DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9569]

RIN 1545–BK72

Use of Differential Income Stream as a Consideration in Assessing the Best Method

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that implement the use of the differential income stream as a consideration in assessing the best method in connection with a cost sharing arrangement. The text of these temporary regulations also serves as part of the text of proposed regulations contained in a cross-reference notice of proposed rulemaking (REG–145474–11) published in the Proposed Rules section in this issue of the **Federal Register**. This document also contains final regulations that provide cross-references in the final cost sharing regulations to relevant sections of these temporary regulations.

DATES: *Effective Date:* These regulations are effective December 19, 2011.

Applicability Dates: For dates of applicability, see § 1.482–7T(l).

FOR FURTHER INFORMATION CONTACT: Joseph L. Tobin or Mumal R. Hemrajani, (202) 435–5265 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

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) (REG–144615–02) on August 29, 2005 (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 numerous comments on a wide range of issues addressed in the 2005 proposed regulations. In response to these comments, temporary and proposed regulations were published in the **Federal Register** (74 FR 340–01 and 74 FR 236–01) (REG–144615–02) on January 5, 2009 (2008 temporary regulations). Corrections to the 2008 temporary regulations were published in the **Federal Register** on February 27, 2009 (74 FR 8863–01), March 5, 2009 (74 FR 9570–01, 74 FR 9570–02, and 74 FR 9577–01), and March 19, 2009 (74 FR 11644–01). A public hearing was held on April 21, 2009.

The Treasury Department and the IRS received comments on a range of issues addressed in the 2008 temporary regulations. Final regulations were issued in a previous issue of the **Federal Register** (REG–144615–02) (TD 9568) in December 2011 (''final regulations''). Certain guidance regarding discount rates was reserved in the final regulations because the Treasury Department and the IRS believe it is appropriate to solicit public comments on that subject matter. As explained herein, these temporary regulations provide a portion of that reserved guidance on discount rates. Simultaneous with these temporary regulations, the other portion of such reserved guidance concerning discount rates is being provided in proposed regulations elsewhere in this issue of the **Federal Register** (proposed regulations).

Explanation of Provisions

The Treasury Department and the IRS are aware that some taxpayers are taking unreasonable positions in applying the income method by using relatively low licensing discount rates, and relatively high cost sharing discount rates, without sufficiently considering the appropriate interrelationship of the discount rates and financial projections, thus deriving PCT Payments that are not in accordance with the arm's length standard.

In light of these concerns, the Treasury Department and the IRS are providing additional guidance as follows: (1) In the final regulations, further guidance on comparing the financial projections associated with the cost sharing alternative discounted at the rate appropriate for the cost sharing alternative with the financial projections associated with the licensing alternative discounted at the rate appropriate for the licensing alternative, and evaluating reliability considerations associated with such a comparison (§ 1.482–7(g)(4)(vi)(F)(*1*) (Reflection of similar risk profiles in cost sharing alternative and licensing alternative)); (2) in these temporary regulations, further guidance on evaluating results of application of the income method (§ 1.482–7T(g)(2)(v)(B)(*2*) (Implied discount rates) and (4)(vi)(F)(*2*) (Use of differential income stream as a consideration in assessing the best method)); and (3) in proposed regulations, a new specified application of the income method for directly determining the arm's length charge for PCT Payments (§ 1.482–7(g)(4)(v) (Application of income method using differential income stream)).

