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DEPARTMENT OF THE TREASURY

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Chapter	1.1.1	Determination of Buy-In/Buy-Out Amounts	Level 3 UIL	9411.01-01
Sub-Chapter	1.1.1.1	Platform Contribution Transactions - Initial Transactions		

Unit Name	Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangements (CSA) – Initial Transaction

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Issue and Transaction Overview

Pricing of PCT in CSAs – Initial Transaction

Under the U.S. cost sharing rules, parties under common control may enter into a "cost sharing arrangement" ("CSA") which allows the parties to share the costs of developing one or more intangibles ("cost shared intangibles") in proportion to each party's share of reasonably anticipated benefits ("RAB Shares") resulting from use of the cost shared intangibles. A payment is required for the contribution by a party of any resource, capability, or right to the CSA if it is reasonably anticipated to contribute to the development of the cost shared intangibles. Any such contribution is a "platform contribution transaction" or a "PCT," and the related payment is a "PCT payment".

The regulations emphasize that the value of the PCT payment should be consistent with the future income anticipated to be earned by the cost shared intangibles. The value of the PCT payment should also consider realistic alternatives available to each participant. The regulations contain various methods for valuation of platform contributions, including the "income method." The "best method" rule applies to the choice of method.

Many US companies enter into a CSA with a controlled foreign corporation ("CFC") in a low or no tax jurisdiction. However, the issues discussed in this IPS Unit could also