, except that, rather than acquiring a US corporation, USP acquires new worldwide rights to intangible property (“IP”) from an unrelated party. The IP will be further developed to create a new product line that will be sold by USP and FS. USP contributes the IP to the CSA, and the arm’s length price of the PCT is determined based on an analysis of the projected US versus non-US discounted cash flows. A single RAB share going forward may be based on a blended projected benefit calculation covering the old product lines and the new product line. Alternatively, one RAB share may be used for the old product lines and another RAB share may be used for the new product line if that provides a more reliable measure of RAB. To demonstrate that using two RAB shares provides a more reliable measure of RAB than one RAB share, the taxpayer must demonstrate that: (1) none of the future IDA for the old product line will overlap with or be used in the new product line IDA; (2) none of the future IDA for the new product line will overlap with or be used in the old product line IDA; and (3) reliable segmented financial data can be provided for the old product line and the new line, including the separate IDCs for each product line.

Please call Matthew A. Nieters of the Office of Associate Chief Counsel (International) at (202) 317-6939 if you have any further questions.

By: _____
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