DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 301, and 602

[TD 9441]

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that provide further guidance and clarification regarding methods under section 482 to determine taxable income in connection with a cost sharing arrangement in order to address issues that have arisen in administering the current regulations. The temporary regulations affect domestic and foreign entities that enter into cost sharing arrangements described in the temporary regulations. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on January 5, 2009.

Applicability Date: For dates of applicability, see §§ 1.482–1T(j)(6)(i), 1.482–2T(f), 1.482–4T(h), 1.482–7T(l), 1.482–8T(c), 1.482–9T(n)(3), and 1.301–7701–1(f).

FOR FURTHER INFORMATION CONTACT: Kenneth P. Christman, (202) 435–5265 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and pending receipt and valuation of public comments, approved by the Office of Management and Budget under control number 1545–1364.

The collections of information in these temporary regulations are in § 1.482–7T(b)(2) and (k). Responses to the collections of information are required by the IRS to monitor compliance of controlled taxpayers with the provisions applicable to cost sharing arrangements.

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

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

Background

A notice of proposed rulemaking and notice of public hearing regarding additional guidance to improve compliance with, and administration of, the rules in connection with a cost sharing arrangement (CSA) were published in the **Federal Register** (70 FR 51116) on (REG–144615–02) August 29, 2005 (the 2005 proposed regulations). A correction to the notice of proposed rulemaking and notice of public hearing was published in the **Federal Register** (70 FR 56611) on September 28, 2005. A public hearing was held on December 16, 2005.

The Treasury Department and the IRS received substantial comments on a wide range of issues addressed in the 2005 proposed regulations. In response to these comments, these temporary regulations make several significant changes to the rules of the 2005 proposed regulations. The temporary regulations are generally applicable for CSAs commencing on or after January 5, 2009, with transition rules for certain preexisting arrangements. These regulations are being issued in temporary and proposed form so that taxpayers and the IRS may apply the new cost sharing rules while maintaining the opportunity for further input and refinements before the issuance of final rules.

Explanation of Provisions

A. Overview

The temporary regulations generally provide guidance regarding the application of section 482 and the arm's length method to cost sharing arrangements. Several comments on the proposed regulations questioned whether and how the proposed regulations conform to the arm's length standard, as well as its corollary, the commensurate with income (CWI) requirement added by the Tax Reform Act of 1986. In response, the temporary regulations provide further guidance on the evaluation of the arm's length results of cost sharing transactions (CSTs) and platform contribution transactions (PCTs). The regulations address the material functional and risk allocations in the context of a CSA, including the reasonably anticipated duration of the commitments, the intended scope of the intangible development, the degree and uncertainty of profit potential of the intangibles to be developed, and the extent of platform and other contributions of resources, capabilities, and rights to the development and exploitation of cost shared intangibles (CSA Activity).

Under the temporary regulations, if available data of uncontrolled transactions reflect, or may be reliably adjusted to reflect, similar facts and circumstances to a CSA, they may be the basis for application of a comparable uncontrolled transaction method to value the CST and PCT results. Because of the difficulty of finding data that reliably reflects such facts and circumstances (even after adjustments), the temporary regulations also provide for other methods. These include the newly specified income, acquisition price, market capitalization, and residual profit split methods. The temporary regulations also make related changes to other sections of the regulations, including Temp. Treas. Reg. §§ 1.482–1T, 1.482–4T, 1.482–8T, and 1.482–9T, and Treas. Reg. § 1.6662–6.

B. Flexibility and Scope of CSA Coverage

Commentators criticized the 2005 proposed regulations for lack of flexibility concerning the types and provisions of arrangements eligible for CSA treatment. Some comments also addressed non-conforming intangible development arrangements that would not be treated as CSAs.

In response to these comments, the temporary regulations provide taxpayers with greater flexibility in designing certain aspects of CSAs. The temporary regulations also address the treatment of non-conforming intangible development arrangements.

1. Intangible Development Arrangements Other Than CSAs—Temp. Treas. Reg. §§ 1.482–1T(b)(2)(i) and (iii), 1.482–4T(g), 1.482–7T(b)(5), and 1.482–9T(m)(3)

The 2005 proposed regulations defined the contractual terms, risk allocations, and other material provisions of a CSA covered by the cost sharing rules. While other intangible development arrangements might be referred to colloquially as cost sharing arrangements, they were not to be treated as CSAs by the 2005 proposed regulations unless either a taxpayer substantially complied with the CSA administrative requirements and reasonably concluded that its arrangement was a CSA, or a taxpayer substantially complied with the CSA administrative requirements and the Commissioner determined to apply the CSA rules to the arrangement.

Commentators suggested broadening the scope of intangible development arrangements that meet the CSA definition. Some commentators urged the regulations not to define CSA terms and conditions but to extend CSA treatment to any arrangement that uncontrolled parties might call a cost sharing arrangement, even though such arrangement may involve materially different risk allocations and provisions than addressed in the cost sharing rules. Still other commentators, while accepting that the regulations should define the scope of arrangements treated under the cost sharing rules, suggested that non-conforming arrangements would be subject only to the general principles of Treas. Reg. § 1.482–1 and would not be governed by the sections of the regulations addressed to specific transactional types. Some commentators also expressed concern that the Commissioner might treat a non-conforming arrangement as a CSA even in a situation where that result was not warranted.

Because the cost sharing rules are designed to provide guidance for specific types of transactions and arrangements, the Treasury Department and the IRS continue to believe that the new rules set forth for CSAs should apply only to the transactions intended. From the standpoint of the purpose of the cost sharing rules and their administrability, it is important that the rules be applicable only to the defined scope of intangible development arrangements and apply no more broadly or narrowly than intended. In recognition of taxpayer concerns, however, the temporary regulations seek to provide taxpayers with greater flexibility and scope in the types and provisions of arrangements that may qualify as CSAs.

Under Treas. Reg. § 1.482–1(b)(2)(ii) (Selection of category of method applicable to transaction), non-conforming arrangements are governed by methods provided in other sections of the regulations under section 482, as applied in accordance with Treas. Reg. § 1.482–1. See also Treas. Reg. §§ 1.482–2(d), 3(a), and 4(a), and Temp. Treas. Reg. § 1.482–9T(a). Thus, intangible development arrangements, including partnerships, outside the scope of the cost sharing rules are governed by the transfer of intangible rules of Treas. Reg. § 1.482–4(a), or the controlled services provisions of Temp. Treas. Reg. § 1.482–9T, as appropriate. The temporary regulations make clarifying amendments to Temp. Treas. Reg. §§ 1.482–1T(b)(2)(i) and (iii), 1.482–4T(g), and 1.482–9T(m)(3). These amendments confirm that Treas. Reg. § 1.482–1 provides principles, not methods. For methods, reference must be made to the other sections of the regulations under section 482. While treatment of a CSA is governed by Temp. Treas. Reg. § 1.482–7T, Temp. Treas. Reg. §§ 1.482–4T(g) and 1.482–9T(m)(3), as appropriate, govern intangible development arrangements other than CSAs, including partnerships.

Nevertheless, the methods and best method considerations under the cost sharing rules may be adapted for purposes of the evaluation of non-conforming intangible development arrangements. Importantly, the temporary regulations provide that the analysis under the intangible transfer or controlled services provisions, as applicable, should take into account the principles, methods, comparability, and reliability considerations set forth in Temp. Treas. Reg. § 1.482–7T in determining the best method for purposes of those provisions, including an unspecified method, as those methods and considerations may be appropriately adjusted in light of the differences in the facts and circumstances between the non-conforming arrangement and a CSA.

Finally, Temp. Treas. Reg. § 1.482–7(b)(5) clarifies the circumstances under which the Commissioner may treat an arrangement as a CSA, notwithstanding a technical failure to meet the substantive requirements of a CSA. Namely, the Commissioner must conclude that the taxpayer substantially complied with the CSA administrative requirements and that application of the CSA rules to such non-conforming arrangement will provide the most reliable measure of an arm's length result. For these purposes, the temporary regulations also clarify that applicable contractual provisions will be interpreted by reference to economic substance and the parties' actual conduct, and the Commissioner may disregard terms lacking economic substance and impute terms consistent with the economic substance.

2. Territorial and Other Divisional Interests—Temp. Treas. Reg. § 1.482–7T(b)(1)(iii) and (4)

The 2005 proposed regulations required the controlled participants in a CSA to receive non-overlapping territorial interests that entitled each controlled participant to the perpetual and exclusive right to the profits in its territory attributable cost shared intangibles. Commentators suggested that requiring territorial divisions of interests was overly restrictive and did not align with common business models. They also questioned the need for the non-overlapping, perpetual, and exclusivity conditions.

To provide taxpayers with more flexibility in designing qualifying divisional interests, the temporary regulations permit use of a new basis—the field of use division of interests—in addition to the territorial basis. Further, the regulations also authorize other non-overlapping divisional interests provided that the basis used meets four criteria: (1) The basis must clearly and unambiguously divide all interests in cost shared intangibles among the controlled participants; (2) the consistent use of such basis can be dependably verified from the records maintained by the controlled participants; (3) the rights of the controlled participants to exploit cost shared intangibles are non-overlapping, exclusive, and perpetual; and (4) the resulting benefits associated with each controlled participant's interest in cost shared intangibles are predictable with reasonable reliability. The temporary regulations illustrate instances in which divisional interests tied to specific manufacturing facilities, as an example, would, and would not, qualify under these criteria. See Temp. Treas. Reg. § 1.482–7T(b)(4)(v), Examples 2 and 3.

3. Platform and Other Contributions—Temp. Treas. Reg. § 1.482–7T(c) and (g)(2)(ii)

The 2005 proposed regulations described external contributions for which compensation was due from other controlled participants, that is, preliminary or contemporaneous transactions. A preliminary or contemporaneous transaction corresponded to the buy-in pursuant to § 1.482–7(g) of the 1995 final regulations. Under the 2005 proposed regulations, an external contribution generally consisted of the rights in the reference transaction (RT) in any resource or capability reasonably anticipated to contribute to developing cost shared intangibles. The RT consisted of a transaction, to be designated in the CSA documentation, affording the perpetual and exclusive rights in the subject resource or capability. While the RT was relevant to valuing the compensation obligation under a PCT, the controlled participants were not required to actually enter into the RT. Although the RT assumed perpetual and exclusive rights, proration was required to the extent that the subject resource or capability was reasonably anticipated to contribute both to the CSA Activity and other business activities. Evaluation of the preliminary or contemporaneous transaction compensation obligation for the subject rights could be in the aggregate with preliminary or contemporaneous transaction compensation obligation with respect to other external contributions, or in the aggregate with the compensation obligations with respect to other rights, where valuation on an aggregate basis would provide the most reliable measure of an arm's length result for the aggregated preliminary or contemporaneous transactions and other transactions.

Commentators objected to the RT as overbroad. Commentators further contended that external contributions included elements such as workforce, goodwill or going concern value, or business opportunity, which in the commentators' view either do not constitute intangibles, or are not being transferred, and so, in the commentators' view, are not compensable.

The temporary regulations replace the term ''external contribution'' with the term ''platform contribution'' and replace the term ''preliminary or contemporaneous transaction'' with the term ''platform contribution transaction.'' The temporary regulations, like the 2005 proposed regulations, do not limit platform contributions that must be compensated in PCTs to the transfer of intangibles defined in section 936(h)(3)(B). For example, to the extent a controlled participant (the PCT Payee) contributes the services of its research team for purposes of developing cost shared intangibles pursuant to the CSA, the other controlled participant (the PCT Payor) would owe compensation for the services of such team under Temp. Treas. Reg. § 1.482–9T, just as would be the case in a contract research arrangement. Where there is a combined contribution of research services, intangibles in process, or other resources, capabilities, or rights, the temporary regulations provide for an aggregate valuation where that would provide the most reliable measure of an arm's length result for the aggregated PCTs and other transactions. The treatment available under the cost sharing rules of the contribution of the services of a research team as controlled services is without any inference concerning the potential status of workforce in place as an intangible within the meaning of section 936(h)(3)(B).

On the other hand, the temporary regulations only require the PCT Payor to compensate the PCT Payee for platform contributions, or cross operating contributions, reasonably anticipated to contribute to the CSA Activity in the PCT Payor's division as defined in Temp. Treas. Reg. § 1.482–7T(j)(1)(i). A PCT Payor is not obligated to compensate the PCT Payee for any of the PCT Payee's resources, capabilities, or rights that are reasonably anticipated to benefit only the PCT Payee's operations. Similarly, under the temporary regulations, the PCT Payee is also not entitled to compensation from the PCT Payor on account of any of the PCT Payor's own resources, capabilities, or rights, including any goodwill or going concern value of the PCT Payor. For example, where operations of parties involve undertaking functions and risks of scope and duration comparable to those of the PCT Payor, an application of the income method based on the comparable profits method would retain for the PCT Payor the returns reasonably anticipated to its own contributions to operations in its division, including any goodwill or going concern value associated with those operations, based on the returns to the comparable parties used in the CPM analysis. Similarly, the PCT Payor retains the ability to pursue its own business opportunities in its division, including through operating cost contributions to maintain or develop resources, capabilities, or rights to promote its operations.

In response to comments that the concept of the RT was unnecessary and confusing, the temporary regulations do not use that concept. Instead, the temporary regulations adopt a presumption that a PCT Payee provides any resource, capability, or right to the intangible development activity (IDA) pursuant to the CSA on an exclusive basis. A taxpayer can rebut the presumption by showing to the satisfaction of the Commissioner that the subject resource, capability, or right is reasonably anticipated to contribute not just to the CSA, but to other business activities as well. For example, if the platform resource is a research tool, then the taxpayer could rebut the presumption of exclusivity by establishing to the satisfaction of the Commissioner that the tool is reasonably anticipated not only to be applied in the IDA, but also to be licensed to an uncontrolled taxpayer. The temporary regulations provide guidance on proration of PCT payments in cases where the taxpayer rebuts the presumption.

4. Intangible Development Activity and Costs—Temp. Treas. Reg. § 1.482–7T(d)

Some commentators suggested that taxpayers can limit the application of the cost sharing rules by defining the IDA with reference only to specifically listed platform contributions. Without any inference intended as to the economic substance of such an approach, the temporary regulations are clarified to exclude this possibility. The scope of the IDA includes all activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. The IDA cannot be described merely by a list of particular resources, capabilities, or rights that will be used in the CSA, since the IDA is a function of what are the reasonably anticipated cost shared intangibles and such a list might not identify reasonably anticipated cost shared intangibles. Also, the scope of the IDA may change as the nature or identity of the reasonably anticipated cost shared intangibles or the nature of the activities necessary for their development become clearer. For example, the relevance of certain ongoing work to developing reasonably anticipated cost shared intangibles or the need for additional work may only become clear over time.

The Treasury Department and the IRS requested in Notice 2005–99, 2005–52 CB 1214 comments regarding the valuation of stock options and other stock-based compensation. The Treasury Department and the IRS received comments and continue to consider the technical changes and issues described in Notice 2005–99 and intend to address those in a subsequent regulations project. See Treas. Reg. § 601.601(d)(2)(ii)(*b*).

5. Changes in Participation—Temp. Treas. Reg. § 1.482–7T(f)

The increased flexibility to adopt a divisional basis other than a territorial or field of use basis entails the need for provisions to prevent abuse and facilitate compliance. Capability fluctuations, whether market-driven or strategic, that materially alter the controlled participants' RAB shares as compared with their respective divisional interests create the equivalent of a controlled transfer of interests and should therefore equally occasion arm's length compensation. Accordingly, the temporary regulations modify the change of participation provision to classify such a material capability variation, in addition to a controlled transfer of interest, as a change in participation that requires arm's length consideration by the controlled participant whose RAB share increases, to the controlled participant whose RAB share decreases, as the result of the capability variation.

C. Income and Other Specified and Unspecified Methods

1. Best Method Analysis Considerations—Temp. Treas. Reg. § 1.482–7T(g)(2)

The 2005 proposed regulations articulated ''general principles''—such as the realistic alternatives principle—applicable to any method to determine the arm's length charge in a PCT. Commentators expressed uncertainty about the role intended for these principles. For example, they wondered if these principles themselves dictated, or trumped, methods or applications of methods.

The temporary regulations clarify that these principles were intended to provide supplementary guidance on the application of the best method rule to determine which method, or application of a method, provides the most reliable measure of an arm's length result in the CSA context. In other words, the principles provide best method considerations to aid the competitive evaluation of methods or applications, and are not themselves methods or trumping rules.

a. *Consistency with upfront terms and risk allocation—the investor model—Temp. Treas. Reg. § 1.482–7T(g)(2)(ii).*

The investor model is a core principle of the 2005 proposed regulations. A PCT Payor, through cost sharing and payments made pursuant to the PCT (PCT Payments), is investing for the term of the CSA Activity and expects returns over time consistent with the riskiness of that investment.

The upfront evaluation pursuant to the investor model of expected returns to particular risks assumed in intangible development and exploitation under the facts and circumstances is key to ensuring consistency of the results of a CSA with the arm's length standard. Commentators have criticized the investor model for stripping away risky returns from the PCT Payor. The temporary regulations provide additional guidance to explain that when the PCT Payor assumes risks, it accordingly enjoys the returns (or suffers the detriments) that may result from such risks.

For example, in addition to its cost contributions to developing cost shared intangibles, a PCT Payor may also commit significant operating contributions, such as existing marketing or manufacturing process intangibles, to operations in its division as well as make significant operating cost contributions towards further developing such intangibles. To the extent parties to comparable transactions undertake similar risks of similar scope and duration, the PCT Payor will be appropriately awarded based on a method that relies in whole or part on the returns in such comparable transactions (including applications of the income method based on a CUT or the CPM). To the extent its operating contributions are nonroutine, that is, not reflected in available comparable transactions, then the PCT Payor may share in nonroutine divisional profit under the application of the residual profit split method (RPSM) provided in the temporary regulations.

Moreover, the temporary regulations provide guidance on discount rates and arm's length ranges, so as to further clarify the ability of the PCT Payor to achieve results commensurate with its assumption of risks.

b. *Aggregation of transactions—Temp. Treas. Reg. § 1.482–7T (g)(2)(iv).*

The temporary regulations make conforming changes to the guidance included in the 2005 proposed regulations on aggregate evaluation of multiple transactions. Thus, if the combined effect of transactions in connection with a CSA involving platform, operating, and other contributions of resources, capabilities, or rights are reasonably anticipated to be interrelated, then determination of the arm's length charge for PCTs and other transactions on an aggregate basis may provide the most reliable measure of an arm's length result.

c. *Discount rates—Temp. Treas. Reg. § 1.482–7T(g)(2)(v).*

The 2005 proposed regulations provided general guidance that, where a present value is needed for a purpose in a cost sharing analysis, a discount rate should be used that most reliably reflects the risk of the particular set of activities or transactions based on all the information potentially available at the time for which the present value calculation is to be performed. Further, depending on the particular facts and circumstances, the discount rate may differ among a company's various activities and transactions. As examples, the proposed regulations indicated that a weighted average cost of capital (WACC) of the taxpayer, or an uncontrolled taxpayer, could provide the most reliable basis for a discount rate if the CSA Activity involves the same risk as projects undertaken by the taxpayer, or uncontrolled taxpayer, as a whole. As another example, in certain appropriate conditions, a company's internal hurdle rate for projects of comparable risk might provide a reliable basis for a discount rate in a cost sharing analysis.

Commentators offered several criticisms of the discount rate guidance. Some comments concluded that the 2005 proposed regulations placed an inappropriate emphasis on a taxpayer's WACC as a basis for analysis. Other comments suggested a clarification be made that more than a single discount rate may be appropriate in a cost sharing analysis. Yet other comments addressed whether a discount rate in a cost sharing analysis should be before, or after, tax. Some commentators asserted that cash flows, rather than items entering into income, analytically are the more appropriate amounts to be discounted.

The temporary regulations revise and elaborate upon the best method analysis considerations in regard to discount rates. Guidance is provided recognizing that the appropriate discount rate may, depending on the facts and circumstances, vary between realistic alternatives and forms of payment. As regards discount rate variation between realistic alternatives, for example, licensing intangibles needed for its operations would ordinarily be less risky for a licensee, and so require a lower discount rate, than entering into a CSA which would involve the licensee assuming the additional risk of funding its cost contributions to the IDA. As regards discount rate variation between forms of payment, for example, ordinarily a royalty computed on a profits base would be more volatile, and so require a higher discount rate to discount projected payments to present value, than a royalty computed on a sales base.

The temporary regulations recognize that, in general, discount rates inferred from the operations of the capital markets are post-tax rates. An analysis applying post-tax discount rates would be expected to treat taxes like any other expense. However, the equivalent result may in certain circumstances be achieved by applying a post-tax discount rate to pre-tax net income multiplied by the difference of one minus the tax rate. If such an approach is adopted in applying the income method, to the extent that the controlled participants' respective tax rates are not materially affected by whether they enter into the cost sharing or licensing alternative (or if reliable adjustments may be made for varying tax rates), the mulitiplier (that is, one minus the tax rate) may be cancelled from both sides of the equation of the cost sharing and licensing alternative present values. Accordingly, in such circumstance it is sufficient to apply post-tax discount rates to pre-tax items for the purpose of equating the cost sharing and licensing alternatives. See also the discussion of the income method in this preamble.

The specific reference to a WACC or to hurdle rates are eliminated as unnecessary, but without any inference as to a WACC or a hurdle rate being an appropriate discount rate, or an appropriate starting point in ascertaining a discount rate, depending on the particular facts.

Certain methods in the temporary regulations (such as the income method under Temp. Treas Reg. § 1.482–7T(g)(4)) are theoretically based on valuation techniques that use ''cash flow'' projections rather than income projections. While use of cash flow projections is permitted under these methods, for a number of practical and administrative reasons, detailed guidance on the specific applications of the methods are based on income, rather than cash flow, measures. The Treasury Department and the IRS considered whether to provide guidance on the use of cash flows, rather than income, as the appropriate amounts to be discounted in a cost sharing analysis. The Treasury Department and the IRS continue to consider, and solicit comments, on whether and how the cost sharing rules could reliably be administered on the basis of cash flows instead of operating income, and whether such a basis is consistent with the second sentence of section 482 and its CWI requirement.

d. *Projections—Temp. Treas. Reg. § 1.482–7T(g)(2)(vi).*

The temporary regulations note that the reliability of an estimate will often depend upon the reliability of the projections used in making the estimate. Projections should reflect the best estimates of the items projected (for example, reflecting a probability weighted average of possible outcomes).

e. *Arm's length range—Temp. Treas. Reg. § 1.482–7T(g)(2)(ix).*

The 2005 proposed regulations provided supplemental guidance on applying arm's length methods in the cost sharing context in accordance with the provisions of Treas. Reg. § 1.482–1 including, inter alia, the arm's length range of Treas. Reg. § 1.482–1(e). The proposed regulations did not, however, provide guidance on how to adapt an arm's length range for cost sharing.

The temporary regulations adapt the guidance in Treas. Reg. § 1.482–1(e) for use with some of the methods for computing PCT Payments that are specified in the temporary regulation. The provisions elaborate, where the entire range of results cannot be regarded as of sufficient comparability and reliability, how to derive a statistically enhanced range of arm's length charges for a PCT.

The guidance in Treas. Reg. § 1.482–1(e) regarding arm's length ranges is most easily understood in the context of a method (for example, comparable uncontrolled price, cost plus, resale price, comparable uncontrolled transaction, comparable profits), in which the result of each comparable transaction directly provides an estimate for the result of the controlled transaction. Some of the methods specified in the temporary regulations (for example, the income method) have a different structure, in which an arm's length result is estimated by performing mathematical calculations that depend on two or more input parameters (for example, a relevant discount rate, certain financial projections, a return for routine activities) that must be determined. The additional guidance in this section addresses the arm's length range in the context of such methods.

The temporary regulations distinguish certain input parameters (variable input parameters) that, for purposes of determining an arm's length range, may be assigned more than one possible value. Such input parameters are limited to those whose value is most reliably determined by considering two or more observations of market data (for example, profit levels or stock betas of two or more companies) that have, or with adjustment can be brought to, a similar reliability and comparability, as described in Treas. Reg. § 1.482–1(e)(2)(ii). If there are two or more variable input parameters, the narrowing effect of the interquartile range is used twice: First, to narrow the variation of each input parameter, and again to narrow the resulting set of PCT Payment values. This double narrowing reflects that the use of two or more variable input parameters normally introduces additional unreliability into a method, even though that method may be the best method.

Generally, Treas. Reg. § 1.482–1(e)(3) governs the Commissioner's ability to make an adjustment to a PCT Payment due to the taxpayer's results being outside the arm's length range. Consistent with the principles expressed there, adjustment under the temporary regulations will normally be to the median, as defined in Treas. Reg. § 1.482–1(e)(3). Also, the Commissioner is not required to establish an arm's length range prior to making an allocation under section 482.

