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LEGAL ALERT

September 3, 2013

New Final Regs on Use of Differential Income Stream in Evaluating Cost-Sharing Arrangements

On August 26, 2013, the United States Treasury Department issued new final regulations[1] under Internal Revenue Code (IRC) Section 482. The new regulations provide guidance on the "income method" for determining taxable income in connection with cost-sharing arrangements (CSAs) entered into among members of a controlled group for the joint development of intangibles. Specifically, the regulations provide guidance on measuring the proper arm's-length price of buying into a CSA by calculating the present value of the "differential income stream," i.e., the incremental income projected to result from cost-sharing versus licensing.

Treasury issued final cost-sharing regulations under IRC § 482 in December 2011, reserving guidance related to the differential income stream approach, which it addressed in temporary regulations also promulgated in December 2011.[2] The new regulations finalize those temporary regulations without change.

Background

Under IRC § 482, the Secretary of the Treasury has authority to allocate income, deductions, credits, and allowances among companies under common control, so as to clearly reflect income that relates to transactions between and among such companies (controlled transactions). The regulations under § 482 generally provide that a controlled transaction must be priced at arm's length, i.e., consistent with how such a transaction would be priced if it were entered into by companies not under common control, determined according to the method that best and most reliably measures the arm's-length result.[3] Where the controlled transaction involves the shared development of intangibles, the regulations authorize members of a controlled group (controlled participants) to enter into CSAs. Under a CSA, controlled participants share the costs and risks of developing intangibles according to each participant's proportionate share of the reasonably anticipated benefits of exploiting such intangibles once developed.[4] A controlled participant may contribute to a CSA by making a "platform contribution," i.e., a contribution of resources, capabilities, or rights that the participant has developed, maintained, or acquired independent from the intangible development activity.[5] When a controlled participant makes a platform contribution, the other controlled participants are required to make arm's-length payments to the contributing participant.[6]

These buy-in payments, or "platform contribution transactions" (PCTs), are subject to special rules for determining whether the price is arm's length. One method for determining arm's-length price is the "income method." The income method examines whether the present value of the "cost-sharing alternative," i.e., the economic consequence of entering into the CSA for the projected duration of the CSA activity, equals the present value of the "licensing alternative," i.e., the economic consequence of

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[1] T.D. 9630, 78 Fed. Reg. 52,854 (Aug. 27, 2013).
[2] T.D. 9569, 76 Fed. Reg. 80,249 (Dec. 23, 2011).
[3] Treas. Reg. § 1.482-1(b)(1).
[4] Treas. Reg. §§ 1.482-7(b), (j)(1)(i).
[5] Treas. Reg. § 1.482-7(c)(1).
[6] Treas. Reg. § 1.482-7(b)(1)(ii).

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licensing, over the same period of time, the prospective intangible from or to an unrelated party that has not shared the associated costs or risks of development.[7] The regulations contemplate that the risk profiles associated with the cost-sharing alternative and the licensing alternative may differ, justifying the use of different discount rates to determine the present value of the respective income streams.[8]

New Regulations

While recognizing that different discount rates might be appropriate in the cost-sharing versus licensing contexts, the new final regulations are aimed at curbing the perceived misuse of the income method by taxpayers using inappropriately high or low discount rates to arrive at the present value of the cost-sharing and licensing alternatives.

The new regulations provide guidance on how to analyze the interrelationship between the different discount rates and the reasonableness of the implied discount rate. The regulations define "differential income stream" as the "reasonably anticipated stream of additional positive or negative income over the duration of the CSA Activity that would result (before PCT payments) from undertaking the cost sharing alternative rather than the licensing alternative." The regulations also address the fact that a discount rate may logically be implied from other facts. For example, the discount rate that a taxpayer has applied to determine the present value of the differential income stream can be implied if the amount of the PCT payment and the differential income stream are known. The regulations provide that if this "implied discount rate" is inappropriate in light of the facts and circumstances, any application of the income method that is based on the implied discount rate will be less reliable (and hence more likely to result in a transfer pricing adjustment). Conversely, the regulations also provide that the greater the extent to which the implied discount rate that is applied to the differential income stream is consistent with "reliable direct evidence of the appropriate discount rate" applicable to activities with similar risk profiles, the more reliable the resulting application of the income method will be. Finally, the new regulations provide two new examples of the application of the differential income stream approach (Examples 8 and 9), illustrating how to determine whether an implied discount rate is appropriate.

The new regulations retroactively apply to taxable years beginning on or after December 19, 2011, with the exception of Example 9, which will apply to taxable years beginning on or after August 27, 2013.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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[7] Treas. Reg. § 1.482-7(g)(4).
[8] Treas. Reg. § 1.482-7(g)(2)(v)(A).

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