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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: March 7, 2002

MEMORANDUM FOR: M. KENDALL WILLIAMS
ASSISTANT AREA COUNSEL, CC:LM:CTM:SJ
Attn: Kimberley J. Peterson

FROM: Elizabeth G. Beck
Branch Chief, CC:INTL:BR6

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 3, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Country A =
Country B =
Country C =
Country D =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

FSub =

Industry A =

Market D =

Product A =
Product B =
Product C =
Product D =
Product E =
Product F =

Product Market A =

Product Market B =
Product Market C =

Product Type A =
Product Type B =
Product Type C =
Product Type D =

Region A =

Taxable Year 1 =
Taxable Year 2 =
Taxable Year 3 =

Taxpayer =

USCorp =

X =

Year 1 =
Year 2 =
Year 3 =

ISSUES

1. Pursuant to Treasury Regulation section 1.482-7 (1995), whether a qualified cost sharing arrangement may be modified retroactively by a taxpayer.

2. Whether under Treasury Regulation section 1.482-7(1995) a buy-in payment must reflect the value of all pre-existing intangible property made available to a cost sharing arrangement, as opposed to the value of only those pre-existing intangibles that ultimately are embedded in a manufactured product.

3. Whether the conclusion for Issue 2 above differs with respect to acquired intangible property made available to a cost sharing arrangement.

CONCLUSIONS

1. The provisions of Treasury Regulation section 1.482-7 (1995) do not permit a qualified cost sharing arrangement to be modified retroactively by a taxpayer.

2. A buy-in payment must reflect the value of all pre-existing intangible property made available to a cost sharing arrangement. It is not limited to the value of only those pre-existing intangibles that ultimately are embedded in a manufactured product.

3. The conclusion for Issue 2 does not differ with respect to acquired intangible property made available to a cost sharing arrangement.

FACTS

A. Background

Taxpayer is comprised of affiliated entities filing consolidated income tax returns. This Advice concerns Taxpayer's Taxable Years 2 and 3.

Taxpayer designs, develops, manufactures, markets, sells and services Product Type A and Product Type B for Industry A. Taxpayer's products encompass the broadest range of Industry A products available from any single supplier. Taxpayer's customers comprise a wide array of vertical markets, including Market D. Sometime during Taxable Year 1 or 2, Taxpayer was reorganized to focus on manufacture of products and provision of services with the intent of becoming a one-stop shopping location for its customers. During Taxable Years 2 and 3, Taxpayer held the number one, two and three market positions in Product Market A, Product Market B and Product Market C, respectively.

B. USCorp and FSub operations generally

USCorp is a publicly-held corporation that is the common parent of Taxpayer. USCorp undertakes research and development in the United States on behalf of Taxpayer and also manufactures and distributes worldwide certain products to Taxpayer affiliates and unrelated customers.

FSub, which is wholly-owned by USCorp, was organized under Country A law on Date 1, Year 1. FSub was formed: 1) to act as master distributor for Region A; 2) to act as a coordination center for certain geographic sales of products manufactured by USCorp; and 3) to manufacture products for worldwide distribution using pre-existing intangible property and technology licensed from USCorp or developed pursuant to a cost sharing arrangement with USCorp.[1]

C. USCorp and FSub operations under cost sharing

USCorp purports[2] that on Date 3, Year 1, it executed a Research and Development Cost Sharing Agreement ("CSA") and a Base Technology License Agreement ("BTLA") with FSub. The CSA covers the sharing of costs and risks for research and development services or activities performed by or for USCorp after Date 3, Year 1, whereas the BTLA covers all pre-existing intangible property developed (whether fully-developed or in-process) or acquired by USCorp as of Date 3, Year 1. As discussed further below, the CSA and BTLA each were subsequently amended and applied retroactively to Date 3, Year 1. The effect of the CSA amendment is discussed in Issue 1.

1. Technology Agreements between USCorp and FSub

a. CSA Provisions

The CSA states that the agreement is intended to qualify as a bona fide cost sharing arrangement pursuant to the ". . . Final Cost Sharing regulations issued

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[1] This information was provided in some of Taxpayer's principal documents prepared for its Taxable Year 1. See Treas. Reg. § 1.6662-6(2)(iii)(B).