The Treasury Department and the IRS solicit comments on the design and mechanics of the supplemental guidance on determination of an arm's length range in paragraph (g)(2)(ix) of the temporary regulations, including the limitation of variable input parameters to market-based input parameters. Any alternative proposal should specify the design and mechanics in detail, and should discuss whether such an approach enhances the reliability of the analysis, is administrable, and is not so manipulable as to yield unrealistic ranges.

2. Comparable Uncontrolled Transaction Method—Temp. Treas. Reg. § 1.482–7T(g)(3)

The 2005 proposed regulations provided for possible use of the comparable uncontrolled transaction (CUT) method to determine the arm's length charge in a PCT where appropriate in accordance with the standards of the intangibles transfer and controlled services provisions of the regulations under section 482. Some commentators asserted that any arrangement that uncontrolled parties might call a cost sharing arrangement could serve as a CUT, even though such arrangement may involve materially different risk allocations and provisions than addressed in the cost sharing rules.

In response to these comments, the temporary regulations describe the relevant considerations for purposes of evaluating whether a putative CUT may, or may not, reflect the most reliable measure of an arm's length result. Although all of the factors entering into a best method analysis described in Treas. Reg. §§ 1.482–1(c) and (d) must be considered, comparability and reliability under the CUT method in the CSA context are particularly dependent on similarity of contractual terms, degree to which allocation of risks is proportional to reasonably anticipated benefits from exploiting the results of intangible development, similar period of commitment as to the sharing of intangible development risks, and similar scope, uncertainty, and profit potential of the subject intangible development, including a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with the cost sharing rules.

3. Income Method—Temp. Treas. Reg. § 1.482–7T(g)(4)

The 2005 proposed regulations made the income method a specified method for purposes of evaluating the arm's length charge in a PCT. Under the general rule, the arm's length charge was an amount that equated a controlled participant's present value of entering into a CSA with the present value of the controlled participant 's best realistic alternative. Also provided were two applications of the income method. One, based on a CUT analysis, assumed that a PCT Payee's best realistic alternative would be to develop the cost shared intangibles on its own, bearing all the intangible development costs (IDCs) itself, and then license the cost shared intangibles. A second, based on a comparable profits method (CPM) analysis, assumed that the PCT Payor's best realistic alternative would be to acquire the rights to external contributions (renamed platform contributions under the temporary regulations) for payments with a present value equal to the PCT Payor's anticipated profit, after reward for its routine contributions to its operations, from the CSA Activity in its territory (the only division permitted under the 2005 proposed regulations). Both income method applications provided for a cost contribution adjustment in order to allocate to the PCT Payor the return to its additional risk, as compared to its realistic alternative, of bearing its reasonably anticipated benefits (RAB) share of the IDCs. As set forth in the 2005 proposed regulations, both the CUT and CPM based applications of the income method built in a conversion to a royalty form of payment, either on sales or on operating profit.

Commentators offered several criticisms with reference to the income method. As a general matter, some comments asserted that the income method stripped away risky returns from the PCT Payor. Other comments focused on technical aspects of the method and the applications. In particular, comments pointed to the potential risk differentials between cost sharing and the alternative arrangements. For example, cost sharing would generally be more risky than licensing for the PCT Payor as the result of its sharing with the PCT Payee the risks of the IDA. As a corollary, cost sharing would generally be less risky for the PCT Payee than licensing. The comments observed that these risk differentials would ordinarily be reflected in different discount rates being appropriate under the cost sharing and licensing alternatives. Other comments suggested the possible use of different discounts for different financial flows (sales, cost of sales, operating expenses, cost contributions, etc.).

The temporary regulations provide further guidance on the income method and its applications. In general, they provide that the best realistic alternative of the PCT Payor to entering into the CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Similarly, the best realistic alternative of the PCT Payee to entering into the CSA would be to undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA and license the resulting intangibles to an uncontrolled licensee.

The licensing alternative is derived on the basis of a functional and risk analysis of the cost sharing alternative, but with a shift of the risk of cost contributions to the licensor. Accordingly, the PCT Payor's licensing alternative consists of entering into a license with an uncontrolled party, for a term extending for what would be the duration of the CSA Activity, to license the make-or-sell rights in subsequently to be developed resources, capabilities, or rights of the licensor. Under such license, the licensor would undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Apart from the difference in the allocation of the risks of the IDA, the licensing alternative should assume contractual provisions with regard to non-overlapping divisional intangible interests, and with regard to allocations of other risks, that are consistent with the actual CSA in accordance with the cost sharing rules. For example, the analysis under the licensing alternative should assume a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with the temporary regulations.

The temporary regulations, like the 2005 proposed regulations, describe both CUT-based applications and CPM-based applications of the Income Method. However, they differ from the applications described in the 2005 proposed regulations by equating the cost sharing and licensing alternatives of the PCT Payor using discount rates appropriate to those alternatives. In circumstances where the market-correlated risks as between the cost sharing and licensing alternatives are not materially different, a reliable analysis may be possible by using the same discount rate with respect to both alternatives. Otherwise, as recognized in the best method considerations concerning discount rates, realistic alternatives having the same reasonably anticipated present value may nevertheless involve varying risk exposure and, thus, generally are more reliably evaluated using different discount rates. To the extent that the controlled participants' respective tax rates are not materially affected by whether they enter into the cost sharing or licensing alternative (or reliable adjustments may be made for varying tax rates), it is appropriate to apply post-tax discount rates to pre-tax items for purpose of equating the cost sharing and licensing alternatives. The discount rate for the cost sharing alternative will generally depend on the form of PCT Payments assumed (for example, lump sum, royalty on sales, royalty on divisional profit).

The income method may be applied to determine PCT Payments in any form of payment (for example, lump sum, royalty on sales, royalty on divisional profit). If an income method application is used to determine arm's length PCT Payments in a particular form, then the PCT Payments in that form may be converted to an alternative form in accordance with Temp. Treas. Reg. § 1.482–7(h) (Form of payment rules).

The temporary regulations clarify the opportunities, depending on the facts and circumstances, for the PCT Payor to assume risks and, accordingly, to enjoy the returns (or suffer the detriments) that may result from such risks. For example, in addition to its cost contributions to developing cost shared intangibles, a PCT Payor may also commit significant operating contributions, such as existing marketing or manufacturing process intangibles, to operations in its division as well as make significant operating cost contributions towards further developing such intangibles. To the extent parties to comparable transactions undertake risks of similar scope and duration, the PCT Payor will be appropriately rewarded based on a method that relies in whole or part on returns in such comparable transactions under an application of the income method whether based on a CUT or the

CPM. Where its operating contributions are nonroutine, that is, not reflected in available comparable transactions, the PCT Payor may share in nonroutine divisional profit under the application of the RPSM provided in the temporary regulations. Similarly, while the income method is limited to cases in which only one of the controlled participants provides nonroutine platform contributions as the PCT Payee, the RPSM in the temporary regulations addresses the situation where more than one controlled participant furnishes nonroutine platform contributions.

Yet other comments criticized the income method as positing an unrealistic ''perpetual life.'' The income method is premised on the assumption that, at arm's length, an investor will make a risky investment (for example, in a platform for developing additional technology) only if the investor reasonably anticipates that the present value of its reasonably anticipated operational results will be increased at least by a present value equal to the platform investment. It may be, depending on the facts and circumstances, that the technology is reasonably expected to achieve an incremental improvement in results for only a finite period (after which period, results are reasonably anticipated to return to the levels that would otherwise have been expected absent the investment). The period of enhanced results that justifies the platform investment in such circumstances effectively would correspond to a finite, not a perpetual, life.

4. Acquisition Price and Market Capitalization Methods—Temp. Treas. Reg. § 1.482–7T(g)(5) and (6)

The 2005 proposed regulations included guidance on the acquisition price and market capitalization methods for evaluating the arm's length charge in a PCT. Under the acquisition price method, the arm's length charge for a PCT is the adjusted acquisition price, that is, the acquisition price increased by the value of the target's liabilities on the date of acquisition, and decreased by the value on that date of target's tangible property and any other resources and capabilities not covered by the PCT. Under the market capitalization method, the arm's length charge for a PCT is the adjusted average market capitalization, that is, the average daily market capitalization over the 60 days ending with the date of the PCT, increased by the value of the PCT Payee's liabilities on such date, and decreased on account of tangible property and any other resources and capabilities of the PCT Payee not covered by the PCT.

Commentators questioned the reliability of these methods in light of volatility of stock prices and lack of correlation between stock price and underlying assets, for example, owing to control premiums or economies of integration.

The Treasury Department and the IRS recognize that these comments point to considerations that, depending on the facts and circumstances, will need to be taken into account in a best method analysis that compares the reliability of the results under application of these methods as against the results under application of other methods (which may themselves have aspects that reduce their reliability). The temporary regulations retain the best method considerations from the 2005 proposed regulations that observe that reliability is reduced under these methods if a substantial portion of the target's, or PCT Payor's, nonroutine contributions to business activities is not required to be covered by a PCT and, in the case of the market capitalization method, if the facts and circumstances demonstrate the likelihood of a material divergence between the PCT Payee's average market capitalization and the value of its underlying resources, capabilities, and rights for which reliable adjustments cannot be made. The temporary regulations also provide that proximity in time between the acquisition of the target and the PCT Payment is an important comparability factor under the acquisition price method.

5. Residual Profit Split Method—Temp. Treas. Reg. § 1.482–7T(g)(7)

The temporary regulations conform the modified RPSM from the proposed regulations to the changes made to the income method.

6. Unspecified Methods—Temp. Treas. Reg. § 1.482–7T(g)(8)

Under the temporary regulations in order to use an unspecified method, a taxpayer must maintain documentation to describe and explain the method selected to determine the arm's length payment due in a PCT.

D. Form of Payment

1. Post Formation Acquisitions

The 2005 proposed regulations generally provided taxpayers flexibility to provide for PCT Payments either in fixed amounts (whether in lump sums or installment payments with arm's length interest) or in contingent amounts. PCT Payments could not be paid in shares of stock of the PCT Payor. The form of payment selected for any PCT, including the basis and structure of the payments, had to be specified no later than the date of the PCT. In the case of a post formation acquisition (PFA)—that is, an external contribution (renamed platform contribution in the temporary regulations) that is acquired by a controlled participant in an uncontrolled transaction (either directly, or indirectly through the acquisition of an interest in an entity or tier of entities)—the consideration under the PCT for a PFA had to be paid in the same form as the consideration in the uncontrolled transaction in which the PFA was acquired. An example indicates that acquisitions for stock were considered to be for a fixed form of payment. One principal rationale for the special rules for PFAs was that PFAs stand in the place of IDCs and, therefore, reflect a risk allocation equivalent to that in the IDC context, which requires the sharing of outlays on a fixed form of payment basis. Another principal rationale was the difficulty the IRS has had in examining CSAs using a contingent form of payment for PFAs.

Commentators criticized the same form of payment requirement for PFAs, especially the treatment of stock acquisitions as having a fixed form of payment. The comments pointed out that a purchaser paying with its own stock is selling a part of its business, and thus pays consideration that is ultimately contingent on the success of its business. Other comments objected to the timing mismatch caused by the same form of payment rule, because fixed PCT Payments would be immediately includable, but the PFA assets would be amortizable only over time. Still other comments asserted that taxpayers may choose their form of payment for PFAs, as with other external contributions, so long as the price (taking into account the form of payment) is arm's length.

The temporary regulations do not retain the special rules for PFAs. Subsequent acquisitions remain an important source of platform contributions that occasion the requirement of PCT compensation. However, the temporary regulations no longer require a special form of payment for such compensation. Therefore, controlled participants may choose the form of payment for PCTs regardless of whether the PCTs occur at the outset of the CSA or later. Removal of the special rules for PFAs moots questions regarding whether stock consideration should be treated as contingent or fixed payment and whether (and how) the timing mismatch should be addressed. Nonetheless, the IRS will continue to scrutinize the contractual documentation, pricing, and implementation of contingent forms of payment for PFAs.

2. Contingent Payments—Temp. Treas. Reg. § 1.482–7T(h)(2)(iv) and (v)

The temporary regulations incorporate rules to ensure that the contingent form for PCT Payments is applied properly by both taxpayers and the IRS. In accordance with Treas. Reg. § 1.482–1(d)(3)(iii)(B), a CSA contractual provision that provides for payments for a PCT (or group of PCTs) to be contingent on the exploitation of cost shared intangibles will be respected as consistent with economic substance only if the allocation between the controlled participants of the risks attendant on such form of payment is determinable before the outcomes of such allocation that would have materially affected the PCT pricing are known or reasonably knowable. The temporary regulations require a contingent payment provision to clearly and unambiguously specify the basis on which the contingent payment obligations are to be determined. In particular, the contingent payment provision must clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, the royalty base (such as sales or revenues), and the computation used to determine the PCT Payments. The royalty base specified must permit verification of its proper use by reference to books and records maintained by the controlled participants in the normal course of business (for example, books and records maintained for financial accounting or business management purposes).

The temporary regulations also provide that where a method yields a fixed value for PCT Payments, a conversion may be made to a contingent form of payments. Guidance is also provided on discount rates for purposes of such conversion. Certain forms of payment may involve different risks than others. For example, ordinarily a royalty computed on a profits base would be more volatile, and so require a higher discount rate to discount projected payments to present value, than a royalty computed on a sales base.

E. Periodic Adjustments

1. Determination of Periodic Adjustments—Temp. Treas. Reg. § 1.482–7T(i)(6)(v) and (vi)

The 2005 proposed regulations addressed the CWI principle of the second sentence of section 482 in the context of cost sharing. The Commissioner could make periodic adjustments for an open taxable year (the Adjustment Year) and all subsequent years of the CSA Activity in the event of a Periodic Trigger. Under the 2005 proposed regulations, a Periodic Trigger arose if the PCT Payor realized, over the period beginning with the earliest date on which an IDC occurred through the end of the Adjustment Year, an actually experienced return ratio of the present value of its total territorial operating profits divided by the present value of its investment consisting of the sum of its cost contributions plus PCT Payments, outside the periodic return ratio range of between .5 and 2. In arriving at these present values, the Commissioner would use an applicable discount rate, which in the case of certain publicly traded entities would be their weighted average cost of capital, unless the Commissioner determines, or the controlled participants establish, that another discount rate better reflects the degree of risk of the CSA Activity. Periodic adjustments would be determined under a modified RPSM. Exceptions were provided, such as for an effective CUT or for results due to extraordinary events beyond the controlled participants' control and that could not have been reasonably anticipated. In determining whether to make any periodic adjustments, the Commissioner would consider whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances.

Commentators offered several criticisms of the periodic adjustment rules. Some comments considered the periodic adjustment rules to be inconsistent with the arm's length standard and, through hindsight, to strip away returns to risk. Other comments claimed for taxpayers the same ability as the Commissioner to make periodic adjustments to implement the CWI principle where subsequent results diverge from original expectations. Comments also addressed the exceptions and means for taxpayers to demonstrate their results were arm's length so as to avoid periodic adjustments.

The Treasury Department and the IRS reaffirm that the CWI principle is consistent, and periodic adjustments are to be administered consistently, with the arm's length standard. Congress adopted the CWI principle in 1986 out of concern about related-party long-term transfers of high-profit potential intangibles for relatively insignificant lump sum or royalty consideration justified by reference to putatively comparable transactions between unrelated parties that differed significantly in terms of the division of functionality and risks when compared to the transfers at issue. See H.R. Rep. 99–426, at 424–25 (1985). See also Notice 88–123 (the White Paper), 1988–2 CB 458, 472–74, 477–80. Congress intended that taxpayers be able to ''use certain bona fide cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each.'' H.R. Conf. Rep. No. 99–841, at II–638 (1986). See Treas. Reg. § 601.601(d)(2)(ii)(*b*).

Accordingly, the temporary regulations continue to provide for periodic adjustments along lines similar to those in the intangible transfer section of the regulations, as adapted for the cost sharing context. Compare Treas. Reg. § 1.482–4(f)(2)(Periodic adjustments). The temporary regulations, however, adopt a smaller periodic return ratio range than the 2005 proposed regulations. Setting a Periodic Trigger to occur if the actually experienced return ratio falls outside the periodic return ratio range of between .667 and 1.5 (or between 0.8 and 1.25, if the taxpayer has not substantially complied with the documentation requirements of Temp. Treas. Reg. § 1.482–7T(k)) is intended to isolate situations in which actual results suggest the potential of an absence of arm's length pricing as of the date of the PCT. The Treasury Department and the IRS consider that the periodic return ratio range under the temporary regulations more realistically targets the threshold at which periodic adjustment scrutiny is appropriate. In determining whether to make any periodic adjustments, the Commissioner considers whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances.

The temporary regulations also make conforming changes to the determination of periodic adjustments, in the event of a Periodic Trigger, in light of other changes in the temporary regulations, for example, in the RPSM and form of payment provisions.

2. Advance Pricing Agreement

In addition, the Treasury Department and the IRS intend to issue by revenue procedure separate published guidance that provides an exception to periodic adjustments, similar to exceptions provided in Temp. Treas. Reg. § 1.482–7T(i)(6)(vi), in the context of an advance pricing agreement (APA) entered into pursuant to Rev. Proc. 2006–9, 2006–1 CB 278 (as it may be amended or superseded by subsequent administrative pronouncement). The guidance would provide that no periodic adjustments will be made in any year based on a Trigger PCT that is a covered transaction under the APA. See Treas. Reg. § 601.601(d)(2)(ii)(*b*).

An APA process generally is contemporaneous with a taxpayer's original transactions and involves transparency concerning a taxpayer's upfront efforts to conform to the arm's length standard. Thus, the APA process may overcome the asymmetry in information addressed by the periodic adjustment provisions, eliminating a primary basis for a CWI adjustment. See generally 70 FR 51128–51130 (preamble to 2005 proposed regulations).

The Treasury Department and the IRS considered the possibility of a further exception to periodic adjustments based on documentation that a taxpayer would maintain contemporaneously with a PCT. Compare Treas. Reg. § 1.6662–6(d)(2)(iii). Such an exception was not incorporated into the temporary regulations in light of the concern that documentation prepared only by the taxpayer would not benefit from a similar degree of contemporaneous transparency and explanation as involved in an APA. The Treasury Department and the IRS continue to consider this matter and solicit comments on whether and how a documentation exception could be adapted to the purposes of the CWI principle.

F. Terminology and Table of Definitions—Temp. Treas. Reg. § 1.482–7T(j)(1)

For ease of reference, a comprehensive table of terms is provided. The table sets forth, alphabetically, technical terms used in the regulations, any applicable abbreviations, definitions (if not elsewhere defined in the regulations), and cross references to relevant portions of the regulations where the terms are defined or used.

G. Administrative and Transition Rules—Temp. Treas. Reg. § 1.482–7T(m)

The 2005 proposed regulations included transition rules for existing qualified cost sharing arrangements so as not to disturb taxpayers' reliance on the prior regulations, while providing for appropriate prospective application of the new regulations. Grandfather treatment would have been terminated in certain events, including the occasion of a Periodic Trigger as the result of a subsequent PCT occurring after the regulations' effective date, a material change in the scope of the arrangement, such as a material expansion of the activities undertaken beyond the scope of the intangible development area, or a 50 percent or greater change in the ownership of interests in cost shared intangibles.

Commentators objected to the grandfather termination events, in particular in the case of a subsequent Periodic Trigger or a 50 percent change of ownership, as defeating taxpayers' legitimate expectation under the prior regulations.

The temporary regulations do not terminate grandfather treatment upon a 50 percent change of ownership or on account of a subsequent Periodic Trigger or a material change in scope of the arrangement. The temporary regulations instead adopt a targeted provision that applies the temporary regulations' periodic adjustment rules to PCTs that occur on or after the date of a material change in the scope of the grandfathered CSA. A material change in scope would include a material expansion of the activities undertaken beyond the scope of the intangible development area, as described in former Treas. Reg. § 1.482–7(b)(4)(iv). For this purpose, a contraction of the scope of a CSA, absent a material expansion into one or more lines of research and development beyond the scope of the intangible development area, does not constitute a material change in scope of the CSA. Whether a material change in scope has occurred is determined on a cumulative basis. Therefore, a series of expansions, any one of which is not a material expansion by itself, may collectively constitute a material expansion.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined also that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

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

26 CFR Part 602

Reporting and recordkeeping requirements.

Amendment to the Regulations

■ Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

■ **Par. 2.** Section 1.367(a)–1 is added to read as follows:

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

(a) through (d)(2) [Reserved].

(3) [Reserved] For further guidance, see § 1.367(a)–1T(d)(3).

(d)(4) through (g) [Reserved].

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

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

* * * * *

(d) * * *

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

* * * * *

■ **Par. 4.** Section 1.482–0 is amended by adding the entries for §§ 1.482–1(b)(2)(iii), 1.482–2(e) and (f), 1.482–4(g) and (h) and revising the entries for § 1.482–7 to read as follows:

§ 1.482–0 Outline of regulations under section 482.

* * * * *

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

* * * * *

(b) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(b)(2)(iii).

* * * * *

§ 1.482–2 Determination of taxable income in specific situations.

* * * * *

(e) and (f) [Reserved]. For further guidance, see § 1.482–0T, the entries for § 1.482–2T(e) and (f).

* * * * *

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

* * * * *

(g) and (h) [Reserved]. For further guidance, see § 1.482–0T, the entries for § 1.482–4T(g) and (h).

* * * * *

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

[Reserved]. For further guidance, see § 1.482–0T, the entries for § 1.482–7T.

* * * * *

■ **Par. 5.** Section 1.482–0T is amended as follows:

■ 1. The entries for §§ 1.482–1T(b)(2)(iii), (c), (d)(1), (d)(2), (d)(3)(ii)(A), and (d)(3)(ii)(B) are revised.

■ 2. A new entry for § 1.482–1T(b)(2)(iii) is added.

■ 3. The entries for § 1.482–2T(e) are revised, and new entries for § 1.482–2T(f) are added.

■ 4. The entries for § 1.482–4T(f)(7) are removed, and the entries for § 1.482–4T(g) and (h) are added.

■ 5. The entries for § 1.482–7T are added.

■ 6. The entries for § 1.482–9T(m)(3) and (n) are revised.

The additions and revisions read as follows:

§ 1.482–0T Outline of regulations under section 482 (temporary).

* * * * *

§ 1.482–1T Allocation of income and deductions among taxpayers (temporary).

* * * * *

(b) * * *

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(b)(2)(ii).

(iii) Coordination of methods applicable to certain intangible development arrangements.

(c) through (d)(3)(ii)(B) [Reserved]. For further guidance, see § 1.482–0, the entries for § 1.482–1(c) through (d)(3)(iii)(B).

* * * * *

§ 1.482–2T Determination of taxable income in specific situations (temporary).

* * * * *

(e) Cost sharing arrangement.

(f) Effective/applicability Date.

(1) In general.

(2) Election to apply section paragraph (b) to earlier taxable years.

(3) Expiration date.

* * * * *

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

* * * * *

(g) Coordination with rules governing cost sharing arrangements.

(h) Effective/applicability date.

(1) In general.

(2) Election to apply regulation to earlier taxable years.

(3) Expiration date.

* * * * *

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

(a) In general.

(1) RAB share method for cost sharing transactions (CSTs).

(2) Methods for platform contribution transactions (PCTs).

(3) Methods for other controlled transactions.

(i) Contribution to a CSA by a controlled taxpayer that is not a controlled participant.

(ii) Transfer of interest in a cost shared intangible.

(iii) Other controlled transactions in connection with a CSA.

(iv) Controlled transactions in the absence of a CSA.

(4) Coordination with the arm's length standard.

(b) Cost sharing arrangement.

(1) Substantive requirements.

(i) CSTs.

(ii) PCTs.

(iii) Divisional interests.

(iv) Examples.

(2) Administrative requirements.

(3) Date of a PCT.

(4) Divisional interests.

(i) In general.

(ii) Territorial based divisional interests.

(iii) Field of use based divisional interests.

(iv) Other divisional bases.

(v) Examples.

(5) Treatment of certain arrangements as CSAs.

(i) Situation in which Commissioner must treat arrangement as a CSA.

(ii) Situation in which Commissioner may treat arrangement as a CSA.

(iii) Examples.

(6) Entity classification of CSAs.

(c) Platform contributions.

(1) In general.

(2) Terms of platform contributions.

(i) Presumed to be exclusive.

(ii) Rebuttal of Exclusivity.

(iii) Proration of PCT Payments to the extent allocable to other business activities.

(A) In general.

(B) Determining the proration of PCT Payments.

(3) Categorization of the PCT.

(4) Certain make-or-sell rights excluded.

(i) In general.

(ii) Examples.

(5) Examples.

(d) Intangible development costs.

(1) Determining whether costs are IDCs.

(i) Definition and scope of the IDA.

(ii) Reasonably anticipated cost shared intangible.

(iii) Costs included in IDCs.

(iv) Examples.

(2) Allocation of costs.

(3) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation with the IDA.

(iii) Measurement and timing of stock-based compensation IDC.

(A) In general.