As discussed in the Preamble to the final regulations, any difference, if any, in market-correlated risks between the licensing and cost sharing alternatives is due solely to the different effects on risks of the PCT Payor's making licensing payments under the licensing alternative on the one hand, and the PCT Payor's making cost contributions and PCT Payments under the cost sharing alternative on the other hand. Thus, the difference in risk between the two scenarios should reflect solely (1) the incremental risk, if any, associated with the cost contributions taken on by the PCT Payor in developing cost shared intangibles under the cost sharing alternative, and (2) any difference in risk associated with the particular payment forms of the licensing payments and the PCT Payments, in light of the fact that the licensing payments in the licensing alternative are partially replaced by cost contributions and partially replaced by PCT Payments in the cost sharing alternative, each with its own payment form. Accordingly, the final regulations added § 1.482–7(g)(4)(vi)(F)(*1*) (Reflection of similar risk profiles in cost sharing alternative and licensing alternative), which provides that an analysis under the income method that uses a different discount rate for the cost sharing alternative than the licensing alternative will be more reliable the greater the extent to which any difference between the two discount rates reflects solely those differences in risk profiles of these two alternatives.

These temporary regulations build upon § 1.482–7(g)(4)(vi)(F)(*1*) of the final regulations by providing additional guidance relating to analysis of the interrelationship between the discount rate for the cost sharing alternative and the discount rate for the licensing alternative, and evaluation of the reasonableness of the implied discount rate that may be derived from the differential income stream between the licensing alternative and the cost sharing alternative. The differential income stream is the difference between the PCT Payor's undiscounted operating income under the cost sharing alternative (before PCT Payments) and the PCT Payor's undiscounted operating income under the licensing alternative. This difference equals the licensing payments to be made under the licensing alternative minus the PCT

Payor's cost contributions to be made under the cost sharing alternative. The differential income stream should be discounted at an appropriate rate in order to evaluate the reliability of a determination of the arm's length charge for the PCT Payment. Accordingly, these temporary regulations add § 1.482–7T(g)(4)(vi)(F)(*2*), which provides that an analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream (such as those of the uncontrolled companies described in § 1.482–7T(g)(4)(viii) *Example 8*). The Treasury Department and the IRS have added § 1.482–7T(g)(4)(viii) *Example 8* to illustrate how § 1.482–7T(g)(4)(vi)(F)(*2*) may be used to evaluate the reliability of a particular application of the income method.

The Treasury Department and the IRS are also proposing a new specified application of the income method in § 1.482–7(g)(4)(v), which provides that the determination of the arm's length charge for the PCT Payment can be derived by discounting the differential income stream at an appropriate rate. The differential income stream approach to determining PCT Payments depends on reliably determining the discount rate associated with the differential income stream. This, in turn, requires an understanding of the economic meaning of the differential income stream. For example, assume a CSA in which the PCT Payor does not contribute any platform or operating contributions, and undertakes only routine exploitation activities for which it anticipates a routine return. In such case, the total undiscounted anticipated profits (before PCT Payments) to the CSA in the PCT Payor's territory can be thought of as comprising the anticipated routine exploitation profits plus the anticipated profits associated with the development of the cost shared intangibles in the PCT Payor's territory. Under the licensing alternative, on the other hand, the PCT Payor's total undiscounted anticipated profits consist solely of the anticipated routine exploitation profits. Thus, the differential income stream conceptually corresponds to the anticipated development profits of the cost shared intangibles. For these reasons, an appropriate discount rate for the differential income stream might be determined based, for example, on the weighted average cost of capital of uncontrolled companies whose activities consist primarily of developing intangibles similar to the cost shared intangibles, and whose resources, capabilities, or rights are similar to the platform contributions and cost shared intangibles under the CSA. The proposed regulations also add § 1.482–7(g)(4)(viii) *Example 9* to illustrate this newly specified application of the income method.

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 that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration (CCASBA) for comment on their impact on small business. CCASBA had no comments.

Drafting Information

The principal authors of these regulations are Joseph L. Tobin and Mumal R. Hemrajani, Office of the Associate Chief Counsel (International). However, other personnel from the Internal Revenue Service and the Treasury Department participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Sections 1.482–7 and 1.482–7T also issued under 26 U.S.C. 482. * * *

■ **Par. 2.** Section 1.482–7 is amended by revising paragraphs (g)(2)(v)(B)(*2*) and (g)(4)(vi)(F)(*2*), and adding Example 8 to paragraph (g)(4)(viii), to read as follows:

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

* * * * *

(g) * * *

(2) * * *

(v) * * *

(B) * * *

(*2*) [Reserved]. For further guidance, see § 1.482–7T(g)(2)(v)(B)(*2*).