[2] Based on the copies of documents received by the Examination Team in response to Information Document Requests ("IDRs") issued to Taxpayer, there appear to be discrepancies between the effective date of the agreements and the actual date that the agreements appear to have been executed. Our copies of the Date 3, Year 1 CSA and BTLA were not signed or dated by representatives of USCorp or FSub. In addition, the amendment to the CSA as well as the amendments to the BTLA were signed by a representative of FSub on Date 5, Year 3, and countersigned by a representative of USCorp, again without indication of the date of signature. Finally, USCorp representatives have represented to Examination, without providing further documentation to support this statement, that representatives of USCorp and FSub signed the CSA and BTLA on or about Date 2, Year 2.

under Section 482 of the U.S. Internal Revenue Code of 1986, as amended . . . ." CSA, Recitals.[3] The purpose of the arrangement, per the CSA, is to

> [S]hare the costs and risks of research and development services or activities performed by or for [USCorp] subsequent to [Date 3, Year 1] in relation to the parties' anticipated benefits to be derived from any intangible property that may be created as a result of such activities.

CSA, Recitals. The CSA was to be effective until terminated by either party. CSA, Sections 9.1 and 10.1.

The CSA states that USCorp would grant FSub

> [A] non-exclusive license to use any intangible property that may be produced as a result of the research and development services or activities performed by or for [USCorp] subsequent to [Date 3, Year 1] for the purposes and on the terms and conditions set forth in this Agreement . . . .

CSA Recitals. With the exception of any patents owned by FSub, legal title to all "Intangible Property" was to vest in USCorp, whether the intangibles at issue were in existence as of Date 3, Year 1 (pre-existing intangible property) or were developed pursuant to the CSA (covered intangible property). CSA, Section 3.1.

FSub's rights to use covered intangible property developed pursuant to the CSA were subject to terms specified as a non-exclusive, royalty-free license. Specifically, the CSA provides:

> To the extent of its legal right to do so, and subject to the rights of third parties under any development, research or licensing agreements (whether now in effect or entered into in the future) or arising otherwise, [USCorp], in consideration of [FSub's] sharing of the R&D Costs pursuant to this Cost Sharing Agreement (as from time to time amended), hereby grants [FSub] a non-exclusive, non-transferable, royalty-free worldwide license, (excluding the right to sublicense,

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[3] The CSA was subsequently amended to state that it was intended to constitute a qualified (as opposed to "bona fide") cost sharing arrangement. The 1995 cost sharing regulations, which govern the requirements for *qualified* cost sharing arrangements as opposed to bona fide cost sharing arrangements under the 1968 cost sharing regulations and 1993 temporary cost sharing regulations, are effective for taxable years beginning on or after January 1, 1996. Treas. Reg. § 1.482-7(k). Taxable Years 1, 2 and 3 are years beginning after January 1, 1996. Accordingly, Treasury Regulation section 1.482-7 (1995) is applicable for such years.

> excepting only sublicenses to manufacture products for [FSub]), to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license and otherwise commercially exploit Products embodying Intangible Property anywhere in the Territory, including a non-exclusive, non-transferable, royalty-free worldwide license to use Intangible Property developed during the term of this Cost Sharing Agreement to the extent necessary or appropriate to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license and otherwise commercially exploit Products throughout the Territory.

CSA, Section 4.1. The CSA further provides that FSub's rights in technology developed pursuant to the CSA may be limited by rights granted, ostensibly by USCorp, to third parties in the future. Section 4.6 of the CSA states in part, "The rights granted under this Cost Sharing Agreement to [FSub] are subject to any existing or future third party rights in the Intangible Property . . . ."

Section 2.1 of the CSA required USCorp and FSub to share their respective shares of the "Aggregate R&D Costs" for each taxable year the CSA was effective regardless of whether any "Intangible Property" resulted from any or all of the research and development services or activities performed by or for Taxpayer. "Aggregate R&D Costs" were costs incurred directly or indirectly by Taxpayer for the relevant taxable year, excluding certain in-process R&D that was expensed or any expenses relating to the acquisition of intangibles by either USCorp or FSub. CSA, Section 1.2. Such costs excluded custom research and development performed by Taxpayer on behalf of unrelated parties, as determined by USCorp. CSA, Section 1.10, "Custom Research and Development."