(*1*) Transfers to which section 421 applies.

(*2*) Deductions of foreign controlled participants.

(*3*) Modification of stock option.

(*4*) Expiration or termination of CSA.

(B) Election with respect to options on publicly traded stock.

(*1*) In general.

(*2*) Publicly traded stock.

(*3*) Generally accepted accounting principles.

(*4*) Time and manner of making the election.

(C) Consistency.

(4) IDC share.

(5) Examples.

(e) Reasonably anticipated benefit shares.

(1) Definition.

(i) In general.

(ii) Examples.

(2) Measure of benefits.

(i) In general.

(i) In general.
(ii) Examples.
(2) Special rules.
(i) Consolidated group.
(ii) Trade or business.
(iii) Partnership.
(3) Character.
(i) CST Payments.
(ii) PCT Payments.
(iii) Examples.
(k) CSA administrative requirements.
(1) CSA contractual requirements.
(i) In general.
(ii) Contractual provisions.
(iii) Meaning of contemporaneous.
(A) In general.
(B) Example.
(iv) Interpretation of contractual provisions.
(A) In general.
(B) Examples.
(2) CSA documentation requirements.
(i) In general.
(ii) Additional CSA documentation requirements.
(iii) Coordination rules and production of documents.
(A) Coordination with penalty regulations.
(B) Production of documentation.
(3) CSA accounting requirements.
(i) In general.
(ii) Reliance on financial accounting.
(4) CSA reporting requirements.
(i) CSA Statement.
(ii) Content of CSA Statement.
(iii) Time for filing CSA Statement.
(A) 90-day rule.
(B) Annual return requirement.
(1) In general.
(2) Special filing rule for annual return requirement.
(iv) Examples.
(l) Effective/applicability date.
(m) Transition rule.
(*1*) In general.
(*2*) Transitional modification of applicable provisions.
(3) Special rule for certain periodic adjustments.
(n) Expiration date.

* * * * *

§ 1.482–9T Methods to determine taxable income in connection with a controlled services transaction (temporary).

* * * * *

(m) * * *

(3) Coordination with rules governing cost sharing arrangements. * * *

(n) Effective/applicability dates.

■ **Par. 6.** Section 1.482–1 is amended by revising the last sentence of paragraph (c)(1) to read as follows:

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

* * * * *

(c) * * *

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

* * * * *

■ **Par. 7.** Section 1.482–1T is amended by:

■ 1. Revising paragraphs (b)(2)(i), (b)(2)(ii), (c), (d)(1), (d)(2), (d)(3)(i), (d)(3)(ii) and (j)(6)(iii).

■ 2.Adding a new paragraph (b)(2)(iii).

■ 3.Adding a new sentence to the end of paragraph (j)(6)(i).

The additions and revisions read as follows:

§ 1.482–1T Allocation of income and deductions among taxpayers (temporary).

* * * * *

(b) * * *

(2) *Arm's length methods*—(i) *Methods*. Sections 1.482–2 through 1.482–6, 1.482–7T, and 1.482–9T provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result. Section 1.482–1 and this section provide general principles applicable in determining arm's length results of such controlled transactions, but do not provide methods, for which reference must be made to those other sections in accordance with paragraphs (b)(2)(ii) and (iii) of this section. Section 1.482–7T provides the specific methods to be used to evaluate whether a cost sharing arrangement as defined in § 1.482–7T produces results consistent with an arm's length result.

(ii) [Reserved]. For further guidance, see § 1.482–1(c) through (d)(3)(ii)(C) *Example 1* and *2*.

(iii) *Coordination of methods applicable to certain intangible development arrangements*. Section 1.482–7T provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement as defined in § 1.482–7T. Sections 1.482–4 and 1.482–9T, as appropriate, provide the specific methods to be used to determine arm's length results of arrangements, including partnerships, for sharing the costs and risks of developing intangibles, other than a cost sharing arrangement covered by § 1.482–7T. See also §§ 1.482–4T(g) (Coordination with rules governing cost sharing arrangements) and 1.482–9T(m)(3) (Coordination with rules governing cost sharing arrangements).

(c) through (d)(3)(ii)(C) *Examples 1* and *2*. [Reserved]. For further guidance, see § 1.482–1(c) through (d)(3)(ii)(C) *Example 1* and *2*.

* * * * *

(j) * * *

(6) * * *

(i) * * * The provision of paragraph (b)(2)(iii) of this section is generally applicable on January 5, 2009.

* * * * *

(iii) Except as noted in the succeeding sentence, the applicability of § 1.482–1T expires on or before July 31, 2009. The applicability of paragraph (b)(2)(iii) of this section expires on or before December 30, 2011.

■ **Par. 8.** Section 1.482–2T is amended as follows:

■ 1. Paragraph (e) is redesignated as paragraph (f) and newly-designated paragraph (f) is revised.

■ 2. New paragraph (e) is added.

The addition and revision reads as follows:

§ 1.482–2T Determination of taxable income in specific situations (temporary).

* * * * *

(e) *Cost sharing arrangement.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving a cost sharing arrangement, see § 1.482–7T.

(f) *Effective/applicability date*—(1) *In general*. The provision of paragraph (b) of this section is generally applicable for tax years beginning after December 31, 2006. The provision of paragraph (e) of this section is generally applicable on January 5, 2009.

(2) *Election to apply paragraph (b) to earlier taxable years*. A person may elect to apply the provisions of paragraph (b) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date*. The applicability of paragraph (b) of this section expires on or before July 31, 2009. The applicability of paragraph (e) of this section expires on or before December 30, 2011.

■ **Par. 9.** Section 1.482–4T is amended as follows

■ 1. Paragraph (f)(3)(i)(B) is revised.

■ 2. Paragraph (f)(7) is removed.

■ 3. New paragraphs (g) and (h) are added.

The additions and revision reads as follows:

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

* * * * *

(f) * * *

(3) * * *

(i) * * *

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

* * * * *

(g) *Coordination with rules governing cost sharing arrangements.* Section 1.482–7T provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482–7T. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482–7T is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(h) *Effective/applicability date*—(1) *In general.* Except as provided in the succeeding sentence, the provisions of paragraphs (f)(3) and (4) of this section are generally applicable for taxable years beginning after December 31, 2006. The provisions of paragraphs (f)(3)(i)(B) and (g) of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (f)(3) and (4) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of this section expires on or before December 30, 2011.

■ **Par. 10.** Section 1.482–5 is amended by revising the last sentence of paragraph (c)(2)(iv) to read as follows:

§ 1.482–5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

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

* * * * *

■ **Par. 11.** Section 1.482–7 is redesignated § 1.482–7A, and an undesignated centerheading preceding § 1.482–7A is added to read as follows:

Regulations applicable on or before January 5, 2009.

■ **Par. 12.** Section 1.482–7T is added to read as follows:

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

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

(1) *RAB share method for cost sharing transactions (CSTs).* See paragraph (b)(1)(i) of this section regarding the requirement that controlled participants, as defined in section (j)(1)(i) of this section, share intangible development costs (IDCs) in proportion to their shares of reasonably anticipated benefits (RAB shares) by entering into cost sharing transactions (CSTs).

(2) *Methods for platform contribution transactions (PCTs).* The arm's length amount charged in a platform contribution transaction (PCT) described in paragraph (b)(1)(ii) of this section must be determined under the method or methods applicable under the other section or sections of the section 482 regulations, as supplemented by paragraph (g) of this section. See § 1.482–1(b)(2)(ii) (Selection of category of method applicable to transaction), § 1.482–1T(b)(2)(iii) (Coordination of methods applicable to certain intangible development arrangements), and paragraph (g) of this section (Supplemental guidance on methods applicable to PCTs).

(3) *Methods for other controlled transactions*—(i) *Contribution to a CSA by a controlled taxpayer that is not a controlled participant.* If a controlled taxpayer that is not a controlled participant contributes to developing a cost shared intangible, as defined in section (j)(1)(i) of this section, it must receive consideration from the controlled participants under the rules of § 1.482–4T(f)(4) (Contribution to the value of an intangible owned by another). Such consideration will be treated as an intangible development cost for purposes of paragraph (d) of this section.

(ii) *Transfer of interest in a cost shared intangible.* If at any time (during the term, or upon or after the termination, of a CSA) a controlled participant transfers an interest in a cost shared intangible to another controlled taxpayer, the controlled participant must receive an arm's length amount of consideration from the transferee under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6 as supplemented by paragraph (f)(4) of this section regarding arm's length consideration for a change in participation. For this purpose, a capability variation described in paragraph (f)(3) of this section is considered to be a controlled transfer of interests in cost shared intangibles.

(iii) *Other controlled transactions in connection with a CSA.* Controlled transactions between controlled participants that are not PCTs or CSTs (for example, provision of a cross operating contribution, as defined in paragraph (j)(1)(i) of this section, or make-or-sell rights) require arm's length consideration from the latter controlled participant under the rules of §§ 1.482–1, 1.482–4 through 1.482–6, and 1.482–9T as supplemented by paragraph (g)(2)(iv) of this section.

(iv) *Controlled transactions in the absence of a CSA.* If a controlled transaction is reasonably anticipated to contribute to developing intangibles pursuant to an arrangement that is not a CSA described in paragraph (b)(1) or (5) of this section, whether the results of any such controlled transaction are consistent with an arm's length result must be determined under the applicable rules of the other sections of the regulations under section 482. For example, an arrangement for developing intangibles in which one controlled taxpayer's costs of developing the intangibles significantly exceeds its share of reasonably anticipated benefits from exploiting the developed intangibles would not in substance be a CSA, as described in paragraphs (b)(1)(i) through (iii) of this section or paragraph (b)(5)(i) of this section. In such a case, unless the rules of this section are applicable by reason of paragraph (b)(5) of this section, the arrangement must be analyzed under other applicable sections of regulations under section 482 to determine whether it achieves arm's length results, and if not, to determine any allocations by the Commissioner that are consistent with such other regulations under section 482. See §§ 1.482–1(b)(2)(ii) (Selection of category of method applicable to transaction) and 1.482–1T(b)(2)(iii) (Coordination of methods applicable to certain intangible development arrangements).

(4) *Coordination with the arm's length standard.* A CSA produces results that are consistent with an arm's length result within the meaning of § 1.482–

1(b)(1) if, and only if, each controlled participant's IDC share (as determined under paragraph (d)(4) of this section) equals its RAB share, each controlled participant compensates its RAB share of the value of all platform contributions by other controlled participants, and all other requirements of this section are satisfied.

(b) *Cost sharing arrangement.* A cost sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (4) of this section are met.

(1) *Substantive requirements*—(i) *CSTs.* All controlled participants must commit to, and in fact, engage in cost sharing transactions. In CSTs, the controlled participants make payments to each other (CST Payments) as appropriate, so that in each taxable year each controlled participant's IDC share is in proportion to its respective RAB share.

(ii) *PCTs.* All controlled participants must commit to, and in fact, engage in platform contributions transactions to the extent that there are platform contributions pursuant to paragraph (c) of this section. In a PCT, each other controlled participant (PCT Payor) is obligated to, and must in fact, make arm's length payments (PCT Payments) to each controlled participant (PCT Payee) that provides a platform contribution. For guidance on determining such arm's length obligation, see paragraph (g) of this section.

(iii) *Divisional interests.* Each controlled participant must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest.

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

Example 1. Company A and Company B, who are members of the same controlled group, execute an agreement to jointly develop vaccine X and own the exclusive rights to commercially exploit vaccine X in their respective territories, which together comprise the whole world. The agreement provides that they will share some, but not all, of the costs for developing Vaccine X in proportion to RAB share. Such agreement is not a CSA because Company A and Company B have not agreed to share all of the IDCs in proportion to their respective RAB shares.

Example 2. Company A and Company B agree to share all the costs of developing Vaccine X. The agreement also provides for employing certain resources and capabilities of Company A in this program including a skilled research team and certain research facilities, and provides for Company B to make payments to Company A in this respect. However, the agreement expressly provides that the program will not employ, and so Company B is expressly relieved of the payments in regard to, certain software developed by Company A as a medical research tool to model certain cellular processes expected to be implicated in the operation of Vaccine X even though such software would reasonably be anticipated to be relevant to developing Vaccine X and, thus, would be a platform contribution. See paragraph (c) of this section. Such agreement is not a CSA because Company A and Company B have not engaged in a necessary PCT for purposes of developing Vaccine X.

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

(2) *Administrative requirements.* The CSA must meet the requirements of paragraph (k) of this section.

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

(4) *Divisional interests*—(i) *In general.* Pursuant to paragraph (b)(1)(iii) of this section, each controlled participant must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest. 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 to the extent that such profits are attributable to such interest in the cost shared intangibles.

(ii) *Territorial based divisional interests.* The CSA may divide all interests in cost shared intangibles on a territorial basis as follows. The entire world must be divided into two or more non-overlapping geographic territories. Each controlled participant must receive at least one such territory, and in the aggregate all the participants must receive all such territories. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use, consumption, or disposition of property or services in its territories. Thus, compensation will be required if other members of the controlled group exploit the cost shared intangibles in such territory.

(iii) *Field of use based divisional interests.* The CSA may divide all interests in cost shared intangibles on the basis of all uses (whether or not known at the time of the division) to which cost shared intangibles are to be put as follows. All anticipated uses of cost shared intangibles must be identified. Each controlled participant must be assigned at least one such anticipated use, and in the aggregate all the participants must be assigned all such anticipated uses. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use or uses assigned to it and one controlled participant must be assigned the exclusive and perpetual right to exploit cost shared intangibles through any unanticipated uses.

(iv) *Other divisional bases.* (A) In the event that the CSA does not divide interests in the cost shared intangibles on the basis of exclusive territories or fields of use as described in paragraphs (b)(4)(ii) and (iii) of this section, the CSA may adopt some other basis on which to divide all interests in the cost shared intangibles among the controlled participants, provided that each of the following criteria is met:

(*1*) The basis clearly and unambiguously divides all interests in cost shared intangibles among the controlled participants.

(*2*) The consistent use of such basis for the division of all interests in the cost shared intangibles can be dependably verified from the records maintained by the controlled participants.

(*3*) The rights of the controlled participants to exploit cost shared intangibles are non-overlapping, exclusive, and perpetual.

(*4*) The resulting benefits associated with each controlled participant's interest in cost shared intangibles are predictable with reasonable reliability.

(B) See paragraph (f)(3) of this section for rules regarding the requirement of arm's length consideration for changes in participation in CSAs involving divisions of interest described in this paragraph (b)(4)(iv).

(v) *Examples*. The following examples illustrate the principles of this paragraph (b)(4):

Example 1. Companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. Under the CSA, P receives the interest in product Z in the United States and S receives the interest in product Z in the rest of the world, as described in paragraph (b)(4)(ii) of this section. Both P and S have plants for manufacturing product Z located in their respective geographic territories. However, for commercial reasons, product Z is nevertheless manufactured by P in the United States for sale to customers in certain locations just outside the United States in close proximity to P's U.S. manufacturing plant. Because S owns the territorial rights outside the United States, P must compensate S to ensure that S realizes all the cost shared intangible profits from P's sales of product Z in S's territory. The pricing of such compensation must also ensure that P realizes an appropriate return for its manufacturing efforts. Benefits projected with respect to such sales will be included for purposes of estimating S's, but not P's, RAB share.

Example 2. The facts are the same as in *Example 1* except that P and S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclusive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. Based on these facts, this basis for the division of interests in Product Z is a division described in paragraph (b)(4)(iv) of this section. The basis for the division of interest is unambiguous and clearly defined and its use can be dependably verified. P and S both have non-overlapping, exclusive and perpetual rights in Product Z. The division of interest results in the participant's relative benefits being predictable with reasonable reliability.

Example 3. The facts are the same as in *Example 2* except that P's and S's manufacturing facilities are not expected to operate at full capacity when product Z enters production. Production of Product Z can be shifted at any time between sites owned by P and sites owned by S, although neither P nor S intends to shift production as a result of the agreement. The division of interests in Product Z between P and S based on manufacturing site is not a division described in paragraph (b)(4)(iv) of this section because their relative shares of benefits are not predictable with reasonable reliability. The fact that neither P nor S intends to shift production is irrelevant.

(5) *Treatment of certain arrangements as CSAs*—(*i*) Situation in which Commissioner must treat arrangement as a CSA. The Commissioner must apply the rules of this section to an arrangement among controlled taxpayers if the administrative requirements of paragraph (b)(2) of this section are met with respect to such arrangement and the controlled taxpayers reasonably concluded that such arrangement was a CSA meeting the requirements of paragraphs (b)(1), (3), and (4) of this section.

(ii) *Situation in which Commissioner may treat arrangement as a CSA*. For arrangements among controlled taxpayers not described in paragraph (b)(5)(i) of this section, the Commissioner may apply the provisions of this section if the Commissioner concludes that the administrative requirements of paragraph (b)(2) of this section are met, and, notwithstanding technical failure to meet the substantive requirements of paragraph (b)(1), (3), or (4) of this section, the rules of this section will provide the most reliable measure of an arm's length result. See § 1.482–1(c)(1) (the best method rule). For purposes of applying this paragraph (b)(5)(ii), any such arrangement shall be interpreted by reference to paragraph (k)(1)(iv) of this section.

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

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

(ii) In this case, P and S have substantially complied with the contractual requirements of paragraph (k)(1) of this section and the documentation, accounting, and reporting requirements of paragraphs (k)(2) through (4) of this section and therefore have met the administrative requirements of paragraph (b)(2) of this section. However, because they did not enter into a PCT, as required under paragraphs (b)(1)(ii) and (b)(3) of this section, for the software that was reasonably anticipated to contribute to the development of P–Ves (see paragraph (c) of this section), they cannot reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and treat P and S as entering into a PCT for the software in accordance with the requirements of paragraph (b)(1)(ii) of this section, and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

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

Example 3. (i) The facts are the same as *Example 1* except that P and S do enter into a PCT for the software as required under this paragraph (b). The agreement entered into by P and S provides for a fixed consideration of $50 million per year for four years, payable at the end of each year. This agreement satisfies the arm's length standard. However, S actually pays P consideration at the end of each year in the form of four annual royalties equal to two percent of sales. While such royalties at the time of the PCT were expected to be $50 million per year, actual sales during the first year were less than anticipated and the first royalty payment was only $25 million.

(ii) In this case, P and S failed to implement the terms of their agreement. Under these circumstances, P and S could not reasonably conclude that their arrangement was a CSA, as described in paragraph (b)(1) of this section. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

Example 4. (i) The facts are the same as in *Example 1* except that P does not own proprietary software and P and S use a different method for determining the arm's length amount of the PCT Payment for the P–Cap patent rights from the method used in *Example 1*.

(ii) P and S determine that the arm's length amount of the PCT Payments for the P–Cap patent is $10 million. However, the IRS determines the best method for determining the arm's length amount of the PCT Payments for the P–Cap patent rights and under such method the arm's length amount is $100 million. To determine this $10 million present value, P and S assumed a useful life of eight years for the platform contribution, because the P–Cap patent rights will expire after eight years. However, use of the P–Cap patent rights in research is expected to lead to benefits attributable to exploitation of the cost shared intangibles extending many years beyond the expiration of the P–Cap patent, because use of the P–Cap patent rights will let P and S bring P–Ves to market before the competition, and because P and S expect to apply for additional patents covering P–Ves, which would bar competitors from selling that product for many future years. The assumption by P and S of a useful life for the platform contribution that is less than the anticipated period of exploitation of the cost shared intangibles is contrary to paragraph (g)(2)(ii) of this section, and reduces the reliability of the method used by P and S.

(iii) The method used by P and S employs a declining royalty. The royalty starts at 8% of sales, based on an application of the CUT method in which the purported CUTs all involve licenses to manufacture and sell the current generation of P–Cap, and declines to 0% over eight years, declining by 1% each year. Such make-or-sell rights are fundamentally different from use of the P-Cap patent rights to generate a new product. This difference raises the issue of whether the make-or-sell rights are sufficiently comparable to the rights that are the subject of the PCT Payment. See § 1.482–4(c). While a royalty rate for make-or-sell rights can form the basis for a reliable determination of an arm's length PCT Payment in the CUT-based implementation of the income method described in paragraph (g)(4) of this section, under that method such royalty rate does not decline to zero. Therefore, the use of a declining royalty rate based on an initial rate for make-or-sell rights further reduces the reliability of the method used by P and S.

(iv) Sales of the next-generation product are not anticipated until after seven years, at which point the royalty rate will have declined to 1%. The temporal mismatch between the period of the royalty rate decline and the period of exploitation raises further concerns about the method's reliability.

(v) For the reasons given in paragraphs (ii) through (iv) of this *Example 4*, the method used by P and S is so unreliable and so contrary to provisions of this section that P and S could not reasonably conclude that they had contracted to make arm's length PCT Payments as required by paragraphs (b)(1)(ii) and (b)(3) of this section, and thus could not reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(vi) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other section 482 regulations to determine whether the arrangement reaches an arm's length result.

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

(c) *Platform contributions*—(1) *In general.* A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. The determination whether a resource, capability, or right is reasonably anticipated to contribute to developing cost shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right reasonably determined not to be a platform contribution as of an earlier point in time, may be reasonably determined to be a platform contribution at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles. Notwithstanding the other provisions of this paragraph (c), platform contributions do not include rights in land or depreciable tangible property, and do not include rights in other resources acquired by IDCs. See paragraph (d)(1) of this section.

(2) *Terms of platform contributions*—(i) *Presumed to be exclusive.* For purposes of a PCT, the PCT Payee's provision of a platform contribution is presumed to be exclusive. Thus, it is presumed that the platform resource, capability, or right is not reasonably anticipated to be committed to any business activities other than the CSA Activity, as defined in paragraph (j)(1)(i) of this section, whether carried out by the controlled participants, other controlled taxpayers, or uncontrolled taxpayers.

(ii) *Rebuttal of exclusivity.* The controlled participants may rebut the presumption set forth in paragraph (c)(2)(i) of this section to the satisfaction of the Commissioner. For example, if the platform resource is a research tool, then the controlled participants could rebut the presumption by establishing to the satisfaction of the Commissioner that, as of the date of the PCT, the tool is reasonably anticipated not only to contribute to the CSA Activity but also to be licensed to an uncontrolled taxpayer. In such case, the PCT Payments may need to be prorated as described in paragraph (c)(2)(iii) of this section.

(iii) *Proration of PCT Payments to the extent allocable to other business activities*—(A) *In general.* Some transfer pricing methods employed to determine the arm's length amount of the PCT Payments do so by considering the overall value of the platform contributions as opposed to, for example, the value of the anticipated use of the platform contributions in the CSA Activity. Such a transfer pricing method is consistent with the presumption that the platform contribution is exclusive (that is, that the resources, capabilities or rights that are the subject of a platform contribution are reasonably anticipated to contribute only to the CSA Activity). See paragraph (c)(2)(i) of this section (Terms of platform contributions—Presumed to be exclusive). The PCT Payments determined under such transfer pricing method may have to be prorated if the controlled participants can rebut the presumption that the platform contribution is exclusive to the satisfaction of the Commissioner as provided in paragraph (c)(2)(ii) of this section. In the case of a platform contribution that also contributes to lines of business of a PCT Payor that are not reasonably anticipated to involve exploitation of the cost shared intangibles, the need for explicit proration may in some cases be avoided through aggregation of transactions. See paragraph (g)(2)(iv) of this section (Aggregation of transactions).

(B) *Determining the proration of PCT Payments.* Proration will be done on a reasonable basis in proportion to the relative economic value, as of the date of the PCT, reasonably anticipated to be derived from the platform contribution by the CSA Activity as compared to the value reasonably anticipated to be derived from the platform contribution by other business activities. In the case of an aggregate valuation done under the principles of paragraph (g)(2)(iv) of this section that addresses payment for resources, capabilities, or rights used for business activities other than the CSA Activity (for example, the right to exploit an existing intangible without further development), the proration of the aggregate payments may have to reflect the economic value attributable to such resources, capabilities, or rights as well. For purposes of the best method rule under § 1.482–1(c), the reliability of the analysis under a method that requires proration pursuant to this paragraph is reduced relative to the reliability of an analysis under a method that does not require proration.

(3) *Categorization of the PCT.* For purposes of § 1.482–1(b)(1)(ii) and paragraph (a)(2) of this section, a PCT must be identified by the controlled participants as a particular type of transaction (for example, a license for royalty payments). See paragraph (k)(2)(ii)(I) of this section. Such designation must be consistent with the actual conduct of the controlled participants. If the conduct is consistent with different, economically equivalent types of transaction, then the controlled participants may designate the PCT as being any of such types of transaction. If the controlled participants fail to make such designation in their documentation, the Commissioner may make a designation consistent with the principles of paragraph (k)(1)(iv) of this section.

(4) *Certain make-or-sell rights excluded*—(i) *In general.* Any right to exploit an existing intangible without further development, such as the right to make, replicate, license or sell existing products, does not constitute a platform contribution to a CSA, and the arm's length compensation for such rights (make-or-sell rights) does not satisfy the compensation obligation under a PCT.

