November 28, 2005

Internal Revenue Service
CC:PA:LPD:PR (REG-144615-02),
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: AeA Comments on Proposed Cost Sharing Regulations

Dear Sirs/Madames:

AeA (American Electronics Association) respectfully submits the following comments for consideration in connection with the recently issued proposed cost sharing regulations. The comments are in response to the solicitation for comments in a notice of proposed rulemaking [REG-144615-02] published August 29, 2005, in the Federal Register containing Prop. Treas. Reg. § 1.482-7 (the "Proposed Regulations").

Advancing the business of technology, AeA is the nation's largest high-tech trade association. AeA has more than 2,500 member companies that span the high-technology spectrum—from software, semiconductors and computers—to Internet technology, advanced electronics and telecommunications systems and services. AeA has been the accepted voice of the U.S. technology community since 1943.

I. Executive Summary

According to the Preamble to the Proposed Regulations, the Internal Revenue Service's ("IRS'" or the "Service's") "[e]xperience 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."[1] The existing regulations (Treas. Reg. § 1.482-7) will hereinafter be referred to as the "Existing Regulations." The Preamble further provides that there is a special need for additional guidance on valuing the external contributions (referred to as "buy-ins" under the Existing Regulations) to a cost sharing agreement ("CSA") and the methods that may be applied for making such valuation. Furthermore, the IRS believes that other technical and procedural issues have surfaced under the Existing Regulations. Accordingly, the IRS issued the Proposed Regulations in an attempt to address these issues.

[1] Preamble, 70 Fed. Reg. 51115 (Aug. 29, 2005).

AeA acknowledges that the determination of taxable income associated with the transfers of intangible property is often challenging for both taxpayers and the IRS. This is true for intangible property transfers within or outside a CSA. However, we believe the application of the long standing methods described in Treas. Reg. § 1.482-4 remains viable for the "buy in" for existing intangibles, including partially developed intangibles, and certainly have not been subject to any judicial review that would indicate otherwise. Administrative ease is hardly a justification for replacing these long standing methods with ones that are arbitrary and economically unsound. But we admit that the Proposed Regulations will ease the administration of cost sharing because application of the investor model in combination with the realistic alternative limitation, will end the use of cost sharing, contrary to the intent of Congress as expressed in the legislative history of § 482. Finally, we believe that the Treasury has exceeded its authority to promulgate regulations because, as drafted, the Proposed Regulations direct taxpayers regarding the appropriate form in which they should conduct their business activities, which is beyond the scope of the Treasury's authority.

AeA is also very concerned about the fact that the Proposed Regulations dictate the terms that taxpayers must use to transfer intangible property between related parties. For example, in the case of post formation acquisitions, the Proposed Regulations require that the terms of subsequent transfers of the acquired intangible property to related parties mirror the terms in which those intangibles were acquired. The Proposed Regulations also dictate that rights to the cost shared intangibles held by participants be geographically exclusive and perpetual. We are at a loss as to why the Treasury believes that it has the authority to dictate and must dictate the terms of intellectual property transfers when valid business considerations, such as intellectual property considerations, are the controlling factors. In addition, pursuant to the "all substantial rights" doctrine, very significant gains will be triggered by taxpayers who conform their agreements to geographic and perpetual requirements of the Proposed Regulations. It is difficult to believe that this collateral effect was not considered by Treasury.

AeA also submits that several of the economic principles set forth in the Proposed Regulations are seriously flawed. For example, not only does the realistic alternative principle seem to limit cost sharing to only those participants that possess and contribute intangibles to the CSA but it seems to limit and/or conflict with the application of the investor model. In addition, we doubt that the selection of the appropriate rate of return for the investor model will prove to be any simpler than the selection and adjustments to comparable uncontrolled transactions.

The Proposed Regulations also contain certain transition/grandfather rules. These provisions are oblique and statements in the Preamble seem to conflict with the provisions contained in the Proposed Regulations. In addition, while the Proposed Regulations appear to contain certain transitional relief provisions, we believe that these grandfather provisions do not constitute grandfather rules as typically incorporated into new regulations.

AeA also believes that the Proposed Regulations are inconsistent with the OECD cost contribution guidelines and, if applied unilaterally by the IRS, will lead to even more unresolved

controversies with our treaty partners. In addition, we believe that the Proposed Regulations, if adopted in their current form, could adversely affect U.S. multinationals while creating a U.S. tax windfall for foreign owned U.S. participants to CSAs. AeA also believe these Proposed Regulations, if adopted, will adversely impact the ability of its members to compete for new technology in the global market.

We believe that the Existing Regulations are a better reflection of the intent of Congress and provide better guidance to taxpayers and the IRS than the Proposed Regulations. Taxpayers have spent years and substantial sums understanding and complying with the requirements of the existing cost sharing regulations, and documenting their CSAs. We understand that the government may not have the resources to match the level of investment that has been made by taxpayers, and thus some form of simplification is appealing to the Treasury and the IRS. However, the remedy suggested by the Proposed Regulations is beyond the authority granted to Treasury by the statute, economically unsound and an unnecessary and unjustified encroachment on the way taxpayers choose to deploy and protect their global intellectual property. For these reasons, we urge Treasury and the IRS to completely withdraw these regulations and discontinue their current efforts to modify the Existing Regulations.

II. Background

On December 19, 1995, and May 9, 1996, the Treasury issued final regulations under § 482 of the U.S. Internal Revenue Code of 1986 (the "Code")[2] providing guidance with respect to CSAs. Under the Existing Regulations, two or more members of a group of controlled taxpayers may jointly develop intangible property pursuant to a qualified CSA, and no allocation will be made under § 482 with respect to a participant if the participant's share of the costs of developing the intangible property are equal to its share of reasonably anticipated benefits to be derived from exploitation of that participant's interest in the intangible.[3] If a participant's share of the costs of developing the intangible is not equal to its share of reasonably anticipated benefits, then the district director may generally make allocations to correctly spread the costs by adjusting cost shares.[4] No transfer of intangible property is deemed to occur. An interest in an intangible includes any commercially transferable interest the benefits of which are susceptible of valuation.[5]

The objective of the cost allocation rules of Treas. Reg. § 1.482-7(f) is to determine each participant's share of costs incurred by reference to that participant's reasonably anticipated benefits. A controlled participant's share of reasonably anticipated benefits is equal to all of the benefits the participant reasonably anticipates it will derive from the developed intangibles, divided by the total benefits reasonably anticipated by all controlled participants.[6] The calculation must be made by using the most reliable estimate of reasonably anticipated benefits,

[2] Unless otherwise indicated, all section references in these comments are to sections of the Code, and all references to regulations are to the regulations promulgated thereunder.
[3] Treas. Reg. § 1.482-7(a).
[4] Treas. Reg. § 1.482-7(a)(2).
[5] *Id.*
[6] Treas. Reg. § 1.482-7(f)(3)(i).

taking into account the quality of the data and assumptions used in the analysis.[7] The Existing Regulations set forth two factors to consider in assessing the reliability of an estimate – (1) the reliability of the basis used for measuring benefits,[8] and (2) the reliability of the projections used to estimate benefits.[9]

The Existing Regulations also address the need to compensate a participant that makes pre-existing intangible property available to the CSA. Under Treas. Reg. § 1.482-7(g), if intangible property is made available to a qualified CSA, the contributing member must be compensated by the other controlled participants by way of a buy-in payment, and the district director may make an allocation under Treas. Reg. § 1.482-1 and -4 through -6 if an arm's length payment is not made. A change in participants' interests in covered intangibles is also considered a transfer of an intangible for which the district director may impose an arm's length charge.[10] Further, if a participant bears a share of the costs of development that is more or less than its share of reasonably anticipated benefits, the district director may determine that the participant that bore a disproportionately greater share of costs must receive an arm's length payment from any controlled participant(s) that bore a disproportionately lesser share of costs (as compared to its share of reasonably anticipated benefits).[11]

Unassigned interests in developed intangibles are deemed to be owned by each of the controlled participants in an amount equal to their share of the development costs.[12] Therefore, if a geographic market is unassigned by the CSA, and that market is ultimately exploited by one of the controlled participants or another related party, then an arm's length payment must be made to each of the deemed owners consistent with Treas. Reg. § 1.482-7(g)(6).