Under the CSA, FSub's cost sharing payments were determined by subtracting R&D Costs it incurred from its share of the Aggregate R&D Costs. FSub's share of Aggregate R&D Costs was based on a formula that multiplied Aggregate R&D Costs by the resulting value of FSub's planned sales,[4] as projected over the next succeeding five years, divided by Taxpayer's planned consolidated sales for the next succeeding five years. The CSA provided for adjustments to the parties cost sharing payment obligations under certain circumstances. CSA,

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[4] "Planned [FSub] Sales" is further defined by reference to "[FSub] Sales," which are

> [E]qual to the sum of (A) [FSub's] End Customer Revenue from Product Manufactured and Sold by [FSub] [worldwide], plus (B) 10 times the Licensing/Royalty Revenue of [FSub] for such [Taxable] Year, as reflected in the consolidated financial statements of [Taxpayer].

CSA, Section 1.5.

Sections 2.5 - 2.7. The CSA does not appear to include specific provisions regarding buy-in payments from FSub for pre-existing or acquired technology made available by USCorp to the cost sharing arrangement.[5]

b. BTLA Provisions

The original BTLA was to be effective as of Date 3, Year 1. Pursuant to the agreement, USCorp granted FSub a non-exclusive worldwide license to use "Intangible Property" in connection with FSub's manufacture and distribution of certain "Products." The grant of rights by USCorp to FSub included the right to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license, sublicense and otherwise commercially exploit "Products." The agreement also included a grant of rights to use "Intangible Property" to the extent necessary to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license and otherwise commercially exploit "Products." BTLA, Section 2.1. The "Intangible Property" subject to the terms of the non-exclusive license was defined broadly to include

> Any and all intangible technological property and associated intellectual property rights developed or acquired by [USCorp] prior to [Date 3, Year 1] and/or in process as of [Date 3, Year 1], including (but not limited to): (a) inventions, whether or not patented, formulas, processes, procedures, methods, tools, designs, patterns, improvements, original works of authorship, compositions of matter, computer software programs, databases, mask works, hardware, firm ware, trade secrets and other proprietary know-how, and all patents, industrial designs (or equivalent) and copyrights, trade names, trade marks [sic], and applications and registrations with respect thereto; (b) drawings, reports, practices, specifications, software and other documentation and information related to the design, manufacture, installation, operation, repair, maintenance and use of Products; (c) any other technical information; and (d) or other similar items contained within or inherent to any Product covered by this Agreement.

BTLA, Exhibit A, Intangible Property.

The BTLA broadly defined "Products" as

> Any and all products developed or acquired by [USCorp] prior to [Date 3, Year 1] and on the current [USCorp] product price list as of [Date 3,

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[5] This advice uses the term "buy-in payment" to refer to the consideration for pre-existing technology (whether fully-developed or in-process) and acquired technology made available to the cost sharing arrangement.

> Year 1], including, inter alia, all Product A, Product B, Product C, Product D, Product E, software and related products.

BTLA, Exhibit B, Products. Based on the above definitions, it appears that the BTLA granted rights to FSub in all "Intangible Property" and "Products" developed or acquired by USCorp prior to Date 3, Year 1, including Products A, B, C, D, E and F as well as Product Types A, B, C and D.

In exchange for the rights granted under the BTLA, FSub agreed to pay USCorp a royalty equal to a specified percentage of FSub's net sales of "Product" that was contract manufactured by FSub worldwide. Exhibit C of the BTLA, which was to identify a specified royalty rate for the rights granted to FSub, simply stated that "[t]he [r]oyalty shall be determined upon mutual agreement based upon the analysis of an independent third-party review."

In addition to the provisions above relating to the grant of rights and royalty compensation, the original BTLA included a provision governing periodic adjustment of the royalty to be paid from FSub to USCorp, as well as a provision limiting the term of the agreement to five years based on the obsolescence of USCorp's "Intangible Property." BTLA, Sections 3.3, 8.1. Upon termination of the BTLA by either party, it appears that FSub would have no recourse to "Intangible Property" in which it was previously granted rights. Specifically, BTLA Section 8.4 provided that "[FSub] shall discontinue all use of the Intangible Property and shall have no further rights with respect to the Intangible Property . . . ."

The BTLA prohibited alteration or amendment of the agreement "[B]y either party except by a written instrument properly signed and executed by an authorized corporate officer of each of [USCorp] and [FSub]." BTLA, Section 11.2.

c. Year 3 Amendments to BTLA and CSA

The parties amended both the CSA and BTLA in Year 3. The CSA was amended pursuant to the Amended and Restated Research and Development CSA ("Amended CSA"). The BTLA was amended at least three times via an Amended and Restated BTLA ("Amended BTLA"), a First Amendment to Amended and Restated BTLA ("First Amendment") and a Second Amendment to Amended and Restated BTLA ("Second Amendment").