(ii) *Examples.* The following examples illustrate the principles of this paragraph (c)(4):

Example 1. P and S, which are members of the same controlled group, execute a CSA. Under the CSA, P and S will bear their RAB shares of IDCs for developing the second generation of ABC, a computer software program. Prior to that arrangement, P had incurred substantial costs and risks to develop ABC. Concurrent with entering into the arrangement, P (as the licensor) executes a license with S (as the licensee) by which S may make and sell copies of the existing ABC. Such make-or-sell rights do not constitute a platform contribution to the CSA. The rules of §§ 1.482–1 and 1.482–4 through 1.482–6 must be applied to determine the arm's length consideration in connection with the make-or-sell licensing arrangement. In certain circumstances, this determination of the arm's length consideration may be done on an aggregate basis with the evaluation of compensation obligations pursuant to the PCTs entered into by P and S in connection with the CSA. See paragraph (g)(2)(iv) of this section.

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

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

(5) *Examples.* The following examples illustrate the principles of this paragraph (c). In each example, Companies P and S are members of the same controlled group, and execute a CSA providing that each will have the exclusive right to exploit cost shared intangibles in its own territory. See paragraph (b)(4)(ii) of this section (Territorial based divisional interests).

Example 1. Company P has developed and currently markets version 1.0 of a new software application XYZ. Company P and Company S execute a CSA under which they will share the IDCs for developing future versions of XYZ. Version 1.0 is reasonably anticipated to contribute to the development of future versions of XYZ and therefore Company P's rights in version 1.0 constitute a platform contribution from Company P that must be compensated by Company S pursuant to a PCT. Pursuant to paragraph (c)(3) of this section, the controlled participants designate the platform contribution as a transfer of intangibles that would otherwise be governed by § 1.482–4, if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482–4 as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefit of all rights in version 1.0, other than the rights described in paragraph (c)(4) of this section (Certain make-or-sell rights excluded). This includes the right to use version 1.0 for purposes of research and the exclusive right in S's territory to exploit any future products that incorporated the technology of version 1.0, and would cover a term extending as long as the controlled participants were to exploit future versions of XYZ or any other product based on the version 1.0 platform. The compensation obligation of Company S pursuant to the PCT will reflect the full value of the platform contribution, as limited by Company S's RAB share.

Example 2. Company P and Company S execute a CSA under which they will share the IDCs for developing Vaccine Z. Company P will commit to the project its research team that has successfully developed a number of other vaccines. The expertise and existing integration of the research team is a unique resource or capability of Company P which is reasonably anticipated to contribute to the development of Vaccine Z. Therefore, P's provision of the capabilities of the research team constitute a platform contribution for which compensation is due from Company S as part of a PCT. Pursuant to paragraph (c)(3) of this section, the controlled parties designate the platform contribution as a provision of services that would otherwise be governed by § 1.482–9T(a) if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482–9T(a) as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefits by Company P of its research team to the development of Vaccine Z. Because the IDCs include the ongoing compensation of the researchers, the compensation obligation under the PCT is only for the value of the commitment of the research team by Company P to the CSA's development efforts net of such researcher compensation. The value of the compensation obligation of Company S for the PCT will reflect the full value of the provision of services, as limited by Company S's RAB share.

(d) *Intangible development costs*—(1) *Determining whether costs are IDCs*. Costs included in IDCs are determined by reference to the scope of the intangible development activity (IDA).

(i) *Definition and scope of the IDA*. For purposes of this section, the IDA means the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. The IDA cannot be described merely by a list of particular resources, capabilities, or rights that will be used in the CSA, because such a list would not identify reasonably anticipated cost shared intangibles. Also, the scope of the IDA may change as the nature or identity of the reasonably anticipated cost shared intangibles changes or the nature of the activities necessary for their development become clearer. For example, the relevance of certain ongoing work to developing reasonably anticipated cost shared intangibles or the need for additional work may only become clear over time.

(ii) *Reasonably anticipated cost shared intangible*. For purposes of this section, *reasonably anticipated cost shared intangible* means any intangible, within the meaning of § 1.482–4(b), that, at the applicable point in time, the controlled participants intend to develop under the CSA. Reasonably anticipated cost shared intangibles may change over the course of the CSA. The controlled participants may at any time change the reasonably anticipated cost shared intangibles but must document any such change pursuant to paragraph (k)(2)(ii)(A)(*1*) of this section. Removal of reasonably anticipated cost shared intangibles does not affect the controlled participants' interests in cost shared intangibles already developed under the CSA. In addition, the reasonably anticipated cost shared intangibles automatically expand to include the intended result of any further development of a cost shared intangible already developed under the CSA, or applications of such an intangible. However, the controlled participants may override this automatic expansion in a particular case if they separately remove specified further development of such intangible (or specified applications of such intangible) from the IDA, and document such separate removal pursuant to paragraph (k)(2)(ii)(A)(*3*) of this section.

(iii) *Costs included in IDCs*. For purposes of this section, *IDCs* mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. Thus, IDCs include costs incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles. IDCs shall also include the arm's length rental charge for the use of any land or depreciable tangible property (as determined under § 1.482–2(c) (Use of tangible property)) directly identified with, or reasonably allocable to, the IDA. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs. IDCs do not include interest expense, foreign income taxes (as defined in § 1.901–2(a)), or domestic income taxes.

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

Example 1. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted at laboratories A, B, and C but not at other facilities maintained by the controlled participants. The contract does not describe the reasonably anticipated cost shared intangibles with respect to which research and development is to be undertaken. The contract fails to meet the requirements set forth in paragraph (k)(1)(ii)(B) of this section because it fails to adequately describe the scope of the IDA to be undertaken.

Example 2. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted by any of the controlled participants with the goal of developing a cure for a particular disease. Such a cure is thus a reasonably anticipated cost shared intangible. The contract also contains a provision that the IDA will exclude any activity that builds on the results of the controlled participants' prior research concerning Enzyme X even though such activity could reasonably be anticipated to contribute to developing such cure. The contract fails to meet the requirement set forth in paragraph (d)(1)(i) of this section that the scope of the IDA include all of the controlled participants' activities that could reasonably be anticipated to contribute to developing reasonably anticipated cost shared intangibles.

(2) *Allocation of costs.* If a particular cost is directly identified with, or reasonably allocable to, a function the results of which will benefit both the IDA and other business activities, the cost must be allocated on a reasonable basis between the IDA and such other business activities in proportion to the relative economic value that the IDA and such other business activities are anticipated to derive from such results.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) *IDC share.* A controlled participant's IDC share for a taxable year is equal to the controlled participant's

cost contribution for the taxable year, divided by the sum of all IDCs for the taxable year. A controlled participant's cost contribution for a taxable year means all of the IDCs initially borne by the controlled participant, plus all of the CST Payments that the participant makes to other controlled participants, minus all of the CST Payments that the participant receives from other controlled participants.

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

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

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

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

Example 4. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a new computer source code. FP has an executive officer who oversees a research facility and employees dedicated solely to the IDA. The executive officer also oversees other research facilities and employees unrelated to the IDA, and performs certain corporate overhead functions. The full amount of the costs of the research facility and employees dedicated solely to the IDA can be directly identified with the IDA and, therefore, are IDCs. In addition, based on the executive officer's records of time worked on various matters, the controlled participants reasonably allocate 20% of the executive officer's compensation to supervision of the facility and employees dedicated to the IDA, 50% of the executive officer's compensation to supervision of the facilities and employees unrelated to the IDA, and 30% of the executive officer's compensation to corporate overhead functions. The controlled participants also reasonably determine that the results of the executive officer's corporate overhead functions yield equal economic benefit to the IDA and the other business activities of FP. Applying the principles of paragraph (d)(1) of this section, the executive officer's compensation allocated to supervising the facility and employees dedicated to the IDA (amounting to 20% of the executive officer's total compensation) must be treated as IDCs. Applying the principles of paragraph (d)(2) of this section, half of the executive officer's compensation allocated to corporate overhead functions (that is, half of 30% of the executive officer's total compensation), must be treated as IDCs. Therefore, a total of 35% (20% plus 15%) of the executive officer's total compensation must be treated as IDCs.

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

(A) The basis used for measuring benefits, as described in paragraph (e)(2)(ii) of this section.

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

(ii) *Example.* The following example illustrates the principles of this paragraph (e)(1):

Example. (i) USP and FS plan to conduct research to develop Product Lines A and B. USP and FS reasonably anticipate respective benefits from Product Line A of 100X and 200X and respective benefits from Product Line B, respectively, of 300X and 400X. USP and FS thus reasonably anticipate combined benefits from Product Lines A and B of 400X and 600X, respectively.

(ii) USP and FS could enter into a separate CSA to develop Product Line A with respective RAB shares of $33\frac{1}{3}$ percent and $66\frac{2}{3}$ percent (reflecting a ratio of 100X to 200X), and into a separate CSA to develop Product Line B with respective RAB shares of $42\frac{6}{7}$ percent and $57\frac{1}{7}$ percent (reflecting a ratio of 300X to 400X). Alternatively, USP and FS could enter into a single CSA to develop both Product Lines A and B with respective RAB shares of 40 percent and 60 percent (in the ratio of 400X to 600X). If the separate CSAs are chosen, then any costs for activities that contribute to developing both Product Line A and Product Line B will constitute IDCs of the respective CSAs as required by paragraphs (d)(1) and (d)(2) of this section.

(2) *Measure of benefits*—(i) *In general.* In order to estimate a controlled participant's RAB share, the amount of each controlled participant's reasonably anticipated benefits must be measured on a basis that is consistent for all such participants. See paragraph (e)(2)(ii)(E) *Example 9* of this section. If a controlled participant transfers a cost shared intangible to another controlled taxpayer, other than by way of a transfer described in paragraph (f) of this section, that controlled participant's benefits from the transferred intangible must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Reasonably anticipated benefits are measured either on a direct basis, by reference to estimated benefits to be generated by the use of cost shared

intangibles (generally based on additional revenues plus cost savings less any additional costs incurred), or on an indirect basis, by reference to certain measurements that reasonably can be assumed to relate to benefits to be generated. Such indirect bases of measurement of anticipated benefits are described in paragraph (e)(2)(ii) of this section. A controlled participant's reasonably anticipated benefits must be measured on the basis, whether direct or indirect, that most reliably determines RAB shares. In determining which of two bases of measurement is most reliable, the factors set forth in § 1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in cost shared intangibles. See *Examples 4* and *7* of paragraph (e)(2)(ii)(E) of this section.

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

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

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

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

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

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

Example 1. Controlled parties A and B enter into a CSA to develop product and process intangibles for already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of $100M from sales of Product P until it becomes obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of $20M in present value revenue from the product intangible, while B reasonably anticipates an increase of only $10M in present value from the product intangible. Further, A and B each reasonably anticipate spending an additional amount equal to $5M in present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving an amount equal to $2M in present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($20M) plus its reasonably anticipated cost savings ($2M) less its reasonably anticipated increased costs ($5M), which equals $17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue ($10M) plus its reasonably anticipated cost savings ($2M) less its reasonably anticipated increased costs ($5M), which equals $7M. Thus A's reasonably anticipated benefits are $17M and B's reasonably anticipated benefits are $7M.

Example 2. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a CSA to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of $2 per unit of feedstock produced and rates for each are expected to remain similar in the future. The new process, if it is successful, will reduce the amount of electricity required by each company to produce a unit of the feedstock by 50%. Switching to the new process would not require FP or USS to incur significant investment or other costs. Therefore, the cost savings each company is expected to achieve after implementing the new process are $1 per unit of feedstock produced. Under the CSA, FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring RAB shares and dividing the IDCs because each controlled participant is expected to have a similar $1 (50% of current charge of $2) decrease in costs per unit of the feedstock produced.

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

Example 4. The facts are the same as in *Example 3*, except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, USS would incur significant construction costs in order to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring RAB shares. In order to reliably determine RAB shares, the Commissioner measures the reasonably anticipated benefits of USS and FP on a direct basis. USS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs, less its reasonably anticipated costs of adopting the new process. FS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new anesthetic drugs. USP obtains the right to market any resulting drugs in the United States and FS obtains the right to market any resulting drugs in the rest of the world. USP and FS determine RAB shares on the basis of their respective total anticipated operating profit from all drugs under development. USP anticipates that it will receive a much higher profit than FS per unit sold because the price of the drugs is not regulated in the United States, whereas the price of the drugs is regulated in many non-U.S. jurisdictions. In both controlled participants' territories, the anticipated operating profits are almost entirely attributable to the use of the cost shared intangibles. In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 6. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) manufacture and sell fertilizers. They enter into a CSA to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the CSA, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the new form of fertilizer in the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the controlled participants' respective markets.

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

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

Example 7. The facts are the same as in *Example 6*, except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring RAB shares unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 8. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not measure benefits based on the number of entry-level employees hired by each. Rather, they measure benefits based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring RAB shares is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 9. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a CSA to develop computer software that each will market and install on customers' computer systems. The controlled participants measure benefits on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each controlled participant is not the most reliable because all of the benefits received by controlled participants are not taken into account. In order to reliably determine RAB shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other controlled participants' projected benefits from sales (for example, all controlled participants might measure their benefits on the basis of operating profit).

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

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

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

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

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

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

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

(f) *Changes in participation under a CSA*—(1) *In general.* A change in participation under a CSA occurs when there is either a controlled transfer of interests or a capability variation. A change in participation requires arm's length consideration under paragraph (a)(3)(ii) of this section, and as more fully described in this paragraph (f).

(2) *Controlled transfer of interests.* A controlled transfer of interests occurs when a participant in a CSA transfers all or part of its interests in cost shared intangibles under the CSA in a controlled transaction, and the transferee assumes the associated obligations under the CSA. After the controlled transfer of interests occurs, the CSA will still exist if at least two controlled participants still have interests in the cost shared intangibles. In such a case, the transferee will be treated as succeeding to the transferor's prior history under the CSA as pertains to the transferred interests, including the transferor's cost contributions, benefits derived, and PCT Payments attributable to such rights or obligations. A transfer that would otherwise constitute a controlled transfer of interests for purposes of this paragraph (f)(2) shall not constitute a controlled transfer of interests if it also constitutes a capability variation for purposes of paragraph (f)(3) of this section.

(3) *Capability variation.* A capability variation occurs when, in a CSA in which interests in cost shared intangibles are divided as described in paragraph (b)(4)(iv) of this section, the controlled participants' division of interests or their relative capabilities or capacities to benefit from the cost shared intangibles are materially altered. For purposes of paragraph (a)(3)(ii) of this section, a capability variation is considered to be a controlled transfer of interests in cost shared intangibles, in which any controlled participant whose RAB share decreases as a result of the capability variation is a transferor, and any controlled participant whose RAB share thus increases is the transferee of the interests in cost shared intangibles.

(4) *Arm's length consideration for a change in participation.* In the event of a change in participation, the arm's length amount of consideration from the transferee, under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6 and paragraph (a)(3)(ii) of this section, will be determined consistent with the reasonably anticipated incremental change in the returns to the transferee and transferor resulting from such change in participation. Such changes in returns will themselves depend on the reasonably anticipated incremental changes in the benefits from exploiting the cost shared intangibles, IDCs borne, and PCT Payments (if any). However, any arm's length consideration required under this paragraph (f)(4) with respect to a capability variation shall be reduced as necessary to prevent duplication of an adjustment already performed under paragraph (i)(2)(ii)(A) of this section that resulted from the same capability variation. If an adjustment has been performed already under this paragraph (f)(4) with respect to a capability variation, then for purposes of any adjustment to be performed under paragraph (i)(2)(ii)(A) of this section, the controlled participants' projected benefit shares referred to in paragraph (i)(2)(ii)(A) of this section shall be considered to be the controlled participants' respective RAB shares after the capability variation occurred.

(5) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. X, Y, and Z are the only controlled participants in a CSA. The CSA divides interests in cost shared intangibles on a territorial basis as described in paragraph (b)(4)(ii) of this section. X is assigned the territories of the Americas, Y is assigned the territory of the UK and Australia, and Z is assigned the rest of the world. When the CSA is formed, X has a platform contribution T. Under the PCTs for T, Y, and Z are each obligated to pay X royalties equal to five percent of their respective sales. Aside from T, there are no platform contributions. Two years after the formation of the CSA, Y transfers to Z its interest in cost shared intangibles relating to the UK territory, and the associated obligations, in a controlled transfer of interests described in paragraph (f)(2) of this section. At that time the reasonably anticipated benefits from exploiting cost shared intangibles in the UK have a present value of $11M, the reasonably anticipated IDCs to be borne relating to the UK territory have a present value of $3M, and the reasonably anticipated PCT Payments to be made to X relating to sales in the UK territory have a present value of $2M. As arm's length consideration for the change in participation due to the controlled transfer of interests, Z must pay Y compensation with an anticipated present value of $11M, less $3M, less $2M, which equals $6M.

Example 2. As in *Example 2* of paragraph (b)(4)(v) of this section, companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. P and S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclusive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. When the CSA is formed, P has a platform contribution T. Under the PCT for T, S is obligated to pay P sales-based royalties according to a certain formula. Aside from T, there are no other platform contributions. Two years after the formation of the CSA, owing to a change in plans not reasonably foreseeable at the time the CSA was entered into, S acquires additional facilities F for the manufacture of Product Z. Such acquisition constitutes a capability variation described in paragraph (f)(3) of this section. Under this capability variation, S's RAB share increases from 50% to 60%. Accordingly, there is a compensable change in participation under paragraph (f)(3) of this section.

(g) *Supplemental guidance on methods applicable to PCTs*—(1) *In general.* This paragraph (g) provides supplemental guidance on applying the methods listed in this paragraph (g)(1) for purposes of evaluating the arm's length amount charged in a PCT. Each method will yield a value for the compensation obligation of each PCT Payor consistent with the product of the combined pre-tax value to all controlled participants of the platform contribution that is the subject of the PCT and the PCT Payor's RAB share. The methods are—

(i) The comparable uncontrolled transaction method described in § 1.482–4(c), or the comparable uncontrolled services price method described in § 1.482–9T(c), as further described in paragraph (g)(3) of this section;

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

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

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

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

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

(2) *Best method analysis applicable for evaluation of a PCT pursuant to a CSA*—(i) *In general.* Each method must be applied in accordance with the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e), except as those provisions are modified in this paragraph (g).

(ii) *Consistency with upfront contractual terms and risk allocation—the investor model*—(A) *In general.* Although all of the factors entering into a best method analysis described in § 1.482–1(c) and (d) must be considered, specific factors may be particularly relevant in the context of a CSA. In particular, the relative reliability of an application of any method depends on the degree of consistency of the analysis with the applicable contractual terms and allocation of risk under the CSA and this section among the controlled participants as of the date of the PCT, unless a change in such terms or allocation has been made in return for arm's length consideration. In this regard, a CSA involves an upfront division of the risks as to both reasonably anticipated obligations and reasonably anticipated benefits over the reasonably anticipated term of the CSA Activity. Accordingly, the relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in the CSA Activity (attributable to platform contributions, operating contributions, as such term is defined in paragraph (j)(1)(i) of this section, operating cost contributions, as such term is defined in paragraph (j)(1)(i) of this section, and cost contributions) is reasonably anticipated to earn a rate of return equal to the appropriate discount rate for the controlled participant's CSA Activity over the entire period of such CSA Activity. If the cost shared intangibles themselves are reasonably anticipated to contribute to developing other intangibles, then the period described in the preceding sentence includes the period, reasonably anticipated as of the date of the PCT, of developing and exploiting such indirectly benefited intangibles.

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

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

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

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

(iv) The assumption that all expenditures amortize on a straight-line basis over four years does not appropriately reflect the principle that as of the date of the PCT regarding DEF, every contribution to the development of GHI, including DEF, is reasonably anticipated to have value throughout the entire period of exploitation of GHI which is projected to continue through Year 10. Under this method as applied by P and S, the share of the residual profit in S's territory that is allocated to P as a PCT Payment from S will decrease every year. After Year 4, P's capital stock in DEF will necessarily be $0, so that P will receive none of the residual profit or loss from GHI sales in S's territory after Year 4 as a PCT Payment.

(v) As a result of this limitation of the PCT Payments to be made by S, the anticipated return to S's aggregate investment in the CSA, over the whole period of S's CSA Activity, is at a rate that is significantly higher than the appropriate discount rate for S's CSA Activity (as determined by a reliable method). This discrepancy is not consistent with the investor model principle that S should anticipate a rate of return to its aggregate investment in the CSA, over the whole period of its CSA Activity, equal to the appropriate discount rate for its CSA Activity. The inconsistency of the method with the investor model materially lessens its reliability for purposes of a best method analysis. See § 1.482–1(c)(2)(ii)(B).

(iii) *Consistency of evaluation with realistic alternatives*—(A) *In general*. The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. This condition is not met, therefore, where for any controlled participant the total anticipated present value of its income attributable to its entering into the CSA, as of the date of the PCT, is less than the total anticipated present value of its income that could be achieved through an alternative arrangement realistically available to that controlled participant. In principle, this comparison is made on a post-tax basis but, in many cases, a comparison made on a pre-tax basis will yield equivalent results. See also paragraph (g)(2)(v)(B)(*1*) of this section (Discount rate variation between realistic alternatives).

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

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

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

(iii) Reasonably reliable estimates indicate that P could develop the product without assistance from S and license the product outside of Country X for a royalty of 20% of sales. Based on reliable financial projections that include all future development costs and licensing revenue that are allocable to the non-Country X market, and using a discount rate appropriate for the riskiness of P's role as a licensor (see paragraph (g)(2)(v) of this section), the post-tax present value of this licensing alternative to P for the non-Country X market (measured as of the date of the PCT) would be $500 million. Thus, based on this realistic alternative, the anticipated post-tax present value under the CSA to P in the non-Country X market (measured as of the date of the PCT), taking into account anticipated development costs allocable to the non-Country X market, and anticipated CST Payments and PCT Payments from S, and using a discount rate appropriate for the riskiness of P's role as a participant in the CSA, should not be less than $500 million.

Example 2. (i) The facts are the same as in *Example 1*, except that there are no reliable estimates of the value to P from the licensing alternative to the CSA. Further, reasonably reliable estimates indicate that an arm's length return for S's routine manufacturing and distribution activities is a 10% mark-up on total costs of goods sold plus operating expenses related to those activities. Finally, the Commissioner determines that the respective activities undertaken by P and S (other than licensing payments, CST Payments, and PCT Payments) would be identical regardless of whether the arrangement was undertaken as a CSA (CSA Scenario) or as a long-term licensing arrangement (Licensing Scenario). In particular, in both Scenarios, P would perform all research activities and S would undertake routine manufacturing and distribution activities associated with its territory.

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

(iii) Based on reliable financial projections that include S's cost contributions and that incorporate S's PCT Payment, as computed by P, and using a discount rate appropriate for the riskiness of S's role as a CSA participant (see paragraph (g)(2)(v) of this section), the anticipated post-tax net present value to S in the CSA Scenario (measured as of Date D) is $800 million. Further, based on these same reliable projections (but incorporating S's licensing payments instead of S's cost contributions and PCT Payment), and using a discount rate appropriate for the riskiness of S's role as a long-term licensee, the anticipated post-tax net present value to S in the Licensing Scenario (measured as of Date D) is $100 million. Thus, S's anticipated post-tax net present value is $700 million greater in the CSA Scenario than in the Licensing Scenario. This result suggests that P's anticipated post-tax present value must be significantly less under the CSA Scenario than under the Licensing Scenario. This means that the reliability of P's analysis as described in paragraph (ii) of this *Example 2* is reduced, since P would not be expected to enter into a cost sharing arrangement if its alternative of being a long-term licensor is preferable.

Example 3. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 2*. In addition, based on reliable financial projections that include S's cost contributions and S's PCT Payment, and using a discount rate appropriate for the riskiness of S's role as a CSA participant, the anticipated post-tax net present value to S under the CSA (measured as of the date of the PCT) is $50 million. Also, instead of entering the CSA, S has the realistic alternative of manufacturing and distributing product Z unrelated to the personal transportation device, with the same anticipated 10% mark-up on total costs that it would anticipate for its routine activities in *Example 2*. Under its realistic alternative, at a discount rate appropriate for the riskiness of S's role with respect to product Z, S anticipates a present value of $100 million.

(ii) Because the lump sum PCT Payment made by S results in S having a considerably lower anticipated net present value than S could achieve through an alternative arrangement realistically available to it, the reliability of P's calculation of the lump sum PCT Payment is reduced.