These rules, which were issued after much effort by Treasury and IRS less than 10 years ago, are a more balanced set of regulations than the Proposed Regulations, providing the IRS with the tools it needs to audit CSAs, including appropriate documentation requirements, while affording taxpayers adequate flexibility to structure their business affairs.

---

[7] *Id.*
[8] Treas. Reg. § 1.482-7(f)(3)(i)(A).
[9] Treas. Reg. § 1.482-7(f)(3)(i)(B).
[10] Treas. Reg. § 1.482-7(g)(1).
[11] *Id.*
[12] Treas. Reg. § 1.482-7(g)(6).

III. Proposed Regulations Exceed the Authority of Treasury Granted by the Statute

Section 482 of the Code provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Thus, under § 482, the IRS has the authority to allocate income, deductions, credits or allowances between controlled taxpayers if the allocation is necessary to prevent the evasion of taxes or to clearly reflect the true income of the controlled taxpayers. The purpose of § 482 is to prevent the artificial shifting of income of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers.

Section 7805(a) of the Code authorizes the Secretary or his delegate "to prescribe all needful rules and regulations for the enforcement of [the tax laws]." The Proposed Regulations, however, far exceed Treasury's authority to promulgate regulations. In *National Mufflers Dealer Association v. United States*,[13] the Supreme Court stated that to determine "whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonized with the plain language of the statute, its origin, and purpose." In *Chevron, USA, Inc. v. Natural Resources Defense Council*,[14] the Supreme Court subsequently stated that if "Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Accordingly, a regulation will be disregarded if it is an unreasonable and inconsistent interpretation of the statute.

Under § 482, the IRS **only** has the authority to reallocate income and deductions based on how taxpayers actually conduct their business activities. The Proposed Regulations, however, go far beyond this scope limitation by actually dictating the manner in which a taxpayer must conduct cost sharing activities. For example, the Proposed Regulations contain specific guidance for an external contribution that is acquired by a controlled participant in an uncontrolled transaction

---

[13] 440 U.S. 472, 477 (1979).
[14] 467 U.S. 837, 842-43 (1984).

that takes place after the formation of the CSA and that as of the date of acquisition is expected to be contributed to the CSA (referred to as a post formation acquisition or "PFA").[15]

In this regard, the Proposed Regulations' requirement that the consideration "for a PFA must be paid in the same form as the uncontrolled transaction in which the PFA was acquired" (the "Same Form Requirement") is contrary to the statute and is unduly restrictive to taxpayers.[16] For example, because a stock acquisition generally requires a lump sum payment for the target company, the payment for any external contribution to the CSA from such an acquisition must also be a lump sum payment pursuant to the Same Form Requirement. There are sound business reasons to allow CSA participants to choose alternative forms of consideration (*e.g.*, fixed installments with interest, contingent payments such as royalties based on sales, or a combination of these).

In addition, Prop. Treas. Reg. § 1. 482-7(b)(4) provides that "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 the property or services for use, consumption, or disposition in such controlled participants territory or territories, to the extent that such profits are attributable to cost shared intangibles." Similarly, the Proposed Regulations prescribe the form of a taxpayer's business activities in the requirement of geographic exclusivity, under which the controlled participants in a CSA must divide all interests in cost shared intangibles such that each participant receives perpetual and exclusive rights to non-overlapping geographic territories. Valid business reasons, including the protection of intellectual property, often exist for not following the contractual forms of transactions dictated by the Proposed Regulations. Nothing in the legislative history of § 482 justifies these dictates, and they are totally inconsistent with the limitations set forth in the Treasury's own current regulatory framework. See Treas. Reg. § 1. 482-1(f)(2)(ii) and Treas. Reg. § 1. 482-1(d)(3)(ii)(B). These Proposed Regulations are an arbitrary limitation on a taxpayer's flexibility to structure intangible property rights based on how they will be utilized, and exceeds the Secretary's authority under the statute.

Further, U.S. case law states that the IRS must accept a transaction actually undertaken by a taxpayer and cannot recast the transaction as an alternative transaction that the taxpayer might have undertaken—but did not. For example, in *Bausch & Lomb v. Commissioner*,[17] the IRS attempted to recharacterize a licensing arrangement between two related parties as a contract manufacturing arrangement for purposes of § 482. The Tax Court rejected this argument and stated although it is possible for a taxpayer to structure transactions in a manner that increases U.S. tax, the taxpayer "is not obligated to arrange his affairs in a manner which maximizes his tax burden."[18]

---

[15] The assets to be contributed may be acquired in a PFA either directly, or indirectly through the acquisition of an interest in an entity or tier of entities. Prop. Treas. Reg. § 1.482-7(b)(3)(v).
[16] Prop. Treas. Reg. § 1.482-7(b)(3)(vi)(B).
[17] 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991)
[18] *Bausch & Lomb*, 92 T.C. at 583.

In *Bausch & Lomb*, the taxpayer formed a wholly-owned Irish manufacturing subsidiary, B&L Ireland, to which it licensed intangibles that the taxpayer had acquired from third parties and subsequently modified. These intangibles allowed the manufacture of soft contact lenses at costs that were substantially below a competitor's costs. B&L Ireland negotiated with an agency of the Irish government ("IDA") an agreement under which IDA was to provide B&L Ireland with a number of incentives, including a ten-year tax holiday, low interest bank loans, free worker training, and subsidized factories. Under the agreement, B&L Ireland agreed that its royalties to the taxpayer would not exceed 5% of net sales. At the start of the arrangement, it was anticipated that B&L Ireland would sell a substantial portion of its output to unrelated European customers. However, due to demand for the product, most of its sales were to the taxpayer with the remainder to the taxpayer's European marketing affiliates. The court rejected the IRS's initial contract manufacturer approach and determined that the appropriate § 482 adjustments involved the determination of arm's length prices for (1) the royalty payable by B&L Ireland for the use of the taxpayer's intangibles, and (2) an arm's-length price for the lenses sold by B&L Ireland to the taxpayer, based on the transaction as structured by the taxpayers.

Similarly, the addition of the commensurate with income standard to § 482 by the Tax Reform Act of 1986 did not override case law requiring the IRS to analyze a taxpayer's transaction as the transaction was structured. In particular, the legislative history to the Tax Reform Act of 1986 states:

> In revising § 482, *the conferees do not intend to preclude the use of certain bona fide research and development 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 unsuccessful as well as successful products within an appropriate product area, and the costs of research and development at all relevant development 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.[19]

The legislative history evidences Congressional intent to allow taxpayers to enter into CSAs in order to jointly share in the costs of developing intangible property. There is no indication in the legislative history that Congress granted or intended to grant the IRS the authority to mandate how taxpayers should structure their cost sharing activities. The IRS is only permitted to evaluate a taxpayer's CSA as structured to determine whether such arrangement complies with arm's length principles. As drafted, the Proposed Regulations severely constrain a taxpayer's ability to decide whether it should cost share to develop intangible property and would permit

[19] Tax Reform Act of 1986, P.L. 99-514 [emphasis added].

cost sharing only when structured in accordance with the Proposed Regulations. Thus, the Proposed Regulations are inconsistent with Congressional intent as evidenced in the legislative history.

The Proposed Regulations are in conflict with the Treasury's own rules. In response to the 1986 Tax Reform Act and the Treasury/IRS White Paper, the IRS issued proposed regulations in 1992, temporary and proposed regulations in 1993, and final regulations in 1994. Treas. Reg. § 1.482-1(f)(2) of the final regulations provides that "[t]he district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance." This is a fundamental principle of the regulations that is clearly violated by numerous provisions of the Proposed Regulations. The 1994 regulations also provide, in Treas. Reg. § 1.482-1(b)(1), that "[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." Thus, the current § 482 regulations test taxpayer economic results under the arm's length standard. They do not mandate that taxpayers structure their affairs to arbitrarily simplify the IRS audit efforts by narrowly constraining the terms and acceptable results of a CSA between related parties, notwithstanding that unrelated parties would ordinarily not agree to such terms.