The Amended CSA purports to date back to Date 3, Year 1, although it appears to have been dated and signed by a representative of FSub on Date 5, Year 3 and countersigned by a representative of USCorp without indication of the date of signature. Revisions to the Amended CSA include additional definitions for "Developed Intangibles" (all "Intangible Property" developed pursuant to the terms of the Amended CSA) and "Developed Products." Section 1.12 of the Amended CSA defined "Developed Products" as

> [A]ll Products which utilize or incorporate the Developed Intangibles, manufactured or marketed, or proposed to be manufactured or marketed, at any time during the term of this Agreement by [Taxpayer excluding FSub], and all components, parts, sub-assemblies, software and documentation associated with or incorporated in any of the foregoing.

The above definition of "Developed Products" is relevant to USCorp's non-exclusive, worldwide, royalty-free license of rights to FSub in products developed under the CSA and Amended CSA.

The Amended BTLA[6] purports to be effective back to Date 3, Year 1, the effective date of the BTLA. The parties agreed that the Amended BTLA replaced and superseded the Date 3, Year 1 BTLA. The Amended BTLA bases buy-in royalty payments from FSub on specified royalty rates payable per "Product Line," whereas pursuant to the BTLA, FSub's buy-in payments to Taxpayer were previously based on FSub's net sales of "Products." Compare BTLA, Section 3.1 and Exhibits B and C with Amended BTLA, Section 3.1 and Exhibits B, C and D. Although the shift from royalty rates based on net sales of "Products" in the BTLA to royalty rates based on net sales of "Product Lines" under the Date 5, Year 3 Amended BTLA may reflect Year 2 changes in Taxpayer's operating structure, it is unclear whether the shift from "Products" to "Product Lines" may have narrowed the scope of pre-existing intangible property made available to the cost sharing arrangement on Date 3, Year 1. Another revision in the Amended BTLA was to change the initial term of the agreement from five to four years. Amended BTLA, Section 8.1.

The First and Second Amendments to the BTLA appear to focus on the treatment of intangible property acquired from third parties during Taxpayer's Taxable Year 1. From Date 3, Year 1 through Taxable Year 3, Taxpayer acquired X number of Industry A unrelated companies. In one of its Securities and Exchange Commission filings for Taxable Year 2, Taxpayer explained that it acquires a wide variety of technologies to stay competitive in Industry A.

The First and Second Amendments to the BTLA addressed the buy-in treatment of intangible property of a limited number of those acquisitions. Specifically, the First Amendment supplemented the BTLA definition of "Intangible Property" to include technology acquired by Taxpayer during Taxable Year 1. Corresponding revisions were made to the definitions of "Product," "Product Lines," "Royalties" and "Royalty Rate Implementation." The Second Amendment to the BTLA reflected similar revisions regarding technology acquired from third parties during Taxable Year 2.

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[6] Our copy was signed and dated Date 5, Year 3 by an FSub director and signed but undated by a USCorp representative.

2. USCorp - FSub intercompany transactions

During the first year that the parties claim the CSA was effective, FSub continued to function solely as a distributor of products manufactured by USCorp for sale in Region A. FSub did not begin manufacturing products for worldwide distribution using technology licensed pursuant to the BTLA, or technology developed in accordance with the CSA, until Date 4, Year 2. FSub did not make royalty payments to USCorp for the grant of rights in "Intangible Property" under the BTLA until the date it began manufacturing products, Date 4, Year 2.

The complexity of the relationship between USCorp and FSub may be explained by the functions that they perform. USCorp and FSub both manufacture and distribute each others' products. USCorp and FSub operate in the same geographic sales territory (worldwide) simultaneously, and share the same customer base. Taxpayer has projected that FSub's sales will total almost half of Taxpayer's worldwide sales through 2007. In addition to manufacturing and distributing certain products, FSub also acts as principal with regard to USCorp products that are outsourced for manufacture by third party contract manufacturers. Until Date 3, Year 2, a date during Taxable Year 2 and during the purported operation of the cost sharing arrangement with FSub, USCorp entered into manufacturing agreements with third party contract manufacturers for the manufacture of certain product components to USCorp specifications. These manufacturing agreements were assigned from USCorp to FSub on or about Date 3, Year 2.