(iv) *Aggregation of transactions.* The combined effect of multiple contemporaneous transactions, consisting either of multiple PCTs, or of one or more PCT and one or more other transactions in connection with a CSA that are not governed by this section (such as transactions involving cross operating contributions or make-or-sell rights), may require evaluation in accordance with the principles of aggregation described in § 1.482–1(f)(2)(i). In such cases, it may be that the multiple transactions are reasonably anticipated, as of the date of the PCT(s), to be so interrelated that the method that provides the most reliable measure of an arm's length charge is a method under this section applied on an aggregate basis for the PCT(s) and other transactions. A section 482 adjustment may be made by comparing the aggregate arm's length charge so determined to the aggregate payments actually made for the multiple transactions. In such a case, it generally will not be necessary to allocate separately the aggregate arm's length charge as between various PCTs or as between PCTs and such other transactions. However, such an allocation may be necessary for other purposes, such as applying paragraph (i)(6) (Periodic adjustments) of this section. An aggregate determination of the arm's length charge for multiple transactions will often yield a payment for a controlled participant that is equal to the aggregate value of the platform contributions and other resources, capabilities, and rights covered by the multiple transactions multiplied by that controlled participant's RAB share. Because RAB shares only include benefits from cost shared intangibles, the reliability of an aggregate determination of payments for multiple transactions may be reduced to the extent that it includes transactions covering resources, capabilities, and rights for which the controlled participants' expected benefit shares differ substantially from their RAB shares.

(v) *Discount rate*—(A) *In general.* The best method analysis in connection with certain methods or forms of payment may depend on a rate or rates of return used to convert projected results of transactions to present value, or to otherwise convert monetary amounts at one or more points in time to equivalent amounts at a different point or points in time. For this purpose, a discount rate or rates should be used that most reliably reflect the market-correlated risks of activities or transactions and should be applied to the best estimates of the relevant projected results, 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 market-correlated risk involved and thus, the discount rate, may differ among a company's various activities or transactions. Normally, discount rates are most reliably determined by reference to market information.

(B) *Considerations in best method analysis of discount rate*—(*1*) *Discount rate variation between realistic alternatives.* Realistic alternatives may involve varying risk exposure and, thus, may be more reliably evaluated using different discount rates. In some circumstances, a party may have less risk as a licensee of intangibles needed in its operations, and so require a lower discount rate, than it would have by entering into a CSA to develop such intangibles, which may involve the party's assumption of additional risk in funding its cost contributions to the

IDA. Similarly, self-development of intangibles and licensing out may be riskier for the licensor, and so require a higher discount rate, than entering into a CSA to develop such intangibles, which would relieve the licensor of the obligation to fund a portion of the IDCs of the IDA.

(*2*) *Discount rate variation between forms of payment.* Certain forms of payment may involve different risks than others. For example, ordinarily a royalty computed on a profits base would be more volatile, and so require a higher discount rate to discount projected payments to present value, than a royalty computed on a sales base.

(*3*) *Post-tax rate.* In general, discount rate estimates that may be inferred from the operations of the capital markets are post-tax discount rates. Therefore, an analysis would in principle apply post-tax discount rates to income net of expense items including taxes (post-tax income). However, in certain circumstances the result of applying a post-tax discount rate to post-tax income is equivalent to the product of—

(*i*) The result of applying a post-tax discount rate to income net of expense items other than taxes (pre-tax income); and

(*ii*) The difference of one minus the tax rate.

Therefore, in such circumstances, calculation of pre-tax income, rather than post-tax income, may be sufficient. See, for example, paragraph (g)(4)(i)(G) of this section.

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

Example. (i) P and S form a CSA to develop intangible X, which will be used in product Y. P will develop X, and S will make CST Payments as its cost contributions. At the start of the CSA, P has a platform contribution, for which S commits to make a PCT Payment of 5% of its sales of product Y. As part of the evaluation of whether that PCT Payment is arm's length, the Commissioner considers whether P had a more favorable realistic alternative (see paragraph (g)(2)(iii) of this section). Specifically, the Commissioner compares P's anticipated post-tax discounted present value of the financial projections under the CSA (taking into account S's PCT Payment of 5% of its sales of product Y) with P's anticipated post-tax discounted present value of the financial projections under a reasonably available alternative Licensing Arrangement that consists of developing intangible X on its own and then licensing X to S or to an uncontrolled party similar to S. In undertaking the analysis, the Commissioner determines that, because it would be funding the entire development of the intangible, P undertakes greater risks in the licensing scenario than in the cost sharing scenario (in the cost sharing scenario P would be funding only part of the development of the intangible).

(ii) The Commissioner determines that, as between the two scenarios, all of the components of P's anticipated financial flows are identical, except for the CST and PCT Payments under the CSA, compared to the licensing payments under the Licensing Alternative. Accordingly, the Commissioner concludes that the differences in market-correlated risks between the two scenarios, and therefore the differences in discount rates between the two scenarios, relate to the differences in these components of the financial projections.

(vi) *Financial projections.* The reliability of an estimate of the value of a platform or operating contribution in connection with a PCT will often depend upon the reliability of projections used in making the estimate. Such projections should reflect the best estimates of the items projected (normally reflecting a probability weighted average of possible outcomes). Projections necessary for this purpose may include a projection of sales, IDCs, costs of developing operating contributions, routine operating expenses, and costs of sales. Some method applications directly estimate projections of items attributable to separate development and exploitation by the controlled participants within their respective divisions. Other method applications indirectly estimate projections of items from the perspective of the controlled group as a whole, rather than from the perspective of a particular participant, and then apportion the items so estimated on some assumed basis. For example, in some applications, sales might be directly projected by division, but worldwide projections of other items such as operating expenses might be apportioned among divisions in the same ratio as the divisions' respective sales. Which approach is more reliable depends on which provides the most reliable measure of an arm's length result, considering the competing perspectives under the facts and circumstances in light of the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. For these purposes, projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements in this paragraph (g).

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

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

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

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

(iii) This paragraph (g)(2)(vii) provides that accounting treatment may be a starting point, but is not determinative for purposes of assessing or applying methods to evaluate the arm's length charge in a PCT. The facts here reveal that Company X has nothing of economic value aside from its in-process technology and assembled workforce. The $50 million of the acquisition price allocated to goodwill for accounting purposes, therefore, is economically attributable to either of, or both, the in-process technology and the workforce. That moots the potential issue under the acquisition price method of the reliability of valuation of assets not to be compensated by PCTs, since there are no such assets. Assuming the acquisition price method is otherwise the most reliable method, the aggregate value of Company X's in-process technology and workforce is the full acquisition price of $100 million (subject to possible adjustment for differences in tax liabilities of the type described in paragraph (g)(5)(ii) of this section). Accordingly, the aggregate value of the arm's length PCT Payments due from FSub to USP for the platform contributions consisting of the rights in Company X's in-process technology and workforce will equal $100 million (subject to adjustment as per paragraph (g)(5)(ii) of this section) multiplied by FSub's RAB share.

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

(ii) In this case an analysis of the facts indicates a likelihood that, consistent with the allocation under the accounting treatment (although not necessarily in the same amount), a significant amount of the nonroutine contributions to the USP's business activities consist of goodwill and going concern value economically attributable to the existing U.S. software business rather than to the platform contributions consisting of the rights in the in-process technology and research workforce. In addition, an analysis of the facts indicates that a significant amount of the nonroutine contributions to USP's business activities consist of the make-or-sell rights under the existing software and trademark, which are not platform contributions and might be difficult to value. Accordingly, further consideration must be given to the extent to which these circumstances reduce the relative reliability of the acquisition price method in comparison to other potentially applicable methods for evaluating the PCT Payment.

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

(ii) The Technology X of Company Y acquired by USP is reasonably anticipated to contribute to developing cost shared intangibles and is therefore a platform contribution for which FSub must compensate USP as part of a PCT. Although for accounting purposes a significant portion of the acquisition price of Company Y was allocated to items other than Technology X, the facts demonstrate that USP had no intention of using and therefore placed no economic value on any part of Company Y other than Technology X. If USP was willing to pay $200 million for Company Y solely for purposes of acquiring Technology X, then assuming the acquisition price method is otherwise the most reliable method, the value of Technology X is the full $200 million acquisition price. Accordingly, the value of the arm's length PCT Payment due from FSub to USP for the platform contribution consisting of the rights in Technology X will equal the product of $200 million (subject to adjustment as described in paragraph (g)(5)(ii) of this section) and FSub's RAB share.

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

(B) *Best method analysis for subsequent PCT.* In cases where PCTs occur on different dates, the determination of the arm's length amount charged, respectively, in the prior and subsequent PCTs must be coordinated in a manner that provides the most reliable measure of an arm's length result. In some circumstances, a subsequent PCT may be reliably evaluated independently of other PCTs, as may be possible for example, under the acquisition price method. In other circumstances, the results of prior and subsequent PCTs may be interrelated and so a subsequent PCT may be most reliably evaluated under the residual profit split method of paragraph (g)(7) of this section. In those cases, for purposes of allocating the present value of nonroutine residual divisional profit or loss, and so determining the present value of the subsequent PCT Payments, in accordance with paragraph (g)(7)(iii)(C) of this section, the PCT Payor's interest in cost shared intangibles, both already developed and in process, are treated as additional PCT Payor operating contributions as of the date of the subsequent PCT.

(ix) *Arm's length range*—(A) *In general.* The guidance in § 1.482–1(e) regarding determination of an arm's length range, as modified by this section, applies in evaluating the arm's length amount charged in a PCT under a transfer pricing method provided in this section (applicable method). Section 1.482–1(e)(2)(i) provides that the arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability although use of more than one method may be appropriate for the purposes described in § 1.482–1(c)(2)(iii). The rules provided in § 1.482–1(e) and this section for determining an arm's length range shall not override the rules provided in paragraph (i)(6) of this section for periodic adjustments by the Commissioner. The provisions in paragraphs (g)(2)(ix)(C) and (D) of this section apply only to applicable methods that are based on two or more input parameters as described in paragraph (g)(2)(ix)(B) of this section. For an example of how the rules of this section for determining an arm's length range of PCT Payments are applied, see paragraph (g)(4)(vii) of this section.

(B) *Methods based on two or more input parameters.* An applicable method may determine PCT Payments based on calculations involving two or more parameters whose values depend on the facts and circumstances of the case (input parameters). For some input parameters (market-based input parameters), the value is most reliably determined by reference to data that derives from uncontrolled transactions (market data). For example, the value of the return to a controlled participant's routine contributions, as such term is defined in paragraph (j)(1)(i) of this section, to the CSA Activity (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the profit level of a company with rights, resources, and capabilities comparable to those routine contributions. See § 1.482–5. As another example, the value for the discount rate that reflects the riskiness of a controlled participant's role in the CSA (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the stock beta of a company whose overall risk is comparable to the riskiness of the controlled participant's role in the CSA.

(C) *Variable input parameters*. For some market-based input parameters (variable input parameters), the parameter's value is most reliably determined by considering two or more observations of market data that have, or with adjustment can be brought to, a similar reliability and comparability, as described in § 1.482–1(e)(2)(ii) (for example, profit levels or stock betas of two or more companies). See paragraph (g)(2)(ix)(B) of this section.

(D) *Determination of arm's length PCT Payment*. For purposes of applying this paragraph (g)(2)(ix), each input parameter is assigned a single most reliable value, unless it is a variable input parameter as described in paragraph (g)(2)(ix)(C) of this section. The determination of the arm's length payment depends on the number of variable input parameters.

(*1*) *No variable input parameters*. If there are no variable input parameters, the arm's length PCT Payment is a single value determined by using the single most reliable value determined for each input parameter.

(*2*) *One variable input parameter*. If there is exactly one variable input parameter, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in § 1.482–1(e)(2)(iii)(C), of the set of PCT Payment values calculated by selecting—

(*i*) Iteratively, the value of the variable input parameter that is based on each observation as described in paragraph (g)(2)(ix)(C) of this section; and

(*ii*) The single most reliable values for each other input parameter.

(3) *More than one variable input parameter*. If there are two or more variable input parameters, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in § 1.482–1(e)(2)(iii)(C), of the set of PCT Payment values calculated iteratively using every possible combination of permitted choices of values for the input parameters. For input parameters other than a variable input parameter, the only such permitted choice is the single most reliable value. For variable input parameters, such permitted choices include any value that is—

(*i*) Based on one of the observations described in paragraph (g)(2)(ix)(C) of this section; and

(*ii*) Within the interquartile range (as described in § 1.482–1(e)(2)(iii)(C)) of the set of all values so based.

(E) *Adjustments*. Section 1.482–1(e)(3), applied as modified by this paragraph (g)(2)(ix), determines when the Commissioner may make an adjustment to a PCT Payment due to the taxpayer's results being outside the arm's length range. Adjustment will be to the median, as defined in § 1.482–1(e)(3). Thus, the Commissioner is not required to establish an arm's length range prior to making an allocation under section 482.

(x) *Valuation undertaken on a pre-tax basis*. PCT Payments in general may increase the PCT Payee's tax liability and decrease the PCT Payor's tax liability. The arm's length amount of a PCT Payment determined under the methods in this paragraph (g) is the value of the PCT Payment itself, without regard to such tax effects. Therefore, the methods under this section must be applied, with suitable adjustments if needed, to determine the PCT Payments on a pre-tax basis. See paragraphs (g)(2)(v)(B)(3), (g)(4)(i)(G), (g)(5)(ii), and (g)(6)(ii) of this section.

(3) *Comparable uncontrolled transaction method*. The comparable uncontrolled transaction (CUT) method described in § 1.482–4(c), and the comparable uncontrolled services price (CUSP) method described in § 1.482–9T(c), may be applied to evaluate whether the amount charged in a PCT is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Although all of the factors entering into a best method analysis described in § 1.482–1(c) and (d) must be considered, comparability and reliability under this method are particularly dependent on similarity of contractual terms, degree to which allocation of risks is proportional to reasonably anticipated benefits from exploiting the results of intangible development, similar period of commitment as to the sharing of intangible development risks, and similar scope, uncertainty, and profit potential of the subject intangible development, including a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section. When applied in the manner described in § 1.482–4(c) or 1.482–9T(c), the CUT or CUSP method will typically yield an arm's length total value for the platform contribution that is the subject of the PCT. That value must then be multiplied by each PCT Payor's respective RAB share in order to determine the arm's length PCT Payment due from each PCT Payor. The reliability of a CUT or CUSP that yields a value for the platform contribution only in the PCT Payor's division will be reduced to the extent that value is not consistent with the total worldwide value of the platform contribution multiplied by the PCT Payor's RAB share.

(4) *Income method*—(i) *In general*—(A) *Equating cost sharing and licensing alternatives*. The income method evaluates whether the amount charged in a PCT is arm's length by reference to a controlled participant's best realistic alternative to entering into a CSA. Under this method, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT, of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. In general, the best realistic alternative of the PCT Payor to entering into the CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Similarly, the best realistic alternative of the PCT Payee to entering into the CSA would be to undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA and license the resulting intangibles to an uncontrolled licensee. Paragraphs (g)(4)(ii) through (iv) of this section describe specific applications of the income method, but do not exclude other possible applications of this method.

(B) *Cost sharing alternative*. The PCT Payor's cost sharing alternative corresponds to the actual CSA in accordance with this section, with the PCT Payor's obligation to make the PCT Payments to be determined and its commitment for the duration of the IDA to bear cost contributions.

(C) *Licensing alternative*. The licensing alternative is derived on the basis of a functional and risk analysis of the cost sharing alternative, but with a shift of the risk of cost contributions to the licensor. Accordingly, the PCT Payor's licensing alternative consists of entering into a license with an uncontrolled party, for a term extending for what would be the duration of the CSA Activity, to license the make-or-sell rights in to-be-developed resources, capabilities, or rights of the licensor. Under such license, the licensor would undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Apart from any difference in the allocation of the risks of the IDA, the licensing alternative should assume contractual provisions with regard to non-overlapping divisional intangible interests, and with regard to allocations of other risks, that are consistent with the actual CSA in accordance with this section. For example, the analysis under the licensing alternative should assume a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section.

(D) *Only one controlled participant with nonroutine platform contributions.* This method involves only one of the controlled participants providing nonroutine platform contributions as the PCT Payee. For a method under which more than one controlled participant may be a PCT Payee, see the application of the residual profit method pursuant to paragraph (g)(7) of this section.

(E) *Income method payment forms.* The income method may be applied to determine PCT Payments in any form of payment (for example, lump sum, royalty on sales, or royalty on divisional profit). For converting to another form of payment, see generally § 1.482–7(h) (Form of payment rules).

(F) *Discount rates appropriate to cost sharing and licensing alternatives.*

(*1*) The present value of the cost sharing and licensing alternatives, respectively, should be determined using the appropriate discount rates in accordance with paragraph (g)(2)(v) of this section. See, for example, § 1.482–7(g)(2)(v)(B)(*1*) (Discount rate variation between realistic alternatives). In circumstances where the market-correlated risks as between the cost sharing and licensing alternatives are not materially different, a reliable analysis may be possible by using the same discount rate with respect to both alternatives.

(*2*) The discount rate for the cost sharing alternative will generally depend on the form of PCT Payments assumed (for example, lump sum, royalty on sales, royalty on divisional profit).

(G) *The effect of taxation on determining the arm's length amount.* In principle, the present values of the cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income (including the post-tax value to the controlled participant of the PCT Payments). If such approach is adopted, then the post-tax value of the PCT Payments must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis. See paragraph (g)(2)(x) of this section. In certain circumstances, post-tax income may be derived as the product of the result of applying a post-tax discount rate to pre-tax income, and a factor equal to one minus the tax rate. See paragraph (g)(2)(v)(B)(*3*) of this section. Moreover, to the extent that a controlled participant's tax rate is not materially affected by whether it enters into the cost sharing or licensing alternative (or reliable adjustments may be made for varying tax rates), the factor (that is, one minus the tax rate) may be cancelled from both sides of the equation of the cost sharing and licensing alternative present values. Accordingly, in such circumstance it is sufficient to apply post-tax discount rates to projections of pre-tax income for the purpose of equating the cost sharing and licensing alternatives. The specific applications of the income method described in paragraphs (g)(4)(ii) through (iv) of this section and the examples set forth in paragraph (g)(4)(vii) of this section assume that such circumstance applies.

(ii) *Evaluation of PCT Payor's cost sharing alternative.* The present value of the PCT Payor's cost sharing alternative is the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus operating cost contributions, minus cost contributions, minus PCT Payments.

(iii) *Evaluation of PCT Payor's licensing alternative*—(A) *Evaluation based on CUT.* The present value of the PCT Payor's licensing alternative may be determined using the comparable uncontrolled transaction method, as described in § 1.482–4(c)(1) and (2). In this case, the present value of the PCT Payor's licensing alternative is the present value of the stream, over what would be the duration of the CSA Activity under the cost sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus the licensing payments as determined under the comparable uncontrolled transaction method.

(B) *Evaluation based on CPM.* The present value of the PCT Payor's licensing alternative may be determined using the comparable profits method, as described in § 1.482–5. In this case, the present value of the licensing alternative is determined as in paragraph (g)(4)(iii)(A) of this section, except that the PCT Payor's licensing payments, as defined in paragraph (j)(1)(i) of this section, are determined to be a lump sum, as of the date of the PCT, equal to the present value (using the discount rate appropriate for the licensing alternative) of the stream, over what would be the duration of the CSA Activity under the cost sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus market returns for routine contributions, as defined in paragraph (j)(1)(i) of this section.

(iv) *Lump sum payment form.* Where the form of PCT Payment is a lump sum as of the date of the PCT, then, based on paragraphs (g)(4)(i) through (iii) of this section, the PCT Payment equals the difference between—

(A) The present value, using the discount rate appropriate for the cost sharing alternative, of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus cost contributions and operating cost contributions; and

(B) The present value of the licensing alternative.

(v) *Best method analysis considerations.* (A) Whether results derived from this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). Thus, comparability and the quality of data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions, must be considered in determining whether this method provides the most reliable measure of an arm's length result.

(B) This method will be more reliable to the extent that the controlled participants' respective tax rates are not materially affected by whether they enter into the cost sharing or licensing alternative. Even if this assumption of invariant tax rates across alternatives does not hold, this method may still be reliable to the extent that reliable adjustments can be made to reflect the variation in tax rates.

(C) If the licensing alternative is evaluated using the comparable uncontrolled transactions method, as described in paragraph (g)(4)(iii)(A) of this section, any additional comparability and reliability considerations stated in § 1.482–4(c)(2) may apply.

(D) If the licensing alternative is evaluated using the comparable profits method, as described in paragraph (g)(4)(iii)(B) of this section, any additional comparability and reliability considerations stated in § 1.482–5(c) may apply.

(E) This method may be used even if the PCT Payor furnishes significant operating contributions, or commits to assume the risk of significant operating cost contributions, to the PCT Payor's division. However, in such a case, any comparable uncontrolled transactions described in paragraph (g)(4)(iii)(A) of this section, and any comparable transactions used under § 1.482–5(c) as described in paragraphs (g)(4)(iii)(B) of this section, should be consistent with such contributions (or reliable adjustments must be made for material differences).

(vi) *Routine platform and operating contributions*. For purposes of this paragraph (g)(4), any routine contributions that are platform or operating contributions, the valuation and PCT Payments which are determined and made independently of the income method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph, the term ''routine contributions'' shall not include routine platform or operating contributions, and wherever the terms ''cost contributions'' and ''operating cost contributions'' appear in this paragraph, they shall include net routine platform contributions and net routine operating contributions, respectively. Net routine platform contributions are the value of a controlled participant's total reasonably anticipated routine platform contributions, plus its reasonably anticipated PCT Payments to other controlled participants in respect of their routine platform contributions, minus the reasonably anticipated PCT Payments it is to receive from other controlled participants in respect of its routine platform contributions. Net routine operating contributions are the value of a controlled participant's total reasonably anticipated routine operating contributions, plus its reasonably anticipated arm's length compensation to other controlled participants in respect of their routine operating contributions, minus the reasonably anticipated arm's length compensation it is to receive from other controlled participants in respect of its routine operating contributions.

(vii) *Examples*. The following examples illustrate the principles of this paragraph (g)(4):

Example 1. (i) USP, a software company, has developed version 1.0 of a new software application that it is currently marketing. In Year 1 USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the rights to exploit the future versions in the United States, and FS will have the rights to exploit them in the rest of the world. The future rights in version 1.0, and USP's development team, are reasonably anticipated to contribute to the development of future versions and therefore the rights in version 1.0 are platform contributions for which compensation is due from FS as part of a PCT. USP does not transfer the current exploitation rights in version 1.0 to FS. FS does not furnish any platform contributions nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software. FS agrees to make PCT payments in the form of a single lump sum payment as of the date of the PCT.

(ii) In evaluating the CSA, the Commissioner concludes that the cost sharing alternative represents a riskier alternative for FS than the licensing alternative because, in cost sharing, FS will take on the additional risks associated with CST Payments and of making the PCT payments as a single lump sum. Consequently, the Commissioner concludes that the appropriate discount rate to apply in assessing the licensing alternative, based on discount rates of comparable uncontrolled companies undertaking comparable licensing transactions, would be 13% per year, whereas the appropriate discount rate to apply in assessing the cost sharing alternative would be 15% per year. FS undertakes financial projections and anticipates making no sales during the first two years of the CSA in its territory with sales in Years 3 through Year 8 rapidly increasing to $200 million, $400 million, $600 million, $650 million, $700 million and $750 million, respectively. After year 8, sales in the rest of the world are expected to remain at $750 million per annum for the foreseeable future. Costs including routine costs and operating cost contributions are anticipated to equal 60% of gross sales from Year 3, onwards. FS anticipates its cost contributions will equal $50 million per year for the first four years of the CSA and equal 10% of gross sales in each year, thereafter. The Commissioner accepts the financial projections undertaken by FS. The Commissioner determines that the arm's length rate USP would have charged an uncontrolled licensee for a license of future versions of the software had USP further developed version 1.0 on its own is 35% of the sales price, as determined under the comparable uncontrolled transaction method in § 1.482–4(c). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA.

(iii) Based on these projections and applying the appropriate discount rate, the Commissioner determines that under the cost sharing alternative, the present value of its divisional profits (after subtracting the present value of the anticipated operating cost contributions and cost contributions) would be $867 million (for simplicity of calculation in this example, all financial flows are assumed to occur at the beginning of each period). Under the licensing alternative, the present value of the divisional profits and losses minus the operating cost contributions would be $1.592 billion, and the present value of the licensing payments would be $1.393 billion. Therefore, the total value of the licensing alternative would be $199 million. In order for the present value of the cost sharing alternative to equal the present value of the licensing alternative, the present value of the PCT payments must equal $668 million; the arm's length lump sum PCT payment therefore equals $668 million.