Specific provisions in the Proposed Regulations are also inconsistent with the current § 482 regulations. For example, for purposes of the buy-in, the Proposed Regulations significantly limit the application of the comparable uncontrolled transaction method and other long standing arm's length methods under Treas. Reg. § 1.482-4 with the so-called "investor model" and so-called "realistic alternative" requirement. In addition, the Proposed Regulations attempt to resolve inherently factual and technical issues with inappropriate economic principles and by imposing purported arm's length contractual terms rather than testing the arm's length results for arrangements entered into by taxpayers. As discussed in more detail below, under the investor model, all residual profits associated with developed intangible property are attributed to the core intangible property from which the developed intangible property is derived. Thus, instead of attributing the residual profits based on all of the surrounding facts and circumstances, the IRS inappropriately uses the Proposed Regulations to provide an answer to a factually based question, which is inconsistent with the IRS' authority under the statute and accompanying legislative history.

These limitations are in conflict with the legislative history to the Tax Reform Act of 1986, in which Congress applied the exact same standard to determine the arm's length result for transfers or licenses of intangibles within cost sharing and for transfers that are outside of CSAs. No authority exists for undermining the existing and long standing transfer pricing methods under § 482 for purposes of determining the arm's length compensation for contributed external intangibles (i.e., the buy-in).

In light of the foregoing, we believe the Proposed Regulations exceed Treasury's authority under § 482 of the Code, the current § 482 regulations, the legislative history and case law. Under those authorities, the Treasury is only permitted to question the amount charged in controlled

transactions and to make allocations to clearly reflect income based on how taxpayers actually conduct business. The Treasury does not have the authority to create or define arm's length terms. Furthermore, under *National Mufflers* and *Chevron*, the Treasury has the authority to promulgate regulations, but such regulations must carry out the intent and purpose of the underlying statute. As drafted, the Proposed Regulations are inconsistent with § 482. Thus, we believe the Treasury should reconsider the Proposed Regulations in view of the statutory authority, legislative history and case law. Moreover, according to the Preamble, the Proposed Regulations were issued because the Treasury believes that additional guidance is required in order to improve compliance and administration of the cost sharing rules, to provide guidance relating to external contributions, and to address technical and procedural issues under the Existing Regulations. We believe, however, that the Existing Regulations have not been judicially tested to determine whether they effectively address the Treasury's concerns. Accordingly, we believe the Treasury should evaluate the effectiveness of the Existing Regulations before finalizing the Proposed Regulations.

IV. Tax Technical Comments

A. Perpetual and Geographically Exclusive Rights

Under the Proposed Regulations, external contributions (including PFAs) transferred pursuant to a PCT are subject to the rules governing reference transactions ("RTs"). Those rules require that all rights must be conveyed in perpetuity and with geographic exclusivity. These rules result in unwarranted limitations on taxpayers' rights to structure their business transactions, disqualifying arrangements that have been dictated by legitimate intangible property protections and other business considerations, and create inappropriate tax consequences. For example, the required transfer of exclusive, perpetual rights acquired in a PFA under the Proposed Regulations will likely result in characterization of the transfer of the PFA as a sale of the intangible, resulting in gain being recognized immediately under other provisions of the Code. The proposed rules governing timing and form of payments regarding PFAs will also likely result in immediate gain recognition, particularly if the PFA is acquired by virtue of a stock acquisition. There is no logical basis for requiring that the form of a stock acquisition of a corporation from an unrelated party should dictate the form of a subsequent related party transaction regarding intangible property owned by the acquired corporation. These transactions are apples and oranges.

The Proposed Regulations also preclude structures that are consistent with alternative arrangements often entered into between unrelated parties in the context of joint ventures, and thus in essence prevent related parties from transacting in a manner consistent with the arm's length standard. For example, arm's length independent parties that cost share often obtain overlapping or non-exclusive rights. Given that the IRS has adequate tools to address valuation concerns regarding external contributions under the Existing Regulations, it is difficult to understand the rationale compelling the adoption of these restrictions regarding the form of transfers of intangible property rights.

Further, the Proposed Regulations are unclear regarding whether geographic exclusivity and transfers in perpetuity apply to all external contributions. The Proposed Regulations provide that the arm's length amount due under a PCT is determined under a method applicable to the RT. The Proposed Regulations explain that an RT is a transaction providing the benefits of all rights exclusively and perpetually in a resource or capability, excluding any rights to exploit an existing intangible without further development. But the Proposed Regulations go on to provide that "[i]f 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." This suggests that taxpayers may designate an RT that does not transfer perpetual rights with geographic exclusivity. The regulations when finalized should clearly state that RTs can be structured in this manner.

Pursuant to long standing principles of U.S. tax law, the transfer of exclusive geographic and perpetual rights may be characterized as a sale or exchange transaction rather than a license, notwithstanding that the payments by the transferee are contingent on productivity or use.[20] § 453(g) may preclude installment gain treatment with respect to such a "sale," in which case the gain will be recognized immediately in an amount equal to the fair market value of the ascertainable proceeds. Accordingly, taxpayers who conform their CSAs to the specific geographic and perpetual rights requirements of the Proposed Regulations are likely to trigger very large and significant gains on existing cost shared intangibles and future PFAs. This consequence cannot be one that Treasury and the IRS considered, but it demonstrates that the conformity of terms required by the Proposed Regulations is clearly inappropriate and unworkable as drafted.

B. Treatment of Consolidated Groups

The Proposed Regulations require that all members of the same consolidated group be treated as one taxpayer. This includes all members of a group of foreign 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. This rule will require that an affiliate be a cost sharing participant, notwithstanding that the affiliate might never benefit from the intangibles that are developed, and may give rise to significant problems under foreign tax law. In addition, the treatment of transactions between foreign related entities is unclear. For example, if intangible property is developed in a CSA and licensed by a holding company that is the parent of a foreign consolidated group to a manufacturing subsidiary, will that license and the resulting royalties be respected by the United States? This provision raises many troubling issues that are not addressed by the Proposed Regulations, and the need for this rule is doubtful. Accordingly, we recommend that the Treasury consider retaining the Existing Regulations governing consolidated groups, which only apply to U.S. consolidated groups.

[20] *See* Watson v. U.S., 222 F2d 689 (10th Cir. 1955); Marco v. Com'r, 25 TC 544; Rev. Rul. 59-210, 1959-1 CB 217; Rev. Rul. 69-56, 1964-1 CB 133; Rev. Rul. 71-564, 1971-2 CB 179.

C. Application of the "Commensurate With Income" Standard

The Proposed Regulations assert that only the IRS has the authority to invoke certain aspects of the commensurate with income standard, namely the retroactive imposition of periodic adjustments. This position is contrary to the explicit language of § 482. Specifically, § 482 provides, in pertinent part, that: "[i]n the case of any transfer (or license) of intangible property . . . , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." The plain language of the statute indicates that it applies in all cases, not only when invoked by the IRS. In addition, this position is contrary to the current § 482 regulations. Treas. Reg. § 1.482-1(a)(3) permits taxpayers to apply § 482 on their original returns for any year (regardless of whether U.S. taxable income is increased or decreased), and thus allows taxpayers to essentially invoke the commensurate with income standard (which is part of § 482) on its return.

The IRS' rationale prohibiting taxpayers from relying on the commensurate with income standard is unconvincing. According to the Preamble, "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." This statement assumes that taxpayers have perfect foresight regarding the likelihood of success or failure of partially developed technology, which is clearly untrue. This statement will no doubt come as a surprise to the many taxpayers that have entered into CSAs, transferred rights in partially developed technology to their foreign affiliates, and then subsequently concluded after additional research that there was no prospect for a commercially viable product.