* * * * *

(4) * * *

(vi) * * *

(F) * * *

(*2*) [Reserved]. For further guidance, see § 1.482–7T(g)(4)(vi)(F)(*2*).

* * * * *

(viii) * * *

Example 8. [Reserved]. For further guidance, see § 1.482–7T(g)(4)(viii), *Example 8.*

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■ **Par. 3.** 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) through (g)(2)(v)(B)(*1*) [Reserved]. For further guidance, see § 1.482–7(a) through (g)(2)(v)(B)(*1*).

(*2*) *Implied discount rates.* In some circumstances, the particular discount rate or rates used for certain activities or transactions logically imply that certain other activities will have a particular discount rate or set of rates (implied discount rates). To the extent that an implied discount rate is inappropriate in light of the facts and circumstances, which may include reliable direct evidence of the appropriate discount rate applicable for such other activities, the reliability of any method is reduced where such method is based on the discount rates from which such an inappropriate implied discount rate is derived. See paragraphs (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* of this section.

(g)(2)(v)(B)(*3*) through (g)(4)(vi)(F)(*1*) [Reserved]. For further guidance, see § 1.482–7(g)(2)(v)(B)(*3*) through (g)(4)(vi)(F)(*1*).

(*2*) *Use of differential income stream as a consideration in assessing the best method.* An analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream. Such differential income stream is defined as the stream of the reasonably anticipated residuals of the PCT Payor's licensing payments to be made under the licensing alternative, minus the PCT Payor's cost contributions to be made under the cost sharing alternative. See, for example, *Example 8* of this paragraph (g)(4)(viii).

(g)(4)(vii) through (viii) (*Example 7*) [Reserved]. For further guidance, see § 1.482–7(g)(4)(vii) through (g)(4)(viii) (*Example 7*).

(viii) Example 8. (i) The facts are the same as in *Example 1,* except that the taxpayer determines that the appropriate discount rate for the cost sharing alternative is 20%. In addition, the taxpayer determines that the appropriate discount rate for the licensing alternative is 10%. Accordingly, the taxpayer determines that the appropriate present value of the PCT Payment is $146 million.

(ii) Based on the best method analysis described in *Example 2,* the Commissioner determines that the taxpayer's calculation of the present value of the PCT Payments is outside of the interquartile range (as shown in the sixth column of *Example 2*), and thus warrants an adjustment. Furthermore, in evaluating the taxpayer's analysis, the Commissioner undertakes an analysis based on the difference in the financial projections between the cost sharing and licensing alternatives (as shown in column 11 of *Example 1*). This column shows the anticipated differential income stream of additional positive or negative income for FS over the duration of the CSA Activity that would result from undertaking the cost sharing alternative (before any PCT Payments) rather than the licensing alternative. This anticipated differential income stream thus reflects the anticipated incremental undiscounted profits to FS from the incremental activity of undertaking the risk of developing the cost shared intangibles and enjoying the value of its divisional interests. Taxpayer's analysis logically implies that the present value of this stream must be $146 million, since only then would FS have the same anticipated value in both the cost sharing and licensing alternatives. A present value of $146 million implies that the discount rate applicable to this stream is 34.4%. Based on a reliable calculation of discount rates applicable to the anticipated income streams of uncontrolled companies whose resources, capabilities, and rights consist primarily of software applications intangibles and research and development teams similar to USP's platform contributions to the CSA, and which income streams, accordingly, may be reasonably anticipated to reflect a similar risk profile to the differential income stream, the Commissioner concludes that an appropriate discount rate for the anticipated income stream associated with USP's platform contributions (that is, the additional positive or negative income over the duration of the CSA Activity that would result, before PCT Payments, from switching from the licensing alternative to the cost sharing alternative) is 16%, which is significantly less than 34.4%. This conclusion further suggests that Taxpayer's analysis is unreliable. See paragraphs (g)(2)(v)(B)(*2*) and (4)(vi)(F)(*1*) and (*2*) of this section.