As concerns internal manufacture of products, products generally are produced either by USCorp or FSub, but not by both entities. USCorp typically manufactures a smaller number of "high-end" units on a monthly basis, whereas FSub produces thousands of "low-end" units a month. Determining which products are manufactured by FSub or by third party contract manufacturers seems to depend on the manufacturing capability of the third parties, as well as the volume requirements of products. For all USCorp product that is outsourced to third party contract manufacturers for manufacture to USCorp specifications, FSub acts as the principal. To achieve manufacturing efficiency and to avoid duplicative capacity, USCorp outsources 100 percent of its production requirements for selected product lines, while internally manufacturing 100 percent of other product lines. Therefore, a product is either manufactured internally or it is outsourced, but not both.

Transactions between USCorp and FSub fall into three main categories. First, FSub purchases products manufactured by USCorp for direct sale to Region A customers. Second, USCorp purchases products manufactured by FSub for worldwide distribution, excluding distribution into Region A, Country B, Country C and Country D. FSub sells its products in Region A, and sells its products to Taxpayer affiliates for distribution in Country B, Country C and Country D. Third, FSub acts as the principal for all USCorp products that are outsourced. For

Product F that are outsourced for manufacture by third party contract manufacturers, but not shipped directly to customers by the third party contract manufacturers, FSub sells Product F to USCorp for use in U.S. products.

LAW AND ANALYSIS

A. Cost sharing arrangements generally

Section 482 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 section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

I.R.C. § 482 (emphasis added).

The legislative history of the Tax Reform Act of 1986 indicates that Congress amended section 482, by adding the second sentence highlighted above, due to concern over income tax deferral and effective tax exemptions where U.S. corporations transfer intangible property without receiving adequate consideration from related foreign corporations in low tax jurisdictions. Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess., 1013-1014 [“JCT Explanation”]. The second sentence requires that where a transfer or license of intangible property occurs between controlled parties, “the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.” Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2561, et. seq., 1986-3 C.B. (Vol. 1) 1, 478-81 (emphasis added). “Commensurate with income” is a standard by which to ensure that allocation of income between related parties reasonably reflects economic activity and risks undertaken by each. See H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985), 1986-3 C.B. 424-26; JCT Explanation at 1015.[7]

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[7] The 1993 temporary and 1994 final section 482 regulations note that the commensurate-with-income standard is to be applied for taxable years beginning after the December 31, 1986, effective date of the statutory amendment. Prior to the

In revising section 482, Congress did not intend

> [T]o 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 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.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 638 (1986), 1986-3 C.B. 638 (Vol. 4); JCT Explanation at 1017.

Congress singled out the issue of buy-in payments, and noted they must be measured independently of the allocation of cost shares:

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

Id.

B. 1995 cost sharing regulations

On December 20, 1995, the Service published final cost sharing regulations. T.D. 8632, 1996-1 C.B. 85. These final regulations, promulgated in Treasury Regulation section 1.482-7, govern the treatment of cost sharing arrangements for taxable years beginning on or after January 1, 1996. Treas. Reg. § 1.482-7(k).

Section 1.482-7(a)(1) defines a cost sharing arrangement as

> [A]n agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of

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effective dates of the 1993 and 1994 regulations, taxpayers may use any reasonable method consistent with the statute. Temp. Treas. Reg. § 1.482-1T(h)(1993); Treas. Reg. § 1.482-1(j)(3) (1994). A “reasonable method” includes one which applies the regulations or their general principles. Id.

> reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.

Treas. Reg. § 1.482-7(a)(1) (1995). "Benefits" are defined as additional income generated or costs saved by use of the covered intangibles. Treas. Reg. § 1.482-7(e)(1).

Under the 1995 cost sharing regulations, a taxpayer may claim that a cost sharing arrangement is a "qualified cost sharing arrangement," provided it meets the requirements of Treasury Regulation section 1.482-7(b). Treas. Reg. § 1.482-7(a)(1). In general, the Service shall not make section 482 allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development. Treas. Reg. § 1.482-7(a)(2). The Service may apply the cost sharing regulations to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement under Treasury Regulation section 1.482-7. See Treas. Reg. § 1.482-7(a)(1) citing Treas. Reg. § 1.482-d(3)(ii)(B) (Identifying contractual terms).

Among the requirements set forth in Treasury Regulation section 1.482-7(b), a qualified cost sharing arrangement must include two or more participants and be recorded in a document contemporaneous with the formation of the cost sharing arrangement. Treas. Reg. §§ 1.482-7(b)(1), (4). The arrangement also must provide a method to calculate each controlled participant's share of intangible development costs based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits. Treas. Reg. § 1.482-7(b)(2).