Further, from an objective standpoint the IRS has expansive powers to audit, investigate and gather information from taxpayers. Moreover, the § 6662(e) transfer pricing penalty rules compel taxpayers to document their transfer pricing positions contemporaneously and provide that documentation to the IRS within 30 days of a request. Accordingly, the IRS currently has all the tools and authority necessary to evaluate the appropriateness of taxpayers' transfer pricing under cost sharing arrangements.

It is important to consider the arm's length implications of allowing only the IRS to assert the commensurate with income standard. Under this rule, the licensee would not enjoy any upside benefit potential. Presumably in an arm's length negotiation the licensee would seek to limit downside risk to compensate for this. Alternatively, a licensee dealing at arm's length would be unwilling to pay observed market prices from transactions in which there is upside potential. Hence, arm's length acquisition valuations would overstate the amount the licensee would agree to pay at arm's length if the licensee could not enjoy any upside benefits.

D. Proposed Regulations Would Undermine Taxpayers' Ability to Engage in Business

The Proposed Regulations would arbitrarily interfere with a taxpayer's decision regarding whether to enter into a CSA by reserving certain rights to reverse the taxpayer's decision. Under the Proposed Regulations, the IRS may deem a transaction to be a CSA, thereby recharacterizing arrangements that the taxpayer intended not to be CSAs. This will be the case even if the taxpayer structured the arrangement as it did due to intangible property protection considerations or other legitimate business needs. In addition, the IRS reserves the right to disqualify certain transactions, such that they will not be respected as CSAs and will instead be recharacterized as licenses or in some other unspecified form. Thus, the IRS has reserved for itself some extraordinary rights, with no statutory basis or other legal foundation.

E. Treatment of Stock-based Compensation Should Respect Case Law

The final cost sharing regulations should reflect the ultimate result in *Xilinx*.[21] In August of 2005 the Tax Court held that stock-based compensation should not be included in the cost base for purposes of CSAs. The IRS has yet to indicate whether it will appeal this decision. Given these circumstances, we request that the IRS suspend regulations on this issue until such time as the courts have had an opportunity to resolve this question.

F. Cost Sharing Is Not a "Safe Harbor" Granted At The Discretion of the IRS

The Proposed Regulations effectively relegate cost sharing to a government sanctioned "safe harbor" election rather than an arm's length concept, which is inconsistent with Treas. Reg. § 1.482-1(b)(2), the 1986 legislative history, and the Preamble to the Proposed Regulations. In particular, the Preamble provides that "[t]ransactions 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." Notwithstanding this statement, the Proposed Regulations proceed to mandate a restrictive construct that is in substance and practical effect a safe harbor, in essence warning taxpayers that if they structure their CSAs in a manner slightly different than that allowed by the regulations, these arrangements will likely not be respected by the IRS, and the tax consequences of the arrangements will be entirely unclear.

V. Transition/Grandfathering Rules

A. Background

AeA requests clarification of the application of the Proposed Regulations to CSAs entered into before the Proposed Regulations were issued. The Preamble indicates the Proposed Regulations provide "transition rules for modified compliance in the case of qualified CSAs under existing § 1.482-7, as well as rules for terminating such grandfather status."[22] The Preamble further

[21] *See* Xilinx v. Commissioner, 125 T.C. No. 4 (August 29, 2005).
[22] 70 Fed. Reg. at 51168.

provides that the Proposed Regulations would be applicable on their date of publication in the Federal Register. As a result, it indicates that—

> 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 § 482 regulations. See proposed § 1.482-7(a)(3)(iii).[23]

The Preamble also notes the Proposed Regulations provide transition rules pursuant to which an existing CSA that constituted a qualified CSA under the regulations before the effective date will be considered a CSA and "allowed an additional period to conform to the new rules with certain modifications." Importantly, the Preamble provides in the next sentence that—

> [a]lthough 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.[24]

Prop. Treas. Reg. § 1.482-7(l), which is entitled "effective date," provides that the Proposed Regulations apply "on the date of publication of this document as a final regulation in the Federal Register." Consistently, it indicates that CSAs entered into after the effective date, and CSTs and PCTs occurring after such date with respect to CSAs existing as of the effective date, will be subject to the cost sharing regulations (as finally revised). This language contains no suggestion that the Proposed Regulations are effective on other than a prospective basis. Consistently, there is no mention of § 7805(b).

Prop. Treas. Reg. § 1.482-7(m) states that it provides "transition rules" under which an existing CSA that constituted a qualified CSA under the regulations before the effective date will be considered a CSA and "allowed an additional period to conform to the new rules with certain modifications." In particular, conforming would require that controlled participants' CSTs and PCTs comply with the substantive requirements of the regulations. Prop. Treas. Reg. § 1.482-7(m) further specifies that CSTs and PCTs occurring prior to the effective date are subject to the new rules only in the event that PCT Payments become subject to periodic adjustment under Prop. Treas. Reg. § 1.482-7(i)(6) as a result of a subsequent PCT occurring on or after the effective date of the new rules.

---

[23] 70 Fed. Reg. at 51161.
[24] 70 Fed. Reg. at 51132.

The Proposed Regulations specify certain circumstances under which the grandfathered status of a pre-effective date CSA will terminate. In particular, Prop. Treas. Reg. § 1.482-7(m)(2) indicates that an otherwise grandfathered arrangement will cease to be grandfathered from the earliest of the date on which (i) the controlled participants fail to substantially comply with the transitionally modified regulations, (ii) there is a material change in the scope of the CSA (*e.g.*, a material expansion of the CSA activities beyond those undertaken as of the CSA effective date), or (iii) there occurs a 50 percent change in the beneficial ownership of the interests in cost shared intangibles.

B. Discussion

As an initial matter, AeA observes that there appear to be no "grandfather rules" contained in the Proposed Regulations. Although Prop. Treas. Reg. § 1.482-7(m)(2) is entitled "Termination of Grandfather Status," Prop. Treas. Reg. § 1.482-7(m)(1) provides that the legal agreement for each CSA must be amended, when necessary, by the close of the 120th day after the date the final cost sharing regulations are published in the Federal Register. In effect, whenever the rules of the Proposed Regulations are more restrictive and inconsistent with an existing CSA, the regulations require that a cost sharing participant amend its CSA to conform to the new regulations within this 120 day period or risk losing whatever "grandfather status" the participant may have had. This is not a grandfather rule, but rather a transition rule in connection with Proposed Regulations that will apparently have retroactive effect.

AeA finds the "120 day rule" particularly curious, because neither the Preamble nor the Proposed Regulations indicate the final cost sharing regulations will apply retroactively to many taxpayers. Under § 7805(b), Congress has specifically limited the situations in which Treasury may promulgate regulations that apply retroactively. The circumstances under which the Proposed Regulations may be made retroactive have not been met in this instance. Accordingly, AeA submits that the Proposed Regulations are disingenuous in not acknowledging that the Proposed Regulations will retroactively affect existing CSAs. AeA believes the Proposed Regulations constitute retroactive regulations in violation of § 7805(b).

If the Proposed Regulations are finalized, taxpayers will have 120 days to make any required amendments to a grandfathered CSA. AeA submits this is not sufficient time to meet these and other technical, accounting, documentation, and reporting requirements set forth in the Proposed Regulations. We suggest that given the substantial nature of these changes, a taxpayer should have at least one year to conform their cost sharing documentation, or at a minimum until the date the relevant original return is to be filed (with extensions).

AeA submits that the Proposed Regulations should in fact provide "grandfather rules" consistent with other regulations. These rules should provide that CSAs entered into as of a date before the new regulations are finalized are subject only to the cost sharing regulations existing before that date. In other words, the final regulations should not affect pre-existing contractual

arrangements, and should only apply prospectively to CSAs entered into after the effective date. In this regard, taxpayers have relied on the Existing Regulations for the past ten years.

As a result, AeA submits that it is inappropriate for the Proposed Regulations to apply to CSAs where the buy-in payments continue past the effective date of the regulations. Taxpayer expectations and reliance on the Existing Regulations should be respected, and the reasonable expectations of taxpayers who relied on the then Existing Regulations when entering into a CSA should not be disturbed. In any event, the Proposed Regulations should not apply to cost contributions or external contributions (including acquisitions) made before the effective date under any circumstances.