Example 2. Arm's length range. (i) The facts are the same as in Example 1. The licensing discount rate (13%) and the CUT licensing rate (35%) used by the Commissioner as input parameters in applying the income method are the median values of comparable uncontrolled discount rates and license rates, respectively. The observations that are in the interquartile range of the respective input parameters are as follows:

Observations that are within interquartile range	Comparable uncontrolled discount rate (percent)
1	11
2	12
3 (Median)	13
4	15
5	17

Observations that are within interquartile range	Comparable uncontrolled licensing rate (percent)
1	30
2	32
3 (Median)	35
4	37
5	40

(ii) The Commissioner concludes that these estimates of the appropriate arm's length discount rates and licensing rates are independent of each other. Accordingly, the Commissioner undertakes 25 different applications of the income method, using each combination of the discount rate and licensing rate parameters. In undertaking this analysis, the Commissioner assumes that the ratio of the median discount rate for the cost sharing alternative to the median discount rate for the licensing alternative (that is, 15% to 13%) is maintained. The results of the 25 applications of the income method, sorted in ascending order of calculated PCT payment, are as follows:

Income method application no.:	Comparable uncontrolled licensing discount rate (percent)	Comparable uncontrolled CSA discount rate (percent)	Comparable uncontrolled licensing rate (percent)	Calculated lump sum PCT payment	Interquartile range of PCT payments
1	17	19.6	30	291	
2	17	19.6	32	347	
3	15	17.3	30	367	
4	17	19.6	35	431	
5	15	17.3	32	433	
6	13	15	30	469	
7	17	19.6	37	487	LQ = 487
8	15	17.3	35	532	
9	12	13.8	30	535	
10	13	15	32	549	
11	17	19.6	40	571	
12	15	17.3	37	598	
13	11	12.7	30	614	Median = 614
14	12	13.8	32	623	
15	13	15	35	668	
16	15	17.3	40	697	
17	11	12.7	32	712	
18	13	15	37	748	
19	12	13.8	35	755	UQ = 755
20	12	13.8	37	844	
21	11	12.7	35	860	
22	13	15	40	867	
23	11	12.7	37	959	
24	12	13.8	40	976	
25	11	12.7	40	1,107	

(iii) Accordingly, the Commissioner determines that a taxpayer will not be subject to adjustment if its initial (ex ante) determination of the PCT payment is between $487 million and $755 million. In the event that the taxpayer's determination of the appropriate PCT payment falls outside this range, the adjustment made by the Commissioner will ordinarily be to $614.

Example 3. (i) USP, a U.S. software company, has developed version 1.0 of a new software application, employed to store and retrieve complex data sets in certain types of storage media. Version 1.0 is currently being marketed. In Year 1, USP enters into a CSA with its wholly owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the exclusive rights to exploit the future versions in the U.S., and FS will have the exclusive rights to exploit them in the rest of the world. USP's rights in version 1.0, and its development team, are reasonably anticipated to contribute to the development of future versions of the software application and, therefore, the rights in version 1.0 are platform contributions for which compensation is due from FS as part of a PCT. USP also transfers the current exploitation rights in version 1.0 to FS and the arm's length amount of the compensation for such transfer is determined in the aggregate with the arm's length PCT Payments in this *Example 3*. FS does not furnish any platform contributions to the CSA nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software. It is reasonably anticipated that FS will have gross sales of $1000X in its territory for 5 years attributable to its exploitation of version 1.0 and the cost shared intangibles, after which time the software application will be rendered obsolete and unmarketable by the obsolescence of the storage medium technology to which it relates. FS's costs reasonably attributable to the CSA, other than cost contributions and operating cost contributions, are anticipated to be $250X per year. Certain operating cost contributions that will be borne by FS are reasonably anticipated to equal $200X per annum for 5 years. In addition, FS is reasonably anticipated to pay cost contributions of $200X per year as a controlled participant in the CSA.

(ii) FS concludes that its realistic alternative would be to license software from an uncontrolled licensor that would undertake the commitment to bear the entire risk of software development. Applying CPM using the profit levels experienced by uncontrolled licensees with contractual provisions and allocations of risk that are comparable to those of FS's licensing alternative, FS determines that it could, as a licensee, reasonably expect a (pre-tax) routine return equal to 14% of gross sales or $140X per year for 5 years. The remaining net revenue would be paid to the uncontrolled licensor as a license fee of $410X per year. FS determines that the discount rate that would be applied to determine the present value of income and costs attributable to its participation in the licensing alternative would be 12.5% as compared to the 15% discount rate that would be applicable in determining the present valuable of the net income attributable to its participation in the CSA (reflecting the increased risk borne by FS in bearing a share of the R&D costs in the cost sharing alternative and the fact that FS intends to pay the PCT payment as a single lump sum). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA.

(iii) On these facts, the present value to FS of entering into the cost sharing alternative equals the present value of the divisional profits ($1,000X minus $250X) minus operating cost contributions ($200X) minus cost contributions ($200X) minus PCT Payments, determined over 5 years by discounting at a discount rate of 15% (for simplicity of calculation in this example, all financial flows are assumed to occur at the beginning of each period). Thus, the present value of the residuals, prior to subtracting the value of the PCT Payments, is $1349X.

(iv) On these facts, the present value to FS of entering into the licensing alternative would be $561X determined by discounting, over 5 years, divisional profits ($1,000X minus $250X) minus operating cost contributions ($200X) and licensing payments ($410X) at a discount rate of 12.5% per annum. The present value of the cost sharing alternative must also equal $561X but equals $1349X prior to subtracting the present value of the PCT payments. Consequently, the PCT payments must have a present value of $788X. Thus, the arm's length lump sum PCT payment made at the time of the PCT will equal $788X.

(5) *Acquisition price method*—(i) *In general.* The acquisition price method applies the comparable uncontrolled transaction method of § 1.482–4(c), or the comparable uncontrolled services price method described in § 1.482–9T(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction. The acquisition price method is

ordinarily used where substantially all the target's nonroutine contributions, as such term is defined in paragraph (j)(1)(i) of this section, made to the PCT Payee's business activities are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under this method, the arm's length charge for a PCT or group of PCTs covering resources, capabilities, and rights of the target is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares. However, an additional adjustment may be necessary to reflect the fact that PCT Payee's tax liability attributable to the purchase from target may differ from the tax liability attributable to the PCT Payments. See paragraph (g)(2)(x) of this section.

(iii) *Adjusted acquisition price.* The adjusted acquisition price is the acquisition price of the target increased by the value of the target's liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target's tangible property on that date and by the value on that date of any other resources, capabilities, and rights not covered by a PCT or group of PCTs.

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

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

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

(C) The date on which the target is acquired and the date of the PCT are not contemporaneous.

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

Example. USP, a U.S. corporation, and its newly incorporated, wholly-owned foreign subsidiary (FS) enter into a CSA at the start of Year 1 to develop Group Z products. Under the CSA, USP and FS will have the exclusive rights to exploit the Group Z products in the U.S. and the rest of the world, respectively. At the start of Year 2, USP acquires Company X for cash consideration worth $110 million. At this time USP's RAB share is 60% and FS's RAB share is 40%. Company X joins in the filing of a U.S. consolidated income tax return with USP. Under paragraph (j)(2)(i) of this section, Company X and USP are treated as one taxpayer for purposes of this section. Accordingly, the rights in any of Company X's resources and capabilities that are reasonably anticipated to contribute to the development activities of the CSA will be considered platform contributions furnished by USP. Company X's resources and capabilities consist of its workforce, certain technology intangibles, $15 million of tangible property and other assets and $5 million in liabilities. The technology intangibles, as well as Company X's workforce, are reasonably anticipated to contribute to the development of the Group Z products under the CSA and, therefore, the rights in the technology intangibles and the workforce are platform contributions for which FS must make a PCT Payment to USP. None of Company X's existing intangible assets or any of its workforce are anticipated to contribute to activities outside the CSA. For purposes of this example, it is assumed that no additional adjustment on account of tax liabilities (as described in paragraph (g)(5)(ii) of this section) is needed. Applying the acquisition price method, the value of USP's platform contributions is the adjusted acquisition price of $100 million ($110 million acquisition price plus $5 million liabilities less $15 million tangible property and other assets). FS must make a PCT Payment to USP for these platform contributions with a reasonably anticipated present value of $40 million, which is the product of $100 million (the value of the platform contributions) and 40% (FS's RAB share at the time of the PCT).

(6) *Market capitalization method*—(i) *In general.* The market capitalization method applies the comparable uncontrolled transaction method of § 1.482–4(c), or the comparable uncontrolled services price method described in § 1.482–9T(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the average market capitalization of a controlled participant (PCT Payee) whose stock is regularly traded on an established securities market. The market capitalization method is ordinarily used where substantially all of the PCT Payee's nonroutine contributions to the PCT Payee's business are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under the market capitalization method, the arm's length charge for a PCT or group of PCTs covering resources, capabilities, and rights of the PCT Payee is equal to the adjusted average market capitalization, as divided among the controlled participants according to their respective RAB shares. An increase to reflect the fact that a PCT Payment may increase the PCT Payee's tax liability and decrease the PCT Payor's tax liability may be warranted. See paragraph (g)(2)(x) of this section.

(iii) *Average market capitalization.* The average market capitalization is the average of the daily market capitalizations of the PCT Payee over a period of time beginning 60 days before the date of the PCT and ending on the date of the PCT. The daily market capitalization of the PCT Payee is calculated on each day its stock is actively traded as the total number of shares outstanding multiplied by the adjusted closing price of the stock on that day. The adjusted closing price is the daily closing price of the stock, after adjustments for stock-based transactions (dividends and stock splits) and other pending corporate (combination and spin-off) restructuring transactions for which reliable arm's length adjustments can be made.

(iv) *Adjusted average market capitalization.* The adjusted average market capitalization is the average market capitalization of the PCT Payee increased by the value of the PCT Payee's liabilities on the date of the PCT and decreased by the value on such date of the PCT Payee's tangible property and of any other resources, capabilities, or rights of the PCT Payee not covered by a PCT or group of PCTs.

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

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

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

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

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

Example 1. (i) USP, a publicly traded U.S. company, and its newly incorporated wholly-owned foreign subsidiary (FS) enter into a CSA on Date 1 to develop software. At that time USP has in-process software but has no software ready for the market. Under the CSA, USP and FS will have the exclusive rights to exploit the software developed under the CSA in the United States and the rest of the world, respectively. On Date 1, USP's RAB share is 70% and FS's RAB share is 30%. USP's assembled team of researchers and its in-process software are reasonably anticipated to contribute to the development of the software under the CSA. Therefore, the rights in the research team and in-process software are platform contributions for which compensation is due from FS. Further, these rights are not reasonably anticipated to contribute to any business activity other than the CSA Activity.

(ii) On Date 1, USP had an average market capitalization of $205 million, tangible property and other assets that can be reliably valued worth $5 million, and no liabilities. Aside from those assets, USP had no assets other than its research team and in-process software. Applying the market capitalization method, the value of USP's platform contributions is $200 million ($205 million average market capitalization of USP less $5 million of tangible property and other assets). The arm's length value of the PCT Payments FS must make to USP for the platform contributions, before any adjustment on account of tax liability as described in paragraph (g)(2)(ii) of this section, is $60 million, which is the product of $200 million (the value of the platform contributions) and 30% (FS's RAB share on Date 1).

Example 2. Aggregation with make-or-sell rights. (i) The facts are the same as in *Example 1*, except that on Date 1 USP also has existing software ready for the market. USP separately enters into a license agreement with FS for make-or-sell rights for all existing software outside the United States. No marketing has occurred, and USP has no marketing intangibles. This license of current make-or-sell rights is a transaction governed by § 1.482–4. However, after analysis, it is determined that the arm's length PCT Payments and the arm's length payments for the make-or-sell license may be most reliably determined in the aggregate using the market capitalization method, under principles described in paragraph (g)(2)(iv) of this section, and it is further determined that those principles are most reliably implemented by computing the aggregate arm's length charge as the product of the aggregate value of the existing and in-process software and FS's RAB share on Date 1.

(ii) Applying the market capitalization method, the aggregate value of USP's platform contributions and the make-or-sell rights in its existing software is $250 million ($255 million average market capitalization of USP less $5 million of tangible property and other assets). The total arm's length value of the PCT Payments and license payments FS must make to USP for the platform contributions and current make-or-sell rights, before any adjustment on account of tax liability as described in paragraph (g)(2)(ii) of this section, is $75 million, which is the product of $250 million (the value of the platform contributions and the make-or-sell rights) and 30% (FS's RAB share on Date 1).

Example 3. Reduced reliability. The facts are the same as in *Example 1* except that USP also has significant nonroutine assets that will be used solely in a nascent business division that is unrelated to the subject of the CSA and that cannot themselves be reliably valued. Those nonroutine contributions are not platform contributions and accordingly are not required to be covered by a PCT. The reliability of using the market capitalization method to determine the value of USP's platform contributions to the CSA is significantly reduced in this case because that method would require adjusting USP's average market capitalization to account for the significant nonroutine contributions that are not required to be covered by a PCT.

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

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

(iii) *Profit split*—(A) *In general.* Under the residual profit split method, the present value of each controlled participant's residual divisional profit or loss attributable to nonroutine contributions (nonroutine residual divisional profit or loss) is allocated between the controlled participants that each furnish significant nonroutine contributions (including platform or operating contributions) to the relevant business activity in that division.

(B) *Determine nonroutine residual divisional profit or loss.* The present value of each controlled participant's nonroutine residual divisional profit or loss must be determined to reflect the most reliable measure of an arm's length result. The present value of nonroutine residual divisional profit or loss equals the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profit or loss, minus market returns for routine contributions, minus operating cost contributions, minus cost contributions, using a discount rate appropriate to such residuals in accordance with paragraph (g)(2)(v) of this section.

(C) *Allocate nonroutine residual divisional profit or loss*—(*1*) *In general.* The present value of nonroutine residual divisional profit or loss in each controlled participant's division must be allocated among all of the controlled participants based upon the relative values, determined as of the date of the PCTs, of the PCT Payor's as compared to the PCT Payee's nonroutine contributions to the PCT Payor's division. For this purpose, the PCT Payor's nonroutine contribution consists of the sum of the PCT Payor's nonroutine operating contributions and the PCT Payor's RAB share of the PCT Payor's nonroutine platform contributions. For this purpose, the PCT Payee's nonroutine contribution consists of the PCT Payor's RAB share of the PCT Payee's nonroutine platform contributions.

(*2*) *Relative value determination.* The relative values of the controlled participants' nonroutine contributions must be determined so as to reflect the most reliable measure of an arm's length result. Relative values may be measured by external market benchmarks that reflect the fair market value of such nonroutine contributions. Alternatively, the relative value of nonroutine contributions may be estimated by the capitalized cost of developing the nonroutine contributions and updates, as appropriately grown or discounted so that all contributions may be valued on a comparable dollar basis as of the same date. If the nonroutine contributions by a controlled participant are also used in other business activities (such as the exploitation of make-or-sell rights described in paragraph (c)(4) of this section), an allocation of the value of the nonroutine contributions must be made on a reasonable basis among all the business activities in which they are used in proportion to the relative economic value that the relevant business activity and such other business activities are anticipated to derive over time as the result of such nonroutine contributions.

(*3*) *Determination of PCT Payments.* Any amount of the present value of a controlled participant's nonroutine residual divisional profit or loss that is allocated to another controlled participant represents the present value of the PCT Payments due to that other controlled participant for its platform contributions to the relevant business activity in the relevant division. For purposes of paragraph (j)(3)(ii) of this section, the present value of a PCT Payor's PCT Payments under this paragraph shall be deemed reduced to the extent of the present value of any PCT Payments owed to it from other controlled participants under this paragraph (g)(7). The resulting remainder may be converted to a fixed or contingent form of payment in accordance with paragraph (h) (Form of payment rules) of this section.

(*4*) *Routine platform and operating contributions.* For purposes of this paragraph (g)(7), any routine platform or operating contributions, the valuation and PCT Payments for which are determined and made independently of the residual profit split method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph (g)(7), the term ''routine contributions'' shall not include routine platform or operating contributions, and wherever the terms ''cost contributions'' and ''operating cost contributions'' appear in this paragraph (g)(7), they shall include net routine platform contributions and net routine operating contributions, respectively, as defined in paragraph (g)(4)(vi) of this section.

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

(B) *Comparability.* The derivation of the present value of nonroutine residual divisional profit or loss includes a carveout on account of market returns for routine contributions. Thus, the comparability considerations that are relevant for that purpose include those that are relevant for the methods that are used to determine market returns for the routine contributions.

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

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

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

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

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3 through 1.482–5 and § 1.482–9T(c), the carveout on account of market returns for routine contributions relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled participants and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of nonroutine residual divisional profit or loss is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all the controlled participants are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all the controlled participants is affected by the reliability of the data and the assumptions pertaining to each controlled participant. Thus, if the data and assumptions are significantly more reliable with respect to one of the controlled participants than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(v) *Examples.* The following examples illustrate the principles of this paragraph (g)(7):

Example 1. (i) USP, a U.S. electronic data storage company, has partially developed technology for a type of extremely small compact storage devices (nanodisks) which are expected to provide a significant increase in data storage capacity in various types of portable devices such as cell phone, MP3 players, laptop computers and digital cameras. At the same time, USP's wholly-owned subsidiary, FS, has developed significant marketing intangibles outside the United States in the form of customer lists, ongoing relations with various OEMs, and trademarks that are well recognized by consumers due to a long history of marketing successful data storage devices and other hardware used in various types of consumer electronics. At the beginning of Year 1, USP enters into a CSA with FS to develop nanodisk technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit nanodisks in the United States, while FS will have the right to exploit nanodisks in the rest of the world. The partially developed nanodisk technologies owned by USP are reasonably anticipated to contribute to the development of commercially exploitable nanodisks and therefore the rights in the nanodisk technologies constitute platform contributions of USP for which compensation is due under PCTs. FS does not own any intangible assets that constitute platform contributions for the CSA. Due to the fact that nanodisk technologies have yet to be incorporated into any commercially available product, neither USP nor FS transfers rights to make or sell current products in conjunction with the CSA.

(ii) Because only in FS's territory do both controlled participants make significant nonroutine contributions, USP and FS determine that they need to determine the relative value of their respective contributions to operating profit or loss attributable to the CSA only in FS's territory (that is, to FS's divisional profit or loss). FS anticipates making no nanodisk sales during the first year of the CSA in its territory with revenues in Year 2 reaching $200 million. Revenues through Year 5 are reasonably anticipated to increase by 50% per year. The annual growth rate for revenues is then expected to decline to 30% per annum in Years 6 and 7, 20% per annum in Years 8 and 9 and 10% per annum in Year 10. Revenues are then expected to start to decline; declining 10% in Year 11 and 5% per annum, thereafter. The routine costs (costs other than cost contributions, operating cost contributions, routine platform and operating contributions, and nonroutine contributions) that are allocable to this revenue in calculating FS's divisional profit or loss, are anticipated to equal 45% of gross sales from Year 2, onwards. FS undertakes routine distribution activities in its markets that constitute routine contributions to the relevant business activity of exploiting NanoBuild. USP and FS estimate that the total market return on these routine contributions will amount to 6% of the routine costs. FS anticipates that its operating cost contributions will equal $40 million per annum for the first two years of the CSA and $65 and $70 million in Years 3 and 4. Thereafter, operating cost contributions are expected to equal 7% of revenue in each year. FS expects its cost contributions to be $60 million in Year 1, rise to $100 million in Years 2 and 3, and then decline again to $60 million. Thereafter, FS's cost contributions are expected to equal 10% of revenues.

(iii) USP and FS determine the present value of the stream of the reasonably anticipated residuals in FS's territory over the duration of the CSA Activity of the divisional profit or loss (revenues minus routine costs), minus the market returns for routine contributions, the operating cost contributions, and the cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 17.5% per annum (for simplicity of calculation in this example, all financial flows are assumed to occur at the beginning of each period). Therefore, the present value of the nonroutine residual divisional profit is $1.319 billion.

(iv) After analysis, USP and FS determine that the relative value of the nanodisk technologies contributed by USP to CSA (giving effect only to its value in FS's territory) is roughly 150% of the value of FS's marketing intangibles (which only have value in FS's territory). Consequently, 60% of the nonroutine residual divisional profit is attributable to USP's platform contribution. Therefore, FS's PCT payments should have an expected present value equal to $792 million (.6 × $1.319 billion).

Example 2. (i) USP is a U.S. automobile manufacturing company that has completed significant research on the development of diesel-electric hybrid engines that, if they could be successfully manufactured, would result in providing a significant increased fuel economy for a wide variety of motor vehicles. Successful commercialization of the diesel-electric hybrid engine will require the development of a new class of advanced battery that will be light, relatively cheap to manufacture and yet capable of holding a substantial electric charge. FS, a foreign subsidiary of USP, has completed significant research on developing lithium-ion batteries that appear likely to have the requisite characteristics. At the beginning of Year 1, USP enters into a CSA with FS to further develop diesel-electric hybrid engines and lithium-ion battery technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit the diesel-electric hybrid engine and lithium-ion battery technologies in the United States, while FS will have the right to exploit such technologies in the rest of the world. The partially developed diesel-electric hybrid engine and lithium-ion battery technologies owned by USP and FS, respectively, are reasonably anticipated to contribute to the development of commercially exploitable automobile engines and therefore the rights in both these technologies constitute platform contributions of USP and of FS for which compensation is due under PCTs. At the time of inception of the CSA, USP owns operating intangibles in the form of self-developed marketing intangibles which have significant value in the United States, but not in the rest of the world, and that are relevant to exploiting the cost shared intangibles. Similarly, FS owns self-developed marketing intangibles which have significant value in the rest of the world, but not in the United States, and that are relevant to exploiting the cost shared intangibles. Although the new class of diesel-electric hybrid engine using lithium-ion batteries is not yet ready for commercial exploitation, components based on this technology are beginning to be incorporated in current-generation gasoline-electric hybrid engines and the rights to make and sell such products are transferred from USP to FS and vice-versa in conjunction with the inception of the CSA.

(ii) USP's estimated RAB share is 66.7 percent. During Year 1, it is anticipated that sales in USP's territory will be $1000X in Year 1. Sales in FS's territory are anticipated to be $500X. Thereafter, as revenue from the use of components in gasoline-electric hybrids is supplemented by revenues from the production of complete diesel-electric hybrid engines using lithium-ion battery technology, anticipated sales in both territories will increase rapidly at a rate of 50% per annum through Year 4. Anticipated sales are then anticipated to increase at a rate of 40% per annum for another 4 years. Sales are then anticipated to increase at a rate of 30% per annum through Year 10. Thereafter, sales are anticipated to decrease at a rate of 5% per annum for the foreseeable future as new automotive drivetrain technologies displace diesel-electric hybrid engines and lithium-ion batteries. Total operating expenses attributable to product exploitation (including operating cost contributions) equal 40% of sales per year for both USP and FS. USP and FS estimate that the total market return on their routine contributions to the CSA will amount to 6% of the operating expenses. USP is expected to bear ⅔s of the total cost contributions for the foreseeable future. Cost contributions are expected to total $375X in Year 1 (of which $250X are borne by USP) and increase at a rate of 25% per annum through Year 6. In Years 7 through 10, cost contributions are expected to increase 10% a year. Thereafter, cost contributions are expected to decrease by 5% a year for the foreseeable future.

(iii) USP and FS determine the present value of the stream of the reasonably anticipated divisional profit or loss (revenues minus operating costs), minus the market returns for routine contributions, minus cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 12% per year. Therefore, the present value of the nonroutine residual divisional profit in USP's territory is $41,115X and in CFC's territory is $20,557X (for simplicity of calculation in this example, all financial flows are assumed to occur at the beginning of each period).

(iv) After analysis, USP and FS determine that, in the United States the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by USP in the exploitation of the cost shared intangibles (reported as equaling 100 in total), equals: USP's platform contribution (59.5); FS's platform contribution (25.5); and USP's operating intangibles (15). Consequently, the present value of the arm's length amount of the PCT payments that USP should pay to FS for FS's platform contribution is $10,484X (.255 × $41,115X). Similarly, USP and FS determine that, in the rest of the world, the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by FS in the exploitation of the cost shared intangibles can be divided as follows: USP's platform contribution (63); FS's platform contribution (27); and FS's operating intangibles (10). Consequently, the present value of the arm's length amount of the PCT payments that FS should pay to USP for USP's platform contribution is $12,951X (.63 × $20,557X). Therefore, FS is required to make a net payment to USP with a present value of $2,467X ($12,951X − 10,484X).

(8) *Unspecified methods.* Methods not specified in paragraphs (g)(3) through (7) of this section may be used to evaluate whether the amount charged for a PCT is arm's length. Any method used under this paragraph (g)(8) must be applied in accordance with the provisions of § 1.482–1 and of paragraph (g)(2) of this section. Consistent with the specified methods, an unspecified method should take into account the

general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. Therefore, in establishing whether a PCT achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled participant could have realized by choosing a realistic alternative to the CSA. See paragraph (k)(2)(ii)(J) of this section. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482–1(c) (Best method rule). In accordance with § 1.482–1(d) (Comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(h) *Form of payment rules*—(1) *CST Payments.* CST Payments may not be paid in shares of stock in the payor (or stock in any member of the controlled group that includes the controlled participants).

(2) *PCT Payments*—(i) *In general.* The consideration under a PCT for a platform contribution may take one or a combination of both of the following forms:

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

(B) Payments contingent on the exploitation of cost shared intangibles by the PCT Payor (contingent payments).