The Service may make a section 482 allocation with respect to a qualified cost sharing arrangement if the controlled participant's share of intangible development costs differs from that participant's share of reasonably anticipated benefits from the intangibles. Treas. Reg. § 1.482-7(a)(2). A participant's share of intangible development costs (or benefits) is the ratio of the participant's costs (or benefits) of developing intangibles to the total such costs (or benefits) of all controlled participants. Treas. Reg. § 1.482-7(f)(2). If, after any cost allocations the Service may make pursuant to Treasury Regulation section 1.482-7(a)(2), a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the Service may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such case, the Service may make an allocation by which the participant that bore a disproportionately greater share of costs must receive an arm's length payment (under sections 1.482-1 and 1.482-4 through 1.482-6) from the controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time in

consideration for the effective receipt of additional interests in the covered intangibles. Treas. Reg. § 1.482-7(g)(5).

Treasury Regulation sections 1.482-7(a)(2) and 1.482-7(g) address the license, transfer or acquisition of an interest in any pre-existing intangible property, e.g., intangible property developed prior to participation in a cost sharing arrangement, including intangible property acquired from non-participants, typically referred to as the "buy-in." Section 1.482-7(a)(2) provides in pertinent part:

> If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation.

Treas. Reg. § 1.482-7(b)(2) (1995).

Treasury Regulation section 1.482-7(g)(1) provides that a controlled participant that makes intangible property available to a qualified cost sharing arrangement is treated as having transferred interests in such property to the other controlled participants, who must make buy-in payments as provided for in section 1.482-7(g)(2). Treasury Regulation section 1.482-7(g)(2) states,

> If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits . . . . Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee.

Treas. Reg. § 1.482-7(g)(2). If a controlled participant in a qualified cost sharing arrangement transfers, abandons or otherwise relinquishes an interest under the arrangement to the benefit of another controlled participant, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of sections 1.482-1 and 1.482-4 through 1.482-6, for its interest.

DISCUSSION

Issue 1 A qualified cost sharing arrangement may not be modified retroactively by a taxpayer.

If an arrangement constitutes a cost sharing arrangement (as defined under Treasury Regulation section 1.482-7(a)(1))[8] and the taxpayer satisfies the formal requirements of Treasury Regulation section 1.482-7(b), then the taxpayer may claim that it has a "qualified cost sharing arrangement." As a result, the Service is limited to making two types of allocations with respect to the arrangement. Treas. Reg. § 1.482-7(a)(2). First, the Service is limited to allocating costs to the extent necessary to make each controlled participant's share of the costs of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits. Second, if a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer, other than in consideration for bearing a share of the costs of the intangible's development, the Service may make appropriate allocations to reflect an arm's length consideration for the acquisition of an interest in the intangibles pursuant to Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6.

Treasury Regulation section 1.482-7(b) requires, inter alia, that a qualified cost sharing arrangement must:

> (4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement . . . .

Treas. Reg. § 1.482-7(b)(4) (emphasis added). The above language sets forth two requirements. First, the cost sharing arrangement (as defined under Treasury Regulation section 1.482-7(a)(1)) must be reduced to a written document.[9] Second, the written document must be "contemporaneous" with the formation (and any revision) of the cost sharing arrangement.

In this case, Taxpayer claims that the modification relates back and is effective "as of" the stated effective date of the CSA. Accordingly, the issue here is whether Taxpayer's modification to the CSA was "contemporaneous" with the

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[8] A cost sharing arrangement is "an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement." Treas. Reg. § 1.482-7(a)(1) (1995).

[9] The requirement to set forth a cost sharing arrangement in writing dates back to the 1992 proposed regulations, as discussed in the Preamble to the 1995 cost sharing regulations. T.D. 8632, 1996-1 C.B. 85, 87.

effective date of the CSA, i.e., a date three years prior the date of modification. Although there is no definition of "contemporaneous" within the cost sharing regulations, the word generally is defined to mean "existing, occurring or originating during the same period of time." Webster's New Collegiate Dictionary (9th ed. 1990). Thus, " is contemporaneous with the formation" in the context of Treasury Regulation section 1.482-7(b)(4) means "originates at the time of the formation" of the cost sharing arrangement. With respect to amendments, the regulation substitutes the term "revision" for the word "formation." Thus, " is contemporaneous with any revision" in the context of section 1.482-7(b)(4) means "originates at the time of the revision." Accordingly, written revisions (amendments) to cost sharing arrangements apply prospectively.