Another problematic aspect of the Proposed Regulations from a "grandfathering" perspective is how a taxpayer should take into account the new rules concerning geographic exclusivity and the need for perpetual rights. If a taxpayer amends its CSA based on the Proposed Regulations to reflect these new rules, it is unclear whether the CSA will continue to be treated as a CSA or whether it would trigger the rules of the Proposed Regulations that characterize such a transaction as a preliminary or contemporaneous transaction ("PCT"). AeA believes that the final regulations should not require cost sharing participants in pre-existing CSAs that have specified rights (including non-exclusive rights) to amend their CSAs because of the final regulations.

AeA is also concerned about the potential impact of the Proposed Regulations on transactions that may have already been resolved through the expiration of the statute of limitations, an IRS audit settlement, or a court decision. Taxpayer transactions that have been so resolved should not be subject to further adjustments under the final regulations. This includes, in particular, any dispositions of a taxpayer's pre-effective date buy-in transactions, such as closing agreements, final court decisions, or statute of limitations dispositions. Therefore, the final regulations should not allow the Service to re-open prior CSA-related transactions that were entered into under the rules sanctioned by the then-in-effect cost sharing regulations.

An additional concern of AeA is that a post-effective date external contribution and/or post-formation acquisition should not result in a loss of "grandfather" status. For example, if the cost sharing participants in a CSA were to acquire additional intangible property, that fact generally does not require the participants to reevaluate the original transaction, as the Proposed Regulations suggest. Similarly, post-effective date transactions that involve external contributions and acquisitions should not be considered a mechanism that allows the Service to re-open previously closed buy-in transactions for taxpayers that have pre-existing CSAs.

Another concern of AeA is that Prop. Treas. Reg. § 1.482-7(m)(2)(iii) provides that an arrangement will not be considered a CSA as of the date that 50% or more of the value of the interest in the cost-shared intangibles are owned directly or indirectly by one or more persons that were not direct or indirect owners of the relevant interests as of the date the final cost sharing regulations are published in the Federal Register. Acquisitions and post-merger integration occur on a routine basis in today's business climate, and should not cause a potential

loss of grandfather status. Under this rule, it appears that even an ordinary tax-free reorganization could potentially trigger the loss of grandfather status. However, we believe that neither a taxable nor a tax-free transaction in the ownership of the cost sharing participants should trigger a termination of the CSA.

Finally, we note that while the Preamble states that the Proposed Regulations provide guidance regarding the consequences of the termination of grandfather status, the proposed rules are silent with respect to what happens when a grandfathered CSA is terminated under the provisions of the regulations. This contradicts the statement in the Preamble quoted above that the Proposed Regulations do in fact provide rules regarding what happens when a grandfathered CSA is terminated. Similarly, while the Proposed Regulations indicate that a material change in the scope of an arrangement could cause the loss of grandfather status, the term "material change" is not defined. If the rules regarding loss of grandfathered status are retained, additional guidance is needed to clarify the implications of a material change taking place.

VI. Economic/Valuation Issues

A. Background

The Preamble indicates the task of the Proposed Regulations was to give guidance for the terms of related party CSAs that would approximate the economic results which would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. In this regard, the Preamble states "[t]his guidance is necessary because of the fundamental differences in CSAs 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 CSAs under the regulations."[25]

The framework adopted by the Proposed Regulations to provide this guidance is the so-called "investor model" which views each controlled participant in a CSA as making an aggregate investment equal to its (i) cost contributions and (ii) external contributions. The proposed investor model raises a number of economic and valuation-related issues because the Proposed Regulations treat pre- and post-cost sharing investments asymmetrically. This asymmetrical treatment is inconsistent with the commensurate with income principles embodied in § 482, with the § 482 regulations previously issued by the Treasury, and with the generally cumulative nature of intellectual know-how.

One fundamental notion of the commensurate with income standard is that the parties to a CSA who appropriately share the costs and risks of the arrangement should be entitled to share not only in any losses incurred by the arrangement, but the profits as well. In this regard, the Conference Report to the 1986 Act specifically indicates that to the extent one cost sharing participant "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

[25] 70 Fed. Reg. at 51117.

extent than the other, it would be expected that an appropriate return would be provided to such party to reflect its investment."[26] According to the Preamble, the investor model is "grounded" in the legislative history of the 1986 Act, specifically the sentence quoted above.

The contribution by one participant to a CSA in advance of contributions by other participants is a legitimate transfer pricing concern. However, AeA believes the application of the long standing methods described in Treas. Reg. § 1.482-2 and -4 remain viable in addressing the arm's length compensation for intangibles, if any, created during the earlier stage of cost sharing contributions and for any other intangibles contributed by participants to the CSA. Thus, in AeA's view, the introduction of the investor model and its companion, the realistic alternative test, are unnecessary complications and their addition certainly will not ease the administration of cost sharing for taxpayers or the IRS.

Another significant concern of AeA is that the Proposed Regulations' asymmetrical treatment of pre- and post-cost sharing investments unreasonably limits a cost sharing participant's anticipated return through a weighted average cost of capital ("WACC") approach. The proposed rules of Prop. Treas. Reg. § 1.482-7(g)(2)(viii) are inappropriate because a controlled cost sharing participant in an R&D project should be entitled to share in any premium returns that result from the project, consistent with the results expected in an uncontrolled CSA context. In an arm's length CSA between unrelated parties in which both parties share in speculative development risks, both parties would fully share in the profits, if any, attributable to the cost shared Intellectual Property ("IP").

From a valuation perspective, Prop. Treas. Reg. § 1.482-7(g)(2)(viii) indicates valuation must be consistent with two key principles that underlie the investor model. 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."[27] 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."[28] Because Prop. Treas. Reg. § 1.482-7(g)(2)(vi) indicates that the appropriate return methodology under both of these principles commonly is to use a WACC-based calculation, AeA submits that the Proposed Regulations inappropriately limit a cost sharing participant's potential upside return.

The position that a controlled cost sharing participant who bears an appropriate amount of risks and burdens should be entitled to share in any premium returns earned by the relevant project is consistent with the well-established principle that a taxpayer is entitled to transfer a business opportunity.[29] Because such a business opportunity includes the right to earn premium returns from successful future R&D, the Proposed Regulations have the effect of inappropriately denying taxpayers their right to transfer business opportunities.

---

[26] H.R. Conf. Rep. No. 99-841 at II-638 (1986).
[27] 70 Fed. Reg. at 51124.
[28] *Id.* at 51125.
[29] *See* Hospital Corporation of America v. Commissioner, 81 T.C. 520 (1983).

The asymmetrical treatment of pre- and post-cost sharing investments is also inconsistent with the commonly accepted understanding of how know-how accumulates. The investor model implies that PCT payments should be set at a level such that post-cost sharing investments earn an anticipated return equal to a risk-adjusted cost of capital. All of the residual above this return (and above returns to basic functions) is attributed in perpetuity to the pre-cost sharing intangibles. This distinction between the return to pre-cost sharing and post-cost sharing R&D investments is arbitrary and inconsistent with the cumulative nature of know-how.

Know-how is cumulative. It is doubtful that any intellectual property can be traced to some basic idea that does not itself rely on earlier efforts. AeA submits that it is inappropriate to treat pre-cost sharing R&D spending as being somehow fundamentally or qualitatively different from the R&D spending that follows it. Both contribute to value, and both rely on earlier know-how.

Finally, we note the geographic limitation requirement also creates difficult valuation issues. For example, if for business reasons a U.S. taxpayer sells directly into a foreign territory, it would be required under the Proposed Regulations to compensate the local foreign CSA participant that has the relevant territorial rights. This creates difficult valuation problems, particularly if the CSA-developed intangibles are bundled with other technology and/or goods sold to the customer.