(ii) *No PCT Payor Stock.* PCT Payments may not be paid in shares of stock in the PCT Payor (or stock in any member of the controlled group that includes the controlled participants).

(iii) *Specified form of payment*—(A) *In general.* The form of payment selected (subject to the rules of this paragraph (h)) for any PCT, including, in the case of contingent payments, the contingent base and structure of the payments as set forth in paragraph (h)(2)(iii)(B) of this section, must be specified no later than the due date of the applicable tax return (including extensions) for the later of the taxable year of the PCT Payor or PCT Payee that includes the date of that PCT.

(B) *Contingent payments.* In accordance with paragraph (k)(1)(iv)(A) of this section, a provision of a written contract described in paragraph (k)(1) of this section, or of the additional documentation described in paragraph (k)(2) of this section, that provides for payments for a PCT (or group of PCTs) to be contingent on the exploitation of cost shared intangibles will be respected as consistent with economic substance only if the allocation between the controlled participants of the risks attendant on such form of payment is determinable before the outcomes of such allocation that would have materially affected the PCT pricing are known or reasonably knowable. A contingent payment provision must clearly and unambiguously specify the basis on which the contingent payment obligations are to be determined. In particular, the contingent payment provision must clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, the royalty base (such as sales or revenues), and the computation used to determine the PCT Payments. The royalty base specified must be one that permits verification of its proper use by reference to books and records maintained by the controlled participants in the normal course of business (for example, books and records maintained for financial accounting or business management purposes).

(C) *Examples.* The following examples illustrate the principles of this paragraph (h)(2)(iii).

Example 1. A CSA provides that PCT payments with respect to a particular platform contribution shall be contingent payments equal to 15% of the revenues from sales of products that incorporate cost shared intangibles. The terms further permit (but do not require) the controlled participants to adjust such contingent payments in accordance with a formula set forth in the arrangement so that the 15% rate is subject to adjustment by the controlled participants at their discretion on an after-the-fact, uncompensated basis. The Commissioner may impute payment terms that are consistent with economic substance with respect to the platform contribution because the contingent payment provision does not specify the computation used to determine the PCT Payments.

Example 2. Taxpayer, an automobile manufacturer, is a controlled participant in a CSA that involves research and development to perfect certain manufacturing techniques necessary to the actual manufacture of a state-of-the-art, hybrid fuel injection system known as DRL337. The arrangement involves the platform contribution of a design patent covering DRL337. Pursuant to paragraph (h)(2)(iii)(B) of this section, the CSA provides for PCT payments with respect to the platform contribution of the patent in the form of royalties contingent on sales of automobiles that contain the DRL337 system. However, Taxpayer's system of book- and record-keeping does not enable Taxpayer to track which automobile sales involve automobiles that contain the DRL337 system. Because Taxpayer has not complied with paragraph (h)(2)(iii)(B) of this section, the Commissioner may impute payment terms that are consistent with economic substance and susceptible to verification by the Commissioner.

(iv) *Conversion from fixed to contingent form of payment.* With regard to a conversion of a fixed present value to a contingent form of payment, see paragraphs (g)(2)(v) (Discount rate) and (g)(2)(vi) (Financial projections) of this section.

(3) *Coordination of best method rule and form of payment.* A method described in paragraph (g)(1) of this section evaluates the arm's length amount charged in a PCT in terms of a form of payment (method payment form). For example, the method payment form for the acquisition price method described in paragraph (g)(5) of this section, and for the market capitalization method described in paragraph (g)(6) of this section, is fixed payment. Applications of the income method provide different method payment forms. See paragraphs (g)(4)(i)(E) and (g)(4)(iv) of this section. The method payment form may not necessarily correspond to the form of payment specified pursuant to paragraphs (h)(2)(iii) and (k)(2)(ii)(l) of this section (specified payment form). The determination under § 1.482–1(c) of the method that provides the most reliable measure of an arm's length result is to be made without regard to whether the respective method payment forms under the competing methods correspond to the specified payment form. If the method payment form of the method determined under § 1.482–1(c) to provide the most reliable measure of an arm's length result differs from the specified payment form, then the conversion from such method payment form to such specified payment form will be made to the satisfaction of the Commissioner.

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

(2) *CST allocations*—(i) *In general.* The Commissioner may make allocations to adjust the results of a CST so that the results are consistent with an

arm's length result, including any allocations to make each controlled participant's IDC share, as determined under paragraph (d)(4) of this section, equal to that participant's RAB share, as determined under paragraph (e)(1) of this section. Such allocations may result from, for purposes of CST determinations, adjustments to—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SALES

[In millions of dollars]

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

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

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

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

SALES

[In millions of dollars]

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

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

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

SALES

[In millions of dollars]

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

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

SALES

[In millions of dollars]

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

(iii) Combining the actual results through Year 5 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These adjusted benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were unreliable. The Commissioner adjusts cost shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

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

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

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

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

participants' use of such partial undivided interest.

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

(ii) *PRRR*. Except as provided in the next sentence, the *PRRR* will consist of return ratios that are not less than .667 nor more than 1.5. Alternatively, if the controlled participants have not substantially complied with the documentation requirements referenced in paragraph (k) of this section, as modified, if applicable, by paragraphs (m)(2) and (3) of this section, the PRRR will consist of return ratios that are not less than .8 nor more than 1.25.

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

(B) *PVTP*. The *PVTP* is the present value, as of the CSA Start Date, as defined in section (j)(1)(i) of this section, of the PCT Payor's actually experienced divisional profits or losses from the CSA Start Date through the end of the Adjustment Year.

(C) *PVI*. The *PVI* is the present value, as of the CSA Start Date, of the PCT Payor's investment associated with the CSA Activity, defined as the sum of its cost contributions and its PCT Payments, from the CSA Start Date through the end of the Adjustment Year. For purposes of computing the PVI, PCT Payments means all PCT Payments due from a PCT Payor before netting against PCT Payments due from other controlled participants pursuant to paragraph (j)(3)(ii) of this section.

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

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

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

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

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

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

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

(D) *PCT Payor WACC*. The *PCT Payor WACC* is the WACC, as defined in paragraph (j)(1)(i) of this section, of the PCT Payor or the publicly traded company described in paragraph (i)(6)(iv)(C)(*2*)(*ii*) of this section, as the case may be.

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

(v) *Determination of periodic adjustments*. In the event of a Periodic Trigger, subject to paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments with respect to all PCT Payments between all PCT Payors and PCT Payees for the Adjustment Year and all subsequent years for the duration of the CSA Activity pursuant to the residual profit split method as provided in paragraph (g)(7) of this section, subject to the further modifications in this paragraph (i)(6)(v). A periodic adjustment may be made for a particular taxable year without regard to whether the taxable years of the Trigger PCT or other PCTs remain open for statute of limitation purposes.

(A) *In general*. Periodic adjustments are determined by the following steps:

(*1*) First, determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(*3*) of this section pursuant to the Adjusted RPSM as defined in paragraph (i)(6)(v)(B) of this section (first step result).

(*2*) Second, convert the first step result into a stream of contingent payments on a base of reasonably anticipated divisional profits or losses over the entire duration of the CSA Activity, using a level royalty rate (second step rate). See paragraph (h)(2)(iv) of this section (Conversion from fixed to contingent form of payment). This conversion is made based on all information known as of the Determination Date.

(*3*) Third, apply the second step rate to the actual divisional profit or loss for taxable years preceding and including the Adjustment Year to yield a stream of contingent payments for such years, and convert such stream to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section (third step result). For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(*4*) Fourth, convert any actual PCT Payments up through the Adjustment Year to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section. Then subtract such amount from the third step result. Determine the nominal amount in the Adjustment Year that would have a present value as of the CSA Start Date equal to the present value determined in the previous sentence to determine the periodic adjustment in the Adjustment Year.

(*5*) Fifth, apply the second step rate to the actual divisional profit or loss for each taxable year after the Adjustment Year up to and including the taxable year that includes the Determination Date to yield a stream of contingent payments for such years. For this purpose, the second step rate applied to a loss will yield a negative contingent payment for that year. Then subtract from each such payment any actual PCT Payment made for the same year to determine the periodic adjustment for such taxable year.

(*6*) For each taxable year subsequent to the year that includes the Determination Date, the periodic adjustment for such taxable year (which is in lieu of any PCT Payment that would otherwise be payable for that year under the taxpayer's position) equals the second step rate applied to the actual divisional profit or loss for that year. For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(*7*) If the periodic adjustment for any taxable year is a positive amount, then it is an additional PCT Payment owed from the PCT Payor to the PCT Payee for such year. If the periodic adjustment for any taxable year is a negative amount, then it is an additional PCT Payment owed by the PCT Payee to the PCT Payor for such year.

(B) *Adjusted RPSM as of Determination Date.* The Adjusted RPSM is the residual profit split method pursuant to paragraph (g)(7) of this section applied to determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(*3*) of this section, with the following modifications.

(*1*) Actual results up through the Determination Date shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(*2*) Projected results for the balance of the CSA Activity after the Determination Date, as reasonably anticipated as of the Determination Date, shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(*3*) The requirement in paragraph (g)(7)(i) of this section, that at least two controlled participants make significant nonroutine contributions, does not apply.

(vi) *Exceptions to periodic adjustments*—(A) *Controlled participants establish periodic adjustment not warranted.* No periodic adjustment will be made under paragraphs (i)(6)(i) and (i)(6)(v) of this section if the controlled participants establish to the satisfaction of the Commissioner that all the conditions described in one of paragraphs (i)(6)(vi)(A)(*1*) through (*4*) of this section apply with respect to the Trigger PCT.

(*1*) *Transactions involving the same platform contribution as in the Trigger PCT.*

(*i*) The same platform contribution is furnished to an uncontrolled taxpayer under substantially the same circumstances as those of the relevant Trigger PCT and with a similar form of payment as the Trigger PCT;

(*ii*) This transaction serves as the basis for the application of the comparable uncontrolled transaction method described in paragraph (g)(3) of this section, in the first year and all subsequent years in which substantial PCT Payments relating to the Trigger PCT were required to be paid; and

(*iii*) The amount of those PCT Payments in that first year was arm's length.

(*2*) *Results not reasonably anticipated.* The differential between the AERR and the nearest bound of the PRRR is due to extraordinary events beyond the control of the controlled participants that could not reasonably have been anticipated as of the date of the Trigger PCT.

(*3*) *Reduced AERR does not cause Periodic Trigger.* The Periodic Trigger would not have occurred had the PCT Payor's divisional profits or losses used to calculate its PVTP excluded those profits or losses attributable to the PCT Payor's routine contributions to its exploitation of cost shared intangibles, attributable to its operating cost contributions, and attributable to its nonroutine contributions to the CSA Activity.

(*4*) *Increased AERR does not cause Periodic Trigger*—(*i*) The Periodic Trigger would not have occurred had the divisional profits or losses of the PCT Payor used to calculate its PVTP included its reasonably anticipated divisional profits or losses after the Adjustment Year from the CSA Activity, including from its routine contributions, its operating cost contributions, and its nonroutine contributions to that activity, and had the cost contributions and PCT Payments of the PCT Payor used to calculate its PVI included its reasonably anticipated cost contributions and PCT Payments after the Adjustment Year. The reasonably anticipated amounts in the previous sentence are determined based on all information available as of the Determination Date.

(*ii*) For purposes of this paragraph (i)(6)(vi)(A)(*4*), the controlled participants may, if they wish, assume that the average yearly divisional profits or losses for all taxable years prior to and including the Adjustment Year, in which there has been substantial exploitation of cost shared intangibles resulting from the CSA (exploitation years), will continue to be earned in each year over a period of years equal to 15 minus the number of exploitation years prior to and including the Determination Date.

(B) *Circumstances in which Periodic Trigger deemed not to occur.* No Periodic Trigger will be deemed to have occurred at the times and in the circumstances described in paragraph (i)(6)(vi)(B)(*1*) or (*2*) of this section.

(*1*) *10-year period.* In any year subsequent to the 10-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR determined is within the PRRR for each year of such 10-year period.

(*2*) *5-year period.* In any year of the 5-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR falls below the lower bound of the PRRR.

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

Example 1. (i) At the beginning of Year 1, USP, a publicly traded U.S. company, and FS, its wholly-owned foreign subsidiary, enter into a CSA to develop new technology for cell phones. USP has a platform contribution, the rights for an in-process technology that when developed will improve the clarity of calls, for which compensation is due from FS. FS has no platform contributions to the CSA, no operating contributions, and no operating cost contributions. USP and FS agree to fixed

PCT payments of $40 million in Year 1 and $10 million per year for Years 2 through 10. At the beginning of Year 1, the weighted average cost of capital of the controlled group that includes USP and FS is 15%. In Year 9, the Commissioner audits Years 5 through 7 of the CSA and considers whether any periodic adjustments should be made. USP and FS have substantially complied with the documentation requirements of paragraph (k) of this section.

(ii) FS experiences the results reported in the following table from its participation in the CSA through Year 7. In the table, all present values (PV) are reported as of the CSA Start Date, which is the same as the date of the PCT (and reflect a 15% discount rate as discussed in paragraph (iii) of this *Example 1*). Thus, in any year the present value of the cumulative investment is PVI and of the cumulative divisional profit or loss is PVTP. All amounts in this table and the tables that follow are reported in millions of dollars and cost contributions are referred to as ''CCs'' (for simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of the year).

a	b	c	d	e	f	g	h
Year	Sales	Non-CC costs	CCs	PCT payments	Investment (d+e)	Divisional profit or loss (b–c)	AERR (PVTP/PVI) (g/f)
1	0	0	15	40	55	0	
2	0	0	17	10	27	0	
3	0	0	18	10	28	0	
4	680	662	20	10	30	18	
5	836	718	22	10	32	118	
6	1,023	680	24	10	34	343	
7	1,079	747	27	10	37	332	
PV through Year 5	925	846	69	69	138	79	.58
PV through Year 6	1,434	1,184	81	74	155	250	1.62
PV through Year 7	1,900	1,507	93	78	171	393	2.31

(iii) Because USP is publicly traded in the United States and is a member of the controlled group to which FS (the PCT Payor) belongs, for purposes of calculating the AERR for FS, the present values of its PVTP and PVI are determined using an ADR of 15%, the weighted average cost of capital of the controlled group. (It is assumed that no other rate was determined or established, under paragraph (i)(6)(iv)(B) of this section, to better reflect the relevant degree of risk.) At a 15% discount rate, the PVTP, calculated as of Year 1, and based on actual profits realized by FS through Year 7 from exploiting the new cell phone technology developed by the CSA, is $393 million. The PVI, based on FS's cost contributions and its PCT Payments, is $171 million. The AERR for FS is equal to its PVTP divided by its PVI, $393 million/$171 million, or 2.31. There is a Periodic Trigger because FS's AERR of 2.31 falls outside the PRRR of .67 to 1.5, the applicable PRRR for controlled participants complying with the documentation requirements of this section.

(iv) At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 1.62. It is also determined that for Year 6 none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. The Commissioner exercises its discretion under paragraph (i)(6)(i) of this section to make periodic adjustments using Year 6 as the Adjustment Year. Therefore, the arm's length PCT Payments from FS to USP shall be determined for each taxable year using the adjusted residual profit split method described in paragraphs (g)(7)(v)(B) and (i)(6)(v)(B) of this section. Periodic adjustments will be made for each year to the extent the PCT Payments actually made by FS differ from the PCT Payment calculation under the adjusted residual profit split method.

(v) It is determined, as of the Determination Date, that the cost shared intangibles will be exploited through Year 10. FS's return for routine functions (determined by the Commissioner, based on the return for comparable routine functions undertaken by comparable uncontrolled companies, to be 10% of non-CC costs), and its actual and projected results, are described in the following table.

a	b	c	d	e	f	g
Year	Sales	Non-CC costs	Divisional profits or loss (b–c)	CCs	Routine return	Residual profit (d–e–f)
1	0	0	0	15	0	−15
2	0	0	0	17	0	−17
3	0	0	0	18	0	−18
4	680	662	18	20	66	−68
5	836	718	118	22	72	24
6	1,023	680	343	24	68	251
7	1,079	747	332	27	75	230
8	1,138	822	316	29	82	205
9	1,200	894	306	32	89	185
10	1.265	974	291	35	97	159
Cumulative PV through Year 10 as of CSA Start Date	3,080	2,385	695	124	238	332

(vi) The periodic adjustments are calculated in a series of steps set out in paragraph (i)(6)(v)(A) of this section. First, a lump sum for the PCT Payment is determined using the adjusted residual profit split method. Under the method, based on the considerations discussed in paragraph (g)(2)(v) of this section, the appropriate discount rate is 15% per year. The non-routine residual divisional profit or loss described in paragraph (g)(7)(iii)(B) of this section is $332 million. Further under paragraph (g)(7)(iii)(C) of this section, the entire nonroutine residual divisional profit constitutes the PCT Payment because only USP has nonroutine contributions.

(vii) In step two, the first step result ($332 million) is converted into a level royalty rate based on the reasonably anticipated divisional profits or losses of the CSA Activity, the PV of which is reported in the table above (net PV of divisional profit or loss for Years 1 through 10 is $695 million). Consequently, the step two result is a level royalty rate of 47.8% ($332/$694) of the divisional profit in Years 1 through 10.

(viii) In step three, the Commissioner calculates the PCT Payments due through Year 6 by applying the step two royalty rate to the actual divisional profits for each year and then determines the aggregate PV of these PCT Payments as of the CSA Start Date ($120 million as reported in the following table). In step four, the PCT Payments actually made through Year 6 are similarly converted to PV as of the CSA Start Date ($74 million) and subtracted from the amount determined in step three ($120 million − $74 million = $46 million). That difference of $46 million, representing a net PV as of the CSA Start Date, is then converted to a nominal amount, as of the Adjustment Year, of equivalent present value (again using a discount rate of 15%). That nominal amount is $93 million (not shown in the table), and is the periodic adjustment in Year 6.

a	b	c	d	e
Year	Divisional profit	Royalty rate	Nominal royalty due under adjusted RPSM (b*c)	Nominal payments made
Year 1	0	47.8%	$0	$40
Year 2	0	47.8	0	10
Year 3	0	47.8	0	10
Year 4	18	47.8	9	10
Year 5	118	47.8	56	10
Year 6	343	47.8	164	10
Cumulative PV as of Year 1			120	74

(ix) Under step five, the royalties due from FS to USP for Year 7 (the year after the Adjustment Year) through Year 9 (the year including the Determination Date) are determined. (These determinations are made for Years 8 and 9 after the divisional profit for those years becomes available.) For each year, the periodic adjustment is a PCT Payment due in addition to the $10 million PCT Payment that must otherwise be paid under the CSA as described in paragraph (i) of this *Example 1*. That periodic adjustment is calculated as the product of the step two royalty rate and the divisional profit, minus the $10 million that was otherwise paid for that year. The calculations are shown in the following table:

a	b	c	d	E	f
Year	Divisional profit	Royalty rate	Royalty due (b*c)	PCT payments otherwise paid	Periodic adjustment (d–e)
7	332	47.8%	$159	$10	$149
8	316	47.8	151	10	141
9	306	47.8	146	10	136

(x) Under step six, the periodic adjustment for Year 10 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to the divisional profit. This periodic adjustment is a PCT Payment payable from FS to USP, and is in lieu of the $10 payment otherwise due. The calculations are shown in the following table, based on a divisional profit of $291 million. USP and FS experienced the following results in Year 10.

Year	Divisional profit	Royalty rate	Royalty due	PCT payment called for under original agreement but not made	Periodic adjustment
10	291	47.8%	$139	$10 (not paid)	$139

Example 2. The facts are the same as *Example 1* (i) through (iii). At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 1.62. Upon further investigation as to what may have caused the high return in FS's market, the Commissioner learns that, in Years 4 through 6, USP's leading competitors experienced severe, unforeseen disruptions in their supply chains resulting in a significant increase in USP's and FS's market share for cell phones. Further analysis determines that without this unforeseen occurrence the Periodic Trigger would not have occurred. Based on paragraph (i)(6)(vi)(A)(*2*) of this section, the Commissioner determines to his satisfaction that no adjustments are warranted.

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

Term	Definition	Main cross references
Acquisition price		§ 1.482–7T(g)(5)(i).
Adjusted acquisition price		§ 1.482–7T(g)(5)(iii).
Adjusted average market capitalization		§ 1.482–7T(g)(6)(iv).
Adjusted benefit shares		§ 1.482–7T(i)(2)(ii)(A).
Adjusted RPSM		§ 1.482–7T(i)(6)(v)(B).

Term	Definition	Main cross references
Adjustment Year		§ 1.482–7T(i)(6)(i).
ADR		§ 1.482–7T(i)(6)(iv).
AERR		§ 1.482–7T(i)(6)(iii).
Applicable Method		§ 1.482–7T(g)(2)(ix)(A).
Average market capitalization		§ 1.482–7T(g)(6)(iii).
Benefits	*Benefits* means the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	§ 1.482–7T(e)(1)(i).
Capability variation		§ 1.482–7T(f)(3).
Change in participation under a CSA		§ 1.482–7T(f).
Consolidated group		§ 1.482–7T(j)(2)(i).
Contingent payments		§ 1.482–7T(h)(2)(i)(B).
Controlled participant	*Controlled participant* means a controlled taxpayer, as defined under § 1.482–1(i)(5), that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits, as defined in paragraph (e)(1)(i) of this section, from exploiting one or more cost shared intangibles.	§ 1.482–7T(a)(1).
Controlled transfer of interests		§ 1.482–7T(f)(2).
Cost contribution		§ 1.482–7T(d)(4).
Cost shared intangible	*Cost shared intangible* means any intangible, within the meaning of § 1.482–4(b), that is developed by the IDA, including any portion of such intangible that reflects a platform contribution. Therefore, an intangible developed by the IDA is a cost shared intangible even though the intangible was not always or was never a reasonably anticipated cost shared intangible.	§ 1.482–7T(b).
Cost sharing alternative		§ 1.482–7T(g)(4)(i)(B).
Cost sharing arrangement or CSA		§ 1.482–7T(a), (b).
Cost sharing transactions or CSTs		§ 1.482–7T(a)(1), (b)(1)(i).
Cross operating contributions	A *cross operating contribution* is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date that is reasonably anticipated to contribute to the CSA Activity within another controlled participant's division.	§ 1.482–7T(a)(3)(iii), (g)(2)(iv).
CSA Activity	*CSA Activity* is the activity of developing and exploiting cost shared intangibles.	§ 1.482–7T(c)(2)(i).
CSA Start Date	The earliest date that any IDC described in paragraph (d)(1) of this section occurred.	§ 1.482–7T(i)(6)(iii)(B).
CST Payments		§ 1.482–7T(b)(1).
Date of PCT		§ 1.482–7T(b)(3).
Determination Date		§ 1.482–7T(i)(6)(i).
Division	*Division* means the territory or other division that serves as the basis of the division of interests under the CSA in the cost shared intangibles pursuant to § 1.482–7T(b)(4).	See definitions of divisional profit or loss, operating contribution, and operating cost contribution.
Divisional interest		§ 1.482–7T(b)(1)(iii), (b)(4).
Divisional profit or loss	*Divisional profit or loss* means the operating profit or loss as separately earned by each controlled participant in its division from the CSA Activity, determined before any expense (including amortization) on account of cost contributions, operating cost contributions, routine platform and operating contributions, nonroutine contributions (including platform and operating contributions), and tax.	§ 1.482–7T(g)(4)(iii).
Fixed payments		§ 1.482–7T(h)(2)(i)(A).
IDC share		§ 1.482–7T(d)(4).
Input parameters		§ 1.482–7T(g)(2)(ix)(B).
Intangible development activity or IDA		§ 1.482–7T(d)(1).
Intangible development costs or IDCs		§ 1.482–7T(a)(1), (d)(1).
Licensing alternative		§ 1.482–7T(g)(4)(i)(C).
Licensing payments	*Licensing payments* means payments pursuant to the licensing obligations under the licensing alternative.	§ 1.482–7T(g)(4)(iii).