(iii) The Commissioner makes an adjustment of $296 million, so that the present value of the PCT Payments is $442 million (the median results as shown in column 6 of *Example 2*).

(g)(5) through (k) [Reserved]. For further guidance, see § 1.482–7(g)(5) through (k).

(l) *Effective/Applicability Date.* Treas. Reg. § 1.482–7T(g)(2)(v)(B)(*2*), (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* apply to taxable years beginning on or after December 19, 2011.

(m) [Reserved]. For further guidance, see § 1.482–7(m).

(n) *Expiration date.* The applicability of this section expires on December 19, 2014.

Steven T. Miller,

Deputy Commissioner for Services and Enforcement.

Approved: December 8, 2011.

Emily S. McMahon,

Acting Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 165

[Docket No. USCG–2011–1142]

RIN 1625–AA87

Security Zone; On the Waters in Kailua Bay, Oahu, HI

AGENCY: Coast Guard, DHS.

ACTION: Temporary final rule.

SUMMARY: The Coast Guard is establishing a temporary security zone on the waters south of Kapoho Point and a nearby channel in Kailua Bay within the Honolulu Captain of the Port (COTP) Zone. This security zone is necessary to ensure the safety of the President of the United States and his family members.

DATES: This rule is effective from 6 a.m. (HST) on December 21, 2011, through 8 p.m. (HST) on January 7, 2012.

ADDRESSES: Documents indicated in this preamble as being available in the docket USCG–2011–1142 are available online by going to *www.regulations.gov,* inserting USCG–2011–1142 in the ''Keyword'' box, and then clicking ''Search''. They are also available for inspection or copying at the Docket Management Facility (M–30), U.S. Department of Transportation, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary rule, call or email Lieutenant Commander Scott O. Whaley, Waterways Management Division, U.S. Coast Guard Sector Honolulu; telephone (808) 522–8264 (ext. 352), email *Scott.O.Whaley@uscg.mil.* If you have questions on viewing the docket, call Renee V. Wright, Program Manager, Docket Operations, telephone (202) 366–9826.

SUPPLEMENTARY INFORMATION:

Regulatory Information

The Coast Guard is issuing this temporary final rule without prior notice and opportunity to comment pursuant to authority under section 4(a) of the Administrative Procedure Act (APA) (5 U.S.C. 553(b)). This provision authorizes an agency to issue a rule without prior notice and opportunity to comment when the agency, for good cause, finds that those procedures are ''impracticable, unnecessary, or contrary to the public interest.'' Under 5 U.S.C. 553(d)(3), the Coast Guard finds good cause exists for making this rule effective less than 30 days after publication in the **Federal Register**. The details of the President's intended travel to Hawaii were not made available to the Coast Guard in sufficient time to issue a notice of proposed rulemaking. Due to the need for immediate action, the restriction of vessel traffic is necessary to protect the President and his family members; therefore, a 30-day notice period is impracticable. Delaying the effective date would be contrary to the security zone's intended objectives of protecting high-ranking officials, mitigating potential terroristic acts and enhancing public and maritime safety and security. Publishing a Notice of Public Rule Making (NPRM) and delaying the effective date would be contrary to the public interest since the occasion would occur before a notice-and-comment rulemaking could be completed, thereby jeopardizing the safety of the President of the United States, members of his family members, and other senior government officials. The COTP finds that this temporary security zone needs to be effective by December 21, 2011, to ensure the safety of the President of the United States and members of his official party visiting the