B. The Investor Model

The investor model adopted by the Proposed Regulations would impose upon all CSAs an economic framework that is ill-suited to many if not most CSAs. This framework is based on the incorrect assumption of long-run equilibrium conditions of a standard classical economic model in which investors face a continuum of investment opportunities. Importantly, under this model there are numerous potential bidders so that the idiosyncratic characteristics of any particular buyer and seller can be ignored. Further, under this model, interactions are impersonal and rent-extraction is complete.

The framework from which the investor model is derived has been a useful pedagogical tool for introducing generations of students to the basic principles of economics. This simple model is, however, particularly poorly suited to intangible property transactions where (i) there are few potential buyers and sellers, (ii) factual idiosyncrasies of the buyers and sellers are important, and (iii) interactions are not with an impersonal market, but with specific taxpayers who are highly aware of each other and the impact of their actions.

By adopting an oversimplified economic model and ignoring short-run constraints, the Proposed Regulations neglect much of what is known about the economics of technology transfers in the real world. The assumptions of the investor model are especially inappropriate where the relevant intangibles have short-term lives, in contrast to the premises of the investor model framework that follow from its long-run equilibrium emphasis.

The proposed adoption of the investor model raises a number of concerns about the Proposed Regulations. One concern is that the investor model abandons the long standing principle that comparable uncontrolled transactions are preferable to artificially derived proxies for uncontrolled transactions. This principle is at the heart of the arm's length principle and core to the CUT method sanctioned by the regulations.

Another concern is that the investor model attempts to resolve a factual "useful life" determination for external contributions with a contrived regulatory substitute. The Preamble notes that—

> 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.[30]

Given the broad array of intangibles—particularly those that are not platform based—and their differing useful lives, it is more appropriate to make a factual determination as to the useful life of the relevant intangibles on a case by case basis instead of adopting a rule based on incorrect premises.

The investor model asserts that "[i]f the cost shared intangibles are reasonably anticipated to contribute to developing other intangibles, then the period … [over which the Investor Model should be applied] *includes the period of developing and exploiting such indirectly benefited intangibles*" (emphasis added).[31] The inappropriateness of this presumption can be illustrated by the following example.

Assume a taxpayer created version 1.0 of a software program prior to entering into a CSA, and then subsequently builds 10 successive versions of the software program with a total investment many times greater than the initial investment. Under the Proposed Regulations' investor model, all residual profits associated with version 10.0 of the software would continue to be attributed to the software developed in version 1.0.

In the example, how much of the value of version 10.0 is attributable to IP intrinsic in version 1.0 is a *factual* question. Because of the asymmetric treatment of pre- and post-cost sharing R&D, the Proposed Regulations would answer this question in a way that is advantageous for the tax authority of a country that is primarily an early innovator. That is, the Service's position is not merely that the core intangible *has value,* it is that the core intangible *accounts for all residual value for as long as derivative works exist.* In the above example, such an answer is wrong on its face. More fundamentally, it is improper for the Service to use the Proposed Regulations as a vehicle for imposing *any* answers to or presumptions regarding inherently factual questions.

---

[30] 70 Fed. Reg. at 51125.
[31] Prop. Treas. Reg. § 1.482-7(g)(2)(viii)(A), (B).

C. The Best Realistic Alternative Test

Another important premise of the Proposed Regulations is that uncontrolled taxpayers acting at arm's length would evaluate the terms of a proposed transaction and enter into it only if none of the alternative ways for structuring the transaction was preferable. Prop. Treas. Reg. § 1.482-7(g)(2)(vi) incorporates this notion into the regulations by indicating that 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."[32]

The best realistic alternative test of the Proposed Regulations ignores factors other than a CSA participant's expected income when a taxpayer must evaluate the choice among its alternatives for a transaction. Taxpayers often forego investments that have positive anticipated profits, and often base their choices among alternatives on factors other than the expected return on the investment. Risk, diversification, strategic direction, contractual arrangements, and limitations on management resources are just a few of the other important factors that are considered. The Proposed Regulations ignore these factors, however, and assert simply that an alternative cannot be preferable if, "for any controlled participant the total anticipated present value from entering into the CSA … is less than the total anticipated present value that could be achieved through an alternative arrangement realistically available to that controlled participant."[33] These other factors would, however, be taken into account by uncontrolled taxpayers. Accordingly, AeA submits that the Proposed Regulations should be revised to specifically take these critical factors into account.

One straightforward example indicates the potential peril to taxpayers of literally applying the best realistic alternative test of the Proposed Regulations. As a practical matter, some type of contract manufacturing arrangement could be a plausible alternative to almost any CSA. Such an arrangement would maximize income allocable to the U.S. controlled participant (in the case where the U.S. participant is the entity that had the alternative of so structuring the arrangement), and minimize the income allocable to any foreign cost sharing participant. Under such an approach to the best realistic alternative test, the IRS in effect would have the unilateral ability to reject any CSA that left one party with less income that it could have earned under a contract manufacturing alternative. Such an approach, which the Proposed Regulations indicate would be at the sole discretion of the IRS, would effectively repeal cost sharing as a viable option for all U.S.-based multinational taxpayers.

When a company engages in cost sharing with a controlled affiliate, it is not making a substantive decision about how to exploit an intangible (*i.e.*, license vs. self-manufacture). The substantive economic decision has already been made: by keeping the intangible within the controlled group, the company is *directly entering* the foreign market. It is only a question of which member of the controlled group makes the investment. Accordingly, it would appear that

[32] 70 Fed. Reg. at 51124.
[33] Prop. Treas. Reg. 1.482-7(g)(2)(iv)(A).

the Service could in every case assert that contract manufacturing was a realistic alternative, and (by implication) limit the offshore return to a contract manufacturing return. In essence, the unconstrained application of the best realistic alternative principle to controlled transactions is highly artificial and could effectively foreclose all cost sharing. It can reasonably be expected that this provision would enable the IRS to recharacterize unilaterally, with hindsight, all successful cost sharing arrangements with a U.S. controlled participant (that has alternatives available to it), while respecting all unsuccessful cost sharing arrangements with a U.S. controlled participant (that has alternatives available to it).

Another flaw with the Proposed Regulations' best realistic alternative test is that it requires that both controlled cost sharing participants earn a higher return under cost sharing than they would have without cost sharing. Prop. Treas. Reg. § 1.482-7(g)(7)(v), (ix) indicates that the terms of the PCT should leave *both parties* to the transaction better off than they would be had they not entered into the transaction. In this regard, it is simple to show that (i) if the financial projections for a business opportunity are the same in the hands of both the contributor and the purchaser of the relevant R&D, and (ii) the IP transfer results in a tax cost (such as by accelerating a tax liability), then *as a matter of arithmetic* there can be no PCT that will leave both parties better off. As a result, depending on how the realistic alternative test is formulated, there may be many transactions that this test simply forecloses because it creates a standard that cannot be met by every CSA participant in an arrangement.

The Proposed Regulations are also unclear regarding whether the best alternative test and the investor model are considered methods, or should be considered tests that apply to all methods. The best realistic alternative concept arises twice: first, it is described as a stand-alone test that applies to all methods by Prop. Treas. Reg. § 1.482-7(g)(2)(iv). Next, it is described as the essence of the "income" method in the general discussion of that method in Prop. Treas. Reg. § 1.482-7(g)(4)(ii). Similarly, Prop. Treas. Reg. § 1.482-7(g)(2)(iv) and Prop. Treas. Reg. § 1.482-7(g)(2)(viii) indicate that any PCT payments must be consistent with both the best realistic alternative and the investor model, respectively. The discussion of the two is commingled in the Preamble, but the regulations properly describe them as two separate and distinct tests. Apparently *both* tests are intended to be applied to *all* participants.[34] But if the realistic alternative test is to be applied to all methods, why is it necessary to create a specific method that is based on that concept? Moreover, e*ven under the Service's economic model,* the Investor Model should not be applied when both parties to the transaction contribute non-routine intangibles.

To add to the confusion, notwithstanding the assertion of the regulations that the income method is applied "… by reference to the controlled participants' realistic alternatives,"[35] the discussion

---

[34] With respect to the realistic alternative test, the Proposed Regulations provide that "[t]he condition is not met … where for *any* controlled participant…" With respect to the investor model, the Proposed Regulations provide that "[t]he valuation of the amount charged in a PCT must be consistent with the assumption that … *each* controlled participant's …." (emphasis added). Notwithstanding this language, AeA believes that the investor model cannot logically be applied to *all* parties to a CSA. If the investment opportunity yields a return in excess of cost of capital, one party or another must be allocated this return.
[35] Prop. Treas. Reg. § 1.482-7(g)(4)(i).

of the income method using a CPM describes that method completely without any reference to realistic alternatives.[36] Indeed, the income method using a CPM is simply the investor model under another name. This raises two questions: (1) if the income method in general relies on the best realistic alternative concept, why does the income method using a CPM ignore that concept; and (2) why enshrine the investor model in a specified method if that test is to be applied to all methods? Given the above, the Proposed Regulations should be revised to clarify whether these two tests are methods in and of themselves, or rather are tests that apply to all methods.

The Proposed Regulations neither acknowledge the possibility that the investor model and best realistic alternative analysis could lead to different results, nor indicate which method would prevail under such circumstances. It is easy to construct an example that passes one test, but fails the other. Accordingly, the Proposed Regulations should be clarified concerning whether it is the Service's position that all CSAs must pass both tests (which would seem inappropriate).

As noted above, the language of the regulations states that both the realistic alternative test and investor model apply to all cost sharing participants. But in the examples illustrating the regulation (and sometimes in the operative language itself), the Proposed Regulations are selective. For example, in the description of the income method using a CUT,[37] in both the example and directly in the operative language, the Service applies the realistic alternative test to only one party to the transaction, in contravention of its own instructions. The Proposed Regulations should be revised to state explicitly which party is to be tested by which test, and under what conditions.

In addition, application of the realistic alternative test and the investor model may be incompatible with the best method rule in Treas. Reg. § 1.482-1(c). The best method rule establishes that no method has priority; the method that provides the most reliable measure of an arm's length result should prevail. However, the investor model and the realistic alternative test may be read to trump the best method rule, fundamentally undermining a basic principle of the current § 482 regulations. Perhaps most importantly, the regulations are vague on how the realistic alternative should be formulated. At one point the regulations assert that "[t]his application [income method using a CUT] assumes that the best reasonable alternative … would be to license the …intangibles to the other controlled participants.[38] This language is included within the operative regulatory language, not in an example, thereby suggesting that it is a general principal to be applied. The best realistic alternative dictate should be removed from the Proposed Regulations.

[36] Prop. Treas. Reg. § 1.482-7(g)(4)(iv)(A).
[37] Prop. Treas. Reg. 1.482-7(g)(4)(iii).
[38] *Id.*

D. Discount Rate Calculation

Another concern of AeA is the complexity and uncertainty involved in calculating a discount rate under the Proposed Regulations. The calculation required by the Proposed Regulations in the case of a PCT payment under the investor model is somewhat unclear. In this regard, Prop. Treas. Reg. § 1.482-7(g)(2)(vi) provides that 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.

The examples in the Proposed Regulations suggest that the discount rate calculation will be straightforward, although a close examination reveals the proposed rules open the door to numerous new complexities, some of which are highlighted below.

More specific guidance is needed in order to ensure that a discount rate calculation is appropriately determined. A cost sharing participant's cost of capital generally depends on its economic tax rate and capital structure. As a result, the same PCT payment will lead to different rates of return for cost sharing participants with different tax attributes. Although Prop. Treas. Reg. § 1.482-7(g)(2) suggests the use of a WACC based on information from uncontrolled parties or the taxpayers' own WACC, the use of a WACC is inappropriate because a cost sharing participant should be entitled to any premiums earned, as discussed above.

E. The Periodic Trigger Test

The Service may make periodic adjustments with respect to all PCT Payments for an open taxable year (and for all subsequent taxable years for the duration of the CSA Activity) if it determines a particular controlled participant that owes (or owed) a PCT Payment has realized an Actually Experienced Return Ratio (AERR) that is outside the Periodic Return Ratio Range (PRRR). Prop. Treas. Reg. § 1.482-7(h)(6)(v) indicates that when this condition is met, a so-called "Periodic Trigger" occurs. In such a case, the IRS is allowed to make periodic adjustments for the duration of the CSA based on the residual profit split method of Prop. Treas. Reg. § 1.482-7(g)(7).

One problem with the Periodic Trigger Test is that the Proposed Regulations contemplate the Test will be applied separately to each PCT. As a practical matter, however, it will be almost impossible to separate out the profits attributable to different PCTs when there are multiple contributions of intangibles by each of a number of PCTs (and perhaps by multiple contributors) into a single CSA. Thus, the Periodic Trigger Test would be difficult to implement as well as unreliable in situations where there are multiple PCTs.

Another concern of AeA regarding the Periodic Trigger Test is that the Proposed Regulations authorize the Service to make periodic adjustments using the residual profit split method. In some cases, however, another pricing method might be a more reliable indicator of arm's length results. AeA suggests the Proposed Regulations should be revised to provide that the best method rule applies in the case of periodic adjustments and requires that such adjustments be made using the most reliable pricing method.

F. The New Residual Profit Split Method

The second step of the new three step residual profit split method uses a fraction that appears to have no economic basis and is mathematically defective. The second step of this method is to apportion each participant's operating profit (before R&D but after routine returns) between a share attributable to cost contributions and a share attributable to pre-existing intangibles. For each participant this apportionment is based on a fraction. The numerator of the fraction is the present value of that participant's cost contributions. The denominator of the fraction is the present value of that participant's operating profit (before R&D but after routine returns).

In the example in the Proposed Regulations[39] (which was sketchily explained), it appears that the calculation is:

> [4 / (8.4 - .4)] * (8.4 - .4) for the U.S. parent and
> [6 / (12.6 - .6)] * (12.6 - .6) for the foreign subsidiary.

The denominator of the fraction appears to be the same amount as the amount that is being apportioned. In mathematical terms:

> Share of income attributable to cost contributions = (A / B) * B

But this is simply equal to A, by definition. In other words, the amount of income attributable to the cost contributions is simply equal to the cost contributions. Not only is this calculation defective, there also appears to be no economic rationale for this result, which again treats pre- and post- cost sharing R&D asymmetrically.

G. Market Capitalization Method

Prop. Treas. Reg. § 1.482-7(g) sets forth a number of new specified methods for purposes of determining the arm's length compensation due under a PCT. These methods include (i) the income method, (ii) the acquisition price method, and (iii) the market capitalization method. The market capitalization method has been widely criticized by the economic community, and comment letters have set forth in detail numerous problems with the market capitalization method. Rather than summarize all of these comments, AeA reiterates that the fundamental flaw with the market capitalization method is that it is unreliable because stock prices are dependent on a variety of factors that are not related to the relevant intangibles. The reliability of the

[39] Prop. Treas. Reg. § 1.482-7(g)(7)(v).

market capitalization method is hampered further because stock prices are well known to be volatile over the short-term.

The use of the market capitalization method is also inappropriate because it is inconsistent with the best method rule of Treas. Reg. § 1.482-1(c). Treas. Reg. § 1.482-1(c)(1) provides that the "arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result." Accordingly, given the unreliability of the market capitalization method, another reason it should not be sanctioned by the Proposed Regulations is that it is inconsistent with the best method rule of Treas. Reg. § 1.482-1(c).

H. Treatment of Goodwill and Going Concern Value

Clarification of the Proposed Regulations also is needed in connection with the treatment of goodwill and going concern value. AeA believes that goodwill and going concern value should be specifically excluded from the definition of external contributions, as well as preliminary and contemporaneous transactions under the regulations. In this regard, AeA is concerned with the statements made in the Preamble and in the Proposed Regulations which draw economic conclusions without justification to support taxpayer unfavorable positions.

For example, the Preamble indicates that—

> 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 (emphasis added).[40]

This is one example of an attempt by the Proposed Regulations to validate non-economic conclusions using economic language where the conclusions have no economic basis. Similarly, Prop. Treas. Reg. § 1.482-7(g)(2)(vii)(B) of the regulations indicates that an attribution of some amount to goodwill in a purchase valuation will be disregarded, arguing that since the target "has nothing of value aside from its in-process technology and assembled workforce . . . . [t]he …

[40] 70 Fed. Reg. at 51124.

[entire acquisition price] therefore, is economically attributable to either or both the in-process technology and the workforce."

The quoted language of Prop. Treas. Reg. § 1.482-7(g)(2)(vii)(B) reveals two shortcomings in the Treasury's reasoning. First, it is reductionist. There is nothing in economics that says a firm can be decomposed into a set of assets, and that the sum of the values must add up to the value of the firm. This is an accounting (*i.e.*, non-economic) convention that the Proposed Regulations attempt to dress up as an economic conclusion.

Second, the language of Prop. Treas. Reg. § 1.482-7(g)(2)(vii)(B) illustrates the weakness that arises from applying the Treasury's classical equilibrium model to a technology transfer. Especially in the technology arena, purchasers often pay more for a target than appears warranted by the financial prospects of the intangibles in the hands of the target. For accounting purposes the excess is called goodwill. A purchaser will do this because it expects to be able to generate more income from the assets than the target could have. In a small-numbers bargaining world, the target captures a share of these synergies, although the synergies are not purchased intangibles.

In general, this conclusion (and similar examples) is presented by the Treasury as if it was almost self-evident. This is unwarranted, and highlights the fact that the Treasury has adopted an oversimplified economic model and is apparently unaware that the Proposed Regulations' conclusions lack a strong economic foundation.

Finally, the Preamble[41] and the Proposed Regulations[42] characterize research teams as external contributions that warrant a share of residual profits. This position is not supported by current law and exceeds the Treasury 's authority to promulgate regulations under § 482. Consistent with arm's length economic valuations, a research team or work force should be valued based on replacement cost, and thus reflect a cost plus mark-up.

I. PCT Buy-In

The portion of the acquisition price paid to a seller that reflects a buyer's intangibles and synergies should be excluded from the PCT buy-in payment. A portion of the acquisition price (in a PFA) reflects the buyer's synergies and intangibles and is not attributable to the seller's intangibles. It is a well established economic precept that the seller captures value attributable to the buyers' synergies and intangibles. This is yet another reason why the PCT acquisition price/investor model is not economically justified at arm's length for intangibles made available to the CSA.

[41] 70 Fed. Reg. at 51120.
[42] Prop. Treas. Reg. § 1.482-7(b)(1)(viii) Example 1.

J. Heightened Standard of Proof

AeA is also concerned that the Proposed Regulations contain a heightened standard of proof that must be met by a taxpayer in a few different contexts. For example, the Preamble[43] and the Proposed Regulations[44] indicate that when the actual 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, the Service is entitled to make a periodic adjustment. Prop. Treas. Reg. § 1.482-7(i)(6)(vi)(B) contains an exception under which no periodic adjustment will be made if a taxpayer can establish to the satisfaction of the Service that the differential between the taxpayer's actual return ratio and the safe harbor range is due to extraordinary events beyond its control that could not reasonably be expected. Similarly, Prop. Treas. Reg. § 1.482-7(i)(6)(vi)(C) provides an exception that would apply if a taxpayer can establish that a periodic trigger would not have occurred if the operating profits of the participant making a buy-in payment were reduced by the operating profits attributable to its routine and non-routine contributions. Finally, Prop. Treas. Reg. § 1.482-7(i)(6)(vi)(D) sets forth an exception that applies when a taxpayer can establish that a periodic trigger would not have occurred if the operating profits of the buy-in payor included its reasonably anticipated operating profits, cost contributions and PCT payments after the adjustment year.

These stringent exceptions reflect a heightened standard of proof that is unwarranted and unnecessary. A taxpayer already has a sufficiently heavy burden of proof under § 482. In particular, it must prove both that the Service's adjustments are arbitrary, capricious or unreasonable and that the taxpayer's transfer prices are arm's length. Accordingly, AeA respectfully suggests that these provisions that require a heightened standard of proof be omitted from the final regulations.

VII. Policy Considerations

There are several policy reasons the IRS should consider before issuing the Proposed Regulations in final form. First, the Proposed Regulations are inconsistent with existing OECD cost sharing (cost contribution) principles. Moreover, the unilateral approach of the Proposed Regulations will inevitably lead to transfer pricing controversies that cannot be resolved in competent authority negotiations with our treaty partners. In particular, U.S. treaty partners are unlikely to agree that taxation of their residents should depend on terms that would be unacceptable to unrelated parties, and be based on transactions that are different than the transactions the participants actually entered into, or to the fact that the Proposed Regulations only allow the IRS (and not a taxpayer) to make retroactive periodic adjustments. For example, the Same Form Requirement is problematic in conjunction with the proposed RT rule, which charges PCT Payors as though they were owners of acquired intangibles even if their rights are only those of licensees. Accordingly, U.S. treaty partners are unlikely to agree that taxation of their residents should depend on transactions they did not undertake.

[43] 70 Fed. Reg. at 51118.
[44] Prop. Treas. Reg. § 1.482-7(h)(i)(6); Prop. Treas. Reg. § 1.482-7(h)(ii)(A).

Second, by defining workforce as an external contribution and requiring all excess profits be allocated to the participant who makes external contributions, the Proposed Regulations create a significant incentive for all companies to locate or relocate their workforce outside the United States. U.S.-based research and innovation has enabled the U.S. economy to offset the impact of low cost foreign manufacturing and production labor. Significant long term damage to the U.S. economy could result if, through these Proposed Regulations, the IRS is permitted to levy a tax penalty on U.S. multinationals who innovate and conduct U.S. research.

Third, the Proposed Regulations create a significant benefit to foreign parent companies or foreign participants that are in a CSA with a U.S. group. In particular, the Proposed Regulations taken as a whole will result in non-arm's length payments by U.S. participants to foreign participants that make external contributions to CSAs.. This would create a significant economic and tax benefit to foreign companies, thereby reducing a U.S. multinationals' ability to globally compete.

The significant tax cost associated with a PFA may considerably impact U.S. business. In particular, because of the draconian effect of the Same Form Requirement, the Proposed Regulations could impede U.S. mergers and acquisitions activity. It may also adversely impact U.S. multinationals' ability to compete for acquisitions with foreign multinationals. In addition, the Proposed Regulations would adversely impact U.S. multinationals that are globally developing intangible property under a CSA by hindering their ability to compete for acquisitions with U.S. multinationals that are not cost sharing.

Finally, we note that the Proposed Regulations—which are over 200 pages long and include many new acronyms—create extensive contractual, accounting, documentation and reporting requirements for a taxpayer that cost shares in addition to the already substantial obligations under the Existing Regulations. The wording of many provisions is expansive, confusing and vague (*e.g.*, the introduction of new definitions such as "Reference Transactions"), and is likely to lead to litigation with taxpayers and conflict with U.S. treaty partners. Moreover, compliance with these requirements will be costly and time-consuming; whatever the level of costs, they will be borne by some combination of higher prices to consumers, lower return to capital and labor and reduced dividends to shareholders.

In conclusion, AeA believes that the Proposed Regulations exceed the authority granted to Treasury by the statute, constitute flawed tax policy, are economically unsound, and are inconsistent with the legislative history, the current § 482 regulations, and judicial precedent. In addition, they are an unnecessary and unjustified encroachment on the way taxpayers choose to deploy and protect their global intellectual property. The consequence of the non-arm's length principles of the Proposed Regulations will be to impose additional taxes on U.S. multinational companies that innovate and create valuable IP and U.S. jobs. The U.S. economy may be harmed if these Proposed Regulations are finalized in their current form. For these reasons, AeA urges Treasury and the IRS to completely withdraw these regulations and discontinue their current efforts to modify the Existing Regulations.

* * *

Respectfully submitted,

Marie K. Lee
Tax Counsel, AeA
601 Pennsylvania Avenue, NW
North Building, Suite 600
Washington, DC 20004
(202) 682-4448