This requirement is consistent with the very nature of qualified cost sharing arrangements wherein parties agree prospectively to share costs, risks and benefits. The approach of honoring taxpayer agreements reduced to writing prior to entering into the transactions also is consistent with the general principles of Treasury Regulation section 1.482-1(d)(3)(ii)(B)(1) (Identifying contractual terms). This regulation provides that "[t]he contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions." Moreover, retroactive application of an original agreement or subsequent revision might otherwise permit cost sharing arrangement participants to benefit from the use of hindsight to gain significant tax benefits and might result in manipulation of the measurement of anticipated benefits and valuation of buy-in payments.

In this case, Taxpayer modified its CSA on Date 5, Year 3. For purposes of constituting a qualified cost sharing agreement under the 1995 cost sharing regulations, the amendments are effective as of that date, not an earlier date agreed upon by the parties to the agreement. We note, however, that Taxpayer's failure to comply with the requirements of Treasury Regulation section 1.482-7(b)(4) may not be determinative. The Service may apply the rules of Treasury Regulation section 1.482-7 to any arrangement that in substance constitutes a cost sharing arrangement. Treas. Reg. § 1.482-7(a)(1).

Issue 2 A buy-in payment must reflect the value of all pre-existing intangible property made available to a cost sharing arrangement.

As noted above, the cost sharing regulations distinguish the tax treatment of an acquisition of an interest in intangible property from another controlled taxpayer from consideration for bearing a share of the costs of an intangible's development. Treas. Reg. § 1.482-7(a)(2). In the former situation, the cost sharing regulations require a buy-in payment, which is governed by the general rules regarding the transfer of intangible property under Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6. Treas. Reg. § 1.482-7(g)(1), (2).

Treasury Regulation section 1.482-7(g)(1) provides the general rule that buy-in payments must be made to "[a] controlled participant that makes intangible property available to a qualified cost sharing arrangement . . . ." (emphasis added). The provisions of Treasury Regulation section 1.482-7(g)(2) state further that buy-in payments must be made by controlled participants, or uncontrolled participants as the case may be, in a cost sharing arrangement "[i]f a controlled participant makes pre-existing intangible property in which it owns an interest available to other participants for purposes of research in the intangible development area . . . . Such payments will be treated as consideration for a transfer of an interest in the intangible property made available" (emphasis added). Because it is treated as consideration for the transfer of an interest in pre-existing intangible property, the buy-in payment is the arm's length charge for the use of the intangibles under the general rules governing transfers of intangible property under Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6, and is multiplied by the controlled participant's share of reasonably anticipated benefits. Treas. Reg. §§ 1.482-7(a)(2); 1.482-7(g)(1), (2). The provisions of Treasury Regulation section 1.482-4 generally describe methods to determine taxable income in connection with a transfer of intangible property, and require that the arm's length consideration for the transfer of an intangible be commensurate with the income attributable to the intangible. Additionally, Treasury Regulation section 1.482-4(f)(3)(i) provides that "[i]f the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration with respect to such transfer that is determined in accordance with the provisions of this section."

The above language indicates that buy-in payments are valued based on the intangible property that is made available, and as a result, deemed to be transferred to the cost sharing arrangement.[10] The determination of which pre-existing intangible property was made available to a cost sharing arrangement is a factual one.

A buy-in payment cannot be valued based only on whether pre-existing intangible property made available to the cost sharing arrangement ultimately is incorporated into a manufactured product, since there may be value associated with the right to use other pre-existing intangible property made available to the cost sharing arrangement. For example, assume Corporation 1 and Corporation 2 are both participants in a qualified cost sharing arrangement. Corporation 1 makes available to the cost sharing arrangement its pre-existing intangible properties A, B, and C. By operation of the cost sharing arrangement, Corporation 1 is deemed to have transferred interests in such property to Corporation 2, for which Corporation

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[10] Although the section 482 regulations do not define "transfer" or "made available", we note that "transaction" is defined to mean "[A]ny sale, assignment, lease, license, loan, advance, contribution, or any other transfer of an interest in or a right to use any property . . . ." Treas. Reg. § 1.482-1(i)(7) (emphasis added).