Term	Definition	Main cross references
Make-or-sell rights		§ 1.482–7T(c)(4), (g)(2)(iv).
Market-based input parameter		§ 1.482–7T(g)(2)(ix)(B).
Market returns for routine contributions	*Market returns for routine contributions* means returns determined by reference to the returns achieved by uncontrolled taxpayers engaged in activities similar to the relevant business activity in the controlled participant's division, consistent with the methods described in §§ 1.482–3, 1.482–4, 1.482–5, or § 1.482–9T(c).	§ 1.482–7T(g)(4), (g)(7).
Method payment form		§ 1.482–7T(h)(3).
Nonroutine contributions	*Nonroutine contributions* means a controlled participant's contributions to the relevant business activities that are not routine contributions. Nonroutine contributions ordinarily include both nonroutine platform contributions and nonroutine operating contributions used by controlled participants in the commercial exploitation of their interests in the cost shared intangibles (for example, marketing intangibles used by a controlled participant in its division to sell products that are based on the cost shared intangible).	§ 1.482–7T(g).
Nonroutine residual divisional profit or loss		§ 1.482–7T(g)(7)(iii).
Operating contributions	*An operating contribution* is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date that is reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482–7T(g)(2)(ii), (g)(4)(v)(E), (g)(7)(iii)(A) & (C).
Operating cost contributions	*Operating cost contributions* means all costs in the ordinary course of business on or after the CSA Start Date that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, developing resources, capabilities, or rights (other than reasonably anticipated cost shared intangibles) that are reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482–7T(g)(2)(ii), (g)(4)(iii), (g)(7)(iii)(B).
PCT Payee		§ 1.482–7T(b)(1)(ii).
PCT Payment		§ 1.482–7T(b)(1)(ii).
PCT Payor		§ 1.482–7T(b)(1)(ii), (i)(6)(i).
PCT Payor WACC		§ 1.482–7T(i)(6)(iv)(D).
Periodic adjustments		§ 1.482–7T(i)(6)(i).
Periodic Trigger		§ 1.482–7T(i)(6)(i).
Platform contribution transaction or PCT		§ 1.482–7T(a)(2), (b)(1)(ii).
Platform contributions		§ 1.482–7T(c)(1).
Post-tax income		§ 1.482–7T(g)(2)(v)(B)(*3*), (g)(4)(i)(G).
Pre-tax income		§ 1.482–7T(g)(2)(v)(B)(*3*), (g)(4)(i)(G).
Projected benefit shares		§ 1.482–7T(i)(2)(ii)(A).
PRRR		§ 1.482–7T(i)(6)(ii).
PVI		§ 1.482–7T(i)(6)(iii)(C).
PVTP		§ 1.482–7T(i)(6)(iii)(B).
Reasonably anticipated benefits	A controlled participant's *reasonably anticipated benefits* means the benefits that reasonably may be anticipated to be derived from exploiting cost shared intangibles. For purposes of this definition, benefits mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	§ 1.482–7T(e)(1).
Reasonably anticipated benefits or RAB shares		§ 1.482–7T(a)(1), (e)(1).
Reasonably anticipated cost shared intangible		§ 1.482–7T(d)(1)(ii).
Relevant business activity		§ 1.482–7T(g)(7)(i).

Term	Definition	Main cross references
Routine contributions	*Routine contributions* means a controlled participant's contributions to the relevant business activities that are of the same or similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled participants.	§ 1.482–7T(g)(4), (g)(7).
Routine platform and operating contributions, and net routine platform and operating contributions.		§ 1.482–7T(g)(4)(vi), 1.482–7(g)(7)(iii)(C)(*4*).
Specified payment form		§ 1.482–7T(h)(3).
Stock-based compensation		§ 1.482–7T(d)(3).
Stock options		§ 1.482–7T(d)(3)(i).
Subsequent PCT		§ 1.482–7T(g)(2)(viii).
Target		§ 1.482–7T(g)(5)(i).
Trigger PCT		§ 1.482–7T(i)(6)(i).
Variable input parameter		§ 1.482–7T(g)(2)(ix)(C).
WACC	*WACC* means weighted average cost of capital.	§ 1.482–7T(i)(6)(iv)(D).

(ii) *Examples.* The following examples illustrate certain definitions in paragraph (j)(1)(i) of this section:

Example 1. Controlled participant. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a CSA with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The CSA provides that USS will receive the rights to exploit the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to exploit this process in the United States, USS is not a controlled participant because it will not derive a benefit from exploiting the intangible developed under the CSA.

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

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (j)(1)(i) of this section, because it will not derive any benefits from exploiting cost shared intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of paragraph (a)(3) of this section and §§ 1.482–4(f)(3)(iii), 1.482–4T(f)(4), and 1.482–9T, as appropriate. Such consideration must be treated as IDCs incurred by USP and FS in proportion to their RAB shares (that is, 66⅔% and 33⅓%, respectively). R+D will not be considered to bear any share of the IDCs under the arrangement.

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

Example 4. Cost shared intangible. The facts are the same as in Example 3, except that in the course of developing XYZ, the controlled participants by accident discover ABC, a cure for disease D. ABC is a cost shared intangible under the CSA.

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

(2) *Special rules*—(i) *Consolidated group.* For purposes of this section, all members of the same consolidated group shall be treated as one taxpayer. For these purposes, the term *consolidated group* means all members of a group of controlled entities created

or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

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

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

(3) *Character*—(i) *CST Payments.* CST Payments generally will be considered the payor's costs of developing intangibles at the location where such development is conducted. For these purposes, IDCs borne directly by a controlled participant that are deductible are deemed to be reduced to the extent of any CST Payments owed to it by other controlled participants pursuant to the CSA. Each cost sharing payment received by a payee will be treated as coming pro rata from payments made by all payors and will be applied pro rata against the deductions for the taxable year that the payee is allowed in connection with the IDCs. Payments received in excess of such deductions will be treated as in consideration for use of the land and tangible property furnished for purposes of the CSA by the payee. For purposes of the research credit determined under section 41, CST Payments among controlled participants will be treated as provided for intra-group transactions in § 1.41–6(i). Any payment made or received by a taxpayer pursuant to an arrangement that the Commissioner determines not to be a CSA will be subject to the provisions of §§ 1.482–1, 1.482–4 through 1.482–6 and 1.482–9T. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(ii) *PCT Payments.* A PCT Payor's payment required under paragraph (b)(1)(ii) of this section is deemed to be reduced to the extent of any payments owed to it under such paragraph from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors. PCT Payments will be characterized consistently with the designation of the type of transaction pursuant to paragraphs (c)(3) and (k)(2)(ii)(H) of this section. Depending on such designation, such payments will be treated as either consideration for a transfer of an interest in intangible property or for services.

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

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

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

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

[All amounts stated in X's]

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

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

(k) *CSA administrative requirements.* A controlled participant meets the requirements of this paragraph if it substantially complies, respectively, with the CSA contractual, documentation, accounting, and reporting requirements of paragraphs (k)(1), (k)(2), (k)(3), and (k)(4) of this section.

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

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

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

(B) Describe the scope of the IDA to be undertaken and each reasonably anticipated cost shared intangible or class of reasonably anticipated cost shared intangibles;

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

(D) Divide among the controlled participants all divisional interests in cost shared intangibles and specify each controlled participant's divisional interest in the cost shared intangibles, as described in paragraphs (b)(1)(iii) and (b)(4) of this section, that it will own and exploit without any further obligation to compensate any other controlled participant for such interest;

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

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

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

(H) Require the controlled participant to enter into CSTs covering all IDCs, as described in paragraph (b)(1)(i) of this section, in connection with the CSA;

(I) Require the controlled participants to enter into PCTs covering all platform contributions, as described in paragraph (b)(1)(ii) of this section, in connection with the CSA;

(J) Specify the form of payment due under each PCT (or group of PCTs) in existence at the formation (and any revision) of the CSA, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (h) of this section; and

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

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

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

Example. Companies A and B, both of which are members of the same controlled group, commence an IDA on March 1, Year 1. Company A pays the first IDCs in relation to the IDA, as cash salaries to A's research staff, for the staff's work during the first week of March, Year 1. A and B, however, do not sign and date any written contractual agreement until August 1, Year 1, whereupon they execute a "Cost Sharing Agreement" that purports to be "effective as of" March 1 of Year 1. The arrangement fails the requirement that the participants record their arrangement in a written contractual agreement that is contemporaneous with the formation of a CSA. The arrangement has failed to meet the requirements set forth in paragraph (b)(2) of this section and, pursuant to paragraph (b) of this section, cannot be a CSA.

(iv) *Interpretation of contractual provisions*—(A) *In general*. The provisions of a written contract described in this paragraph (k)(1) and of the additional documentation described in paragraph (k)(2) of this section must be clear and unambiguous. The provisions will be interpreted by reference to the economic substance of the transaction and the actual conduct of the controlled participants. See § 1.482–1(d)(3)(ii)(B) (discussing interpretation of contractual terms in assessing the comparability of controlled and uncontrolled transactions). Accordingly, the Commissioner may impute contractual terms in a CSA consistent with the economic substance of the CSA and may disregard contractual terms that lack economic substance. An allocation of risk between controlled participants after the outcome of such risk is known or reasonably knowable lacks economic substance. See § 1.482–1(d)(3)(iii)(B). A contractual term that is disregarded due to a lack of economic substance does not satisfy a contractual requirement set forth in this paragraph (k)(1) or documentation requirement set forth in paragraph (k)(2) of this section. See paragraph (b)(5) of this section for the treatment of an arrangement among controlled taxpayers that fails to comply with the requirements of this section.

(B) *Examples*. The following examples illustrate the principles of this paragraph (k)(1)(iv). In each example, it is assumed that the Commissioner will exercise the discretion granted pursuant to paragraph (b)(5)(ii) of this section to apply the provisions of this section to the arrangement that purports to be a CSA.

Example 1. The contractual provisions recorded upon formation of an arrangement that purports to be a CSA provide that PCT payments with respect to a particular external contribution will consist of payments contingent on sales. Contrary to the contractual provisions, the PCT payments actually made are contingent on profits. Because the controlled participants' actual conduct is different from the contractual terms, the Commissioner may determine, based on the facts and circumstances, that—

(i) The actual payments have economic substance and, therefore, impute payment terms in the CSA consistent with the actual payments; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

Example 2. An arrangement that purports to be a CSA provides that PCT payments with respect to a particular external contribution shall be contingent payments equal to 10% of sales of products that incorporate cost shared intangibles. The contract terms further provide that the controlled participants must adjust such contingent payments in accordance with a formula set forth in the terms. During the first three years of the arrangement, the controlled participants fail to make the adjustments required by the terms with respect to the PCT payments. The Commissioner may determine, based on the facts and circumstances, that—

(i) The contingent payment terms with respect to the external contribution do not have economic substance because the controlled participants did not act in accordance with their upfront risk allocation; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

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

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

(A) Describe the current scope of the IDA and identify—

(*1*) Any additions or subtractions from the list of reasonably anticipated cost shared intangibles reported pursuant to paragraph (k)(1)(ii)(B) of this section;

(*2*) Any cost shared intangible, together with each controlled participant's interest therein; and

(*3*) Any further development of intangibles already developed under the CSA or of specified applications of such intangibles which has been removed from the IDA (see paragraphs (d)(1)(ii) and (j)(1)(i) of this section (definitions of reasonably anticipated cost shared intangible, cost shared intangible)) and the steps (including any accounting classifications and allocations) taken to implement such removal.

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

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

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

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

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

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

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

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

(G) Describe all platform contributions;

(H) Designate the type of transaction involved for each PCT or group of PCTs;

(I) Specify, within the time period provided in paragraph (h)(2)(iii) of this section, the form of payment due under each PCT or group of PCTs, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (h) of this section;

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

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

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

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

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

(*5*) The discount rate or rates, where applicable, used for purposes of evaluating PCT Payments, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (g)(2)(v) of this section;

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

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

(*8*) The method payment form and any conversion made from the method payment form to the specified payment form, as described in paragraph (h)(3) of this section; and

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

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

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

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

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

(B) Permit verification that the amount of any contingent PCT Payments due have been (and are being) properly determined;

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

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

(ii) *Reliance on financial accounting*. For purposes of this section, the controlled participants may not rely solely upon financial accounting to establish satisfaction of the accounting requirements of this paragraph (k)(4) of this section. Rather, the method of accounting must clearly reflect income. *Thor Power Tools Co.* v. *Commissioner*, 439 U.S. 522 (1979).

(4) *CSA reporting requirements*—(i) *CSA Statement*. Each controlled participant must file with the Internal Revenue Service, in the manner described in this paragraph (k)(4), a ''Statement of Controlled Participant to § 1.482–7T Cost Sharing Arrangement'' (CSA Statement) that complies with the requirements of this paragraph (k)(5).

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

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

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

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

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

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

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

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

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

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

Example 1. A and B, both of which file U.S. tax returns, agree to share the costs of developing a new chemical formula in accordance with the provisions of this section. On March 30, Year 1, A and B record their agreement in a written contract styled, ''Cost Sharing Agreement.'' The contract applies by its terms to IDCs occurring after March 1, Year 1. The first IDCs to which the CSA applies occurred on March 15, Year 1. To comply with paragraph (k)(4)(iii)(A) of this section, A and B individually must file separate CSA Statements no later than 90 days after March 15, Year 1 (June 13, Year 1). Further, to comply with paragraph (k)(4)(iii)(B) of this section, A and B must attach copies of their respective CSA Statements to their respective Year 1 U.S. income tax returns.

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

(l) *Effective/applicability date*. This section applies on January 5, 2009.

(m) *Transition rule*—(1) *In general*. An arrangement in existence on January 5, 2009 will be considered a CSA, as described under paragraph (b) of this section, if, prior to such date, it was a qualified cost sharing arrangement under the provisions of § 1.482–7 (as contained in the 26 CFR part 1 edition revised as of January 1, 1996, hereafter referred to as ''former § 1.482–7''), but only if the written contract, as described in paragraph (k)(1) of this section, is amended, if necessary, to conform with, and only if the activities of the controlled participants substantially comply with, the provisions of this section, as modified by paragraphs (m)(2) and (m)(3) of this section, by July 6, 2009.

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

(i) CSTs and PCTs occurring prior to January 5, 2009 shall be subject to the provisions of former § 1.482–7 rather than this section.

(ii) Except to the extent provided in paragraph (m)(3) of this section, PCTs that occur under a CSA that was a qualified cost sharing arrangement under the provisions of former § 1.482–7 and remained in effect on January 5, 2009, shall be subject to the periodic adjustment rules of § 1.482–4(f)(2) rather than the rules of paragraph (i)(6) of this section.

(iii) Paragraphs (b)(1)(iii) and (b)(4) of this section shall not apply.

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

(v) Paragraphs (k)(1)(ii)(H) and (k)(1)(ii)(I) of this section shall be construed as applying only to transactions entered into on or after January 5, 2009.

(vi) The deadline for recordation of the revised written contractual agreement pursuant to paragraph (k)(1)(iii) of this section shall be no later than July 6, 2009.

(vii) Paragraphs (k)(2)(ii)(G) through (J) of this section shall be construed as applying only with reference to PCTs entered into on or after January 5, 2009.

(viii) Paragraph (k)(4)(iii)(A) of this section shall be construed as requiring a CSA Statement with respect to the revised written contractual agreement described in paragraph (m)(3)(vi) of this section no later than September 2, 2009.

(ix) Paragraph (k)(4)(iii)(B) of this section shall be construed as only applying for taxable years ending after the filing of the CSA Statement described in paragraph (m)(2)(viii) of this section.

(3) *Special rule for certain periodic adjustments*. The periodic adjustment rules in paragraph (i)(6) of this section (rather than the rules of § 1.482–4(f)(2)) shall apply to PCTs that occur on or after the date of a material change in the scope of the CSA from its scope as of January 5, 2009. A material change in scope would include a material expansion of the activities undertaken beyond the scope of the intangible development area, as described in former § 1.482–7(b)(4)(iv). For this purpose, a contraction of the scope of a CSA, absent a material expansion into one or more lines of research and development beyond the scope of the intangible development area, does not constitute a material change in scope of the CSA. Whether a material change in scope has occurred is determined on a cumulative basis. Therefore, a series of expansions, any one of which is not a material expansion by itself, may collectively constitute a material expansion.

(n) *Expiration date*. The applicability of this section expires on or before December 30, 2011.

■ **Par. 13.** Section 1.482–8 is amended by revising paragraph (b) *Examples 10, 11*, and *12* and adding *Examples 13, 14, 15, 16, 17* and *18* at the end of paragraph (b) to read as follows:

§ 1.482–8 Examples of the best method rule.

* * * * *

(b) * * *

Examples 10 through *18*. [Reserved]. For further guidance, see § 1.482–8T(b) *Examples 10* through *18*.

■ **Par. 14.** Section 1.482–8T is amended by:

■ 1. Adding *Examples 13, 14, 15, 16, 17* and *18* at the end of paragraph (b).

■ 2. Revising paragraph (c).

The additions and revision reads as follows:

§ 1.482–8T Examples of the best method rule (temporary).

* * * * *

(b) * * *

Example 13. Preference for acquisition price method. (i) USP develops, manufacturers, and distributes pharmaceutical products. USP and FS, USP's wholly-owned subsidiary, enter into a CSA to develop a new oncological drug, Oncol. Immediately prior to entering into the CSA, USP acquires Company X, an unrelated U.S. pharmaceutical company. Company X is solely engaged in oncological pharmaceutical research, and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound X, a promising molecular compound derived from a rare plant, which USP reasonably anticipates will contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol as well. The rights in the Compound X and the commitment of Company X's researchers to the development of Oncol are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, the acquisition price method, based on the lump sum price paid by USP for Company X, is likely to provide a more reliable measure of an arm's length PCT Payment due to USP than the application of any other method. See §§ 1.482–4(c)(2) and 1.482–7T(g)(5)(iv)(A).

Example 14. Preference for market capitalization method. (i) Company X is a publicly traded U.S. company solely engaged in oncological pharmaceutical research and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound Y, a promising molecular compound derived from a rare plant. Company X has no marketable products. Company X enters into a CSA with FS, a newly-formed foreign subsidiary, to develop a new oncological drug, Oncol, derived from Compound Y. Compound Y is reasonably anticipated to contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol under the CSA. The rights in Compound Y and the commitment of Company X's researchers are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, given that Company X's platform contributions covered by PCTs relate to its entire economic value, the application of the market capitalization method, based on the market capitalization of Company X, provides a reliable measure of an arm's length result for Company X's PCTs to the CSA. See §§ 1.482–4(c)(2) and 1.482–7T(g)(6)(v)(A).

Example 15. Preference for market capitalization method. (i) MicroDent, Inc. (MDI) is a publicly traded company that developed a new dental surgical microscope ScopeX–1, which drastically shortens many surgical procedures. On January 1 of Year 1, MDI entered into a CSA with a wholly-owned foreign subsidiary (FS) to develop ScopeX–2, the next generation of ScopeX–1. In the CSA, divisional interests are divided on a territorial basis. The rights associated with ScopeX–1, as well as MDI's research capabilities are reasonably anticipated to contribute to the development of ScopeX–2 and are therefore platform contributions for which compensation is due from FS as part of a PCT. At the time of the PCT, MDI's only product was the ScopeX–1 microscope, although MDI was in the process of developing ScopeX–2. Concurrent with the CSA, MDI separately transfers exclusive and perpetual exploitation rights associated with ScopeX–1 to FS in the same territory as assigned to FS in the CSA.

(ii) Although the transactions between MDI and FS under the CSA are distinct from the transactions between MDI and FS relating to the exploitation rights for ScopeX–1, it is likely to be more reliable to evaluate the combined effect of the transactions than to evaluate them in isolation. This is because the combined transactions between MDI and FS relate to all of the economic value of MDI (that is, the exploitation rights and research rights associated with ScopeX–1, as well as the research capabilities of MDI). In this case, application of the market capitalization method, based on the enterprise value of MDI on January 1 of Year 1, is likely to provides a reliable measure of an arm's length payment for the aggregated transactions. See §§ 1.482–4(c)(2) and 1.482–7T(g)(6)(v)(A).

(iii) Notwithstanding that the market capitalization method provides the most reliable measure of the aggregated transactions between MDI and FS, see § 1.482–7T(g)(2)(iv) for further considerations of when further analysis may be required to distinguish between the remuneration to MDI associated with PCTs under the CSA (for research rights and capabilities associated with ScopeX–1) and the remuneration to MDI for the exploitation rights associated with ScopeX–1.

Example 16. Income method (applied using CPM) preferred to acquisition price method. The facts are the same as *Example 13*, except that the acquisition occurred significantly in advance of formation of the CSA, and reliable adjustments cannot be made for this time difference. In addition, Company X has other valuable molecular patents and associated research capabilities, apart from Compound X, that are not reasonably anticipated to contribute to the development of Oncol and that cannot be reliably valued. The CSA divides divisional interests on a territorial basis. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. FS does not furnish any platform contributions. At the time of the PCT, reliable (ex ante) financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken. In this case, application of the income method using CPM is likely to provide a more reliable measure of an arm's length result than application of the acquisition price method based on the price paid by USP for Company X. See § 1.482–7T(g)(4)(v) and (g)(5)(iv)(C).

Example 17. Evaluation of alternative methods. (i) The facts are the same as *Example 13*, except that the acquisition occurred sometime prior to the CSA, and Company X has some areas of promising research that are not reasonably anticipated to contribute to developing Oncol. For purposes of this example, the CSA is assumed to divide divisional interests on a territorial basis. In general, the Commissioner determines that the acquisition price data is useful in informing the arm's length price, but not necessarily determinative. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. At the time of the PCT, financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken.

(ii) Under the facts, it is possible that the acquisition price method or the income method using CPM might reasonably be applied. Whether the acquisition price method or the income method provides the most reliable evidence of the arm's length price of USP's contributions depends on a number of factors, including the reliability of the financial projections, the reliability of the discount rate chosen, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the in-process research done by Company X that does not constitute platform contributions to the CSA. See § 1.482–7T(g)(4)(v) and (g)(5)(iv)(A) and (C).

Example 18. Evaluation of alternative methods. (i) The facts are the same as *Example 17*, except that FS has a patent on Compound Y, which the parties reasonably anticipate will be useful in mitigating potential side effects associated with Compound X and thereby contribute to the development of Oncol. The rights in Compound Y constitute a platform contribution for which compensation is due from USP as part of a PCT. The value of FS's platform contribution cannot be reliably measured by market benchmarks.

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

(iii) Whether the acquisition price method together with the income method or the residual profit split method provides the most reliable evidence of the arm's length price of the platform contributions of USP and FS depends on a number of factors, including the reliability of the determination of the relative values of the platform contributions for purposes of the RPSM, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the rights in the in-process research done by Company X that does not constitute platform contributions to the CSA. In these circumstances, it is also relevant to consider whether the results of each method are consistent with each other, or whether one or both methods are consistent with other potential methods that could be applied. See § 1.482–7T(g)(4)(v), (g)(5)(iv), and (g)(7)(iv).

(c) *Effective/applicability date*—(1) *In general.* Paragraphs (a) and (b) *Examples 10* through *12* of this section are generally applicable for taxable years beginning after December 31, 2006. Paragraph (b) *Examples 13* through *18* of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) *Examples 10* through *12* of this section to earlier taxable years in accordance with rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of paragraphs (a) and (b) *Examples 10* through *12* of this section expires on or before July 31, 2009. The applicability of paragraph (b) *Examples 13* through *18* of this section expires on or before December 30, 2011.

■ **Par. 15.** Section 1.482–9T is amended by revising paragraph (m)(3), the heading for paragraph (n) and paragraph (n)(3) to read as follows:

§ 1.482–9T Methods to determine taxable income in connection with a controlled services transaction (temporary).

* * * * *

(m) * * *

(3) *Coordination with rules governing cost sharing arrangements.* Section 1.482–7T provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a controlled service transaction, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482–7T. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482–7T is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

* * * * *

(n) *Effective/applicability dates.* * * *

(3) *Expiration dates.* The applicability of this section expires on July 31, 2009, except paragraph (m)(3) of this section, which expires on December 30, 2011.

■ **Par. 16.** Section 1.861–17 is amended by revising paragraph (c)(3)(iv) to read as follows:

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

* * * * *

(c) * * *

(3) * * *

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

* * * * *

■ **Par. 17.** Section 1.6662–6 is amended by:

■ 1. Removing the third and fourth sentences from paragraph (d)(2)(i).

■ 2. Adding a new paragraph (d)(2)(iii)(D).

The addition reads as follows:

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

* * * * *

(d) * * *

(2) * * *

(iii) * * *

(D) Satisfaction of the documentation requirements described in § 1.482–7T(k)(2) for the purpose of complying with the rules for CSAs under § 1.482–7T also satisfies all of the documentation requirements listed in paragraph (d)(2)(iii)(B) of this section, except the requirements listed in paragraphs (d)(2)(iii)(B)(*2*) and (*10*) of this section, with respect to CSTs and PCTs described in § 1.482–7T(b)(1)(i) and (ii), provided that the documentation also satisfies the requirements of paragraph (d)(2)(iii)(A) of this section.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

■ **Par. 18.** The authority citation for part 301 continues to read in part as follows:

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

■ **Par. 19.** Section 301.7701–1 is amended by revising paragraphs (c) and (f) to read as follows:

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

* * * * *

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

* * * * *

(f) *Effective/applicability dates.* Except as provided in the following sentence, the rules of this section are applicable as of January 1, 1997. The rules of paragraph (c) of this section are applicable on January 5, 2009.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 20.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 21.** In § 602.101, paragraph (b) is amended by adding the following entry in numerical order to the table:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control no.
* * * * * * *	
1.482–7T	1545–1364
* * * * * * *	

L.E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2008.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

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