2 must make buy-in payments to Corporation 1 reflecting the arm's length consideration for the transferred intangible property, i.e., intangible properties A, B, and C. Assume further that intangible A, although subject to further research pursuant to the terms of the cost sharing arrangement, does not result in a manufactured product; that no additional research is conducted or performed on intangible B; and that intangible C, subject to additional research and development, results in covered technology D, a manufactured product. Because intangibles A, B, and C each were made available to the cost sharing arrangement, and as a result are deemed to be transfers of interests in said intangibles, Corporation 2 must make buy-in payments to Corporation 1 reflecting arm's length consideration for all three intangibles although only intangible C resulted in covered technology. To allow Corporation 2 to make buy-in payments to Corporation 1 based only on the value of intangible C (that is, the only pre-existing intangible property that resulted in a manufactured product - intangible D), would disregard the transfer of interests in intangibles A and B, which must be compensated at arm's length pursuant to the provisions of Treasury Regulation sections 1.482-1 and 1.482-4 through 1.482-6.

In the instant case, the CSA does not contain provisions addressing the treatment of USCorp's pre-existing intangible property made available to the cost sharing arrangement. Instead, the BTLA governs such intangible property. The BTLA granted rights to FSub to use USCorp's pre-existing "Intangible Property" to the extent necessary to manufacture, have manufactured, make, have made, distribute, use, sell, lease, license, sublicense and otherwise commercially exploit "Products." BTLA, section 2.1. As noted above, "Intangible Property" was defined broadly in BTLA Exhibit A, and included "[a]ny and all intangible technological property and associated intellectual property rights developed or acquired by [USCorp] prior to the effective date of this Agreement and/or in process as of the effective date of this Agreement." BTLA, Exhibit A. Thus, under the BTLA, all of USCorp's pre-existing intangible property was made available to the cost sharing arrangement. The buy-in payment from FSub to USCorp must reflect the value of all pre-existing intangible property made available to the cost sharing arrangement, not merely those pre-existing intangibles ultimately embedded in a manufactured product.

Issue 3 The conclusion for Issue 2 does not differ with respect to acquired intangible property made available to a cost sharing arrangement.

You also have asked whether our conclusion in Issue 2 would differ if acquired intangible property was made available to the CSA, in lieu of USCorp's pre-existing intangible property as discussed in Issue 2. The applicable general rule is found in Treasury Regulation section 1.482-7(g)(1), which states that a buy-in payment must be made to a controlled participant that makes intangible property available to a cost sharing arrangement, as further explained in Treasury Regulation section 1.482-7(g)(2). Section 1.482-7(g)(2) refers to intangible property subject to a buy-in payment as "pre-existing intangibles." The use of this

term to identify intangible property subject to buy-in treatment does not exclude technology acquired from an unrelated party and subsequently made available by a controlled participant to its cost sharing arrangement. The general rule of Treasury Regulation section 1.482-7(g)(1), which defines intangible property subject to a buy-in payment, does not distinguish between pre-existing intangible property made available by a controlled participant to a cost sharing arrangement and intangible property that is acquired by a controlled participant and then made available to a cost sharing arrangement. Accordingly, the same general rule that applies to require a buy-in payment for a controlled participant's pre-existing intangible property made available to the cost sharing arrangement also applies with regard to acquired technology made available by a controlled participant. Our conclusion for Issue 2 therefore does not differ with respect to acquired intangible property made available to a cost sharing arrangement.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The USCorp - FSub cost sharing arrangement may not constitute a taxpayer qualified cost sharing arrangement for Taxable Years 2 and 3 because the CSA does not appear to have been reduced to writing contemporaneously with the formation of the cost sharing arrangement as evidenced by the effective date of the agreement preceding the date of signing of the CSA (Date 5, Year 3) by approximately three years. The same appears to be true of the BTLA and the subsequent amendments to both the CSA and BTLA. If this is true, neither the CSA, nor its subsequent amendments should be given retroactive effect based on Treasury Regulation section 1.482-7(b)(4). However, as noted in Issue 1, Examination has discretion, notwithstanding Taxpayer's failure to comply with the contemporaneous formation requirement of Treasury Regulation section 1.482-7(b)(4), to treat the arrangement in the same manner as a qualified cost sharing arrangement if Examination determined such treatment accords with the substance of the arrangement. Treas. Reg. § 1.482-7(a)(1).

Finally, we note that we have not been asked to advise on the appropriate valuation methodology, form or timing of the buy-in payment. Accordingly, this advice should not be interpreted to state that a deferred royalty payment based on sales of manufactured products necessarily is an inappropriate measure of a buy-in payment.

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of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 874-1490 if you have any further questions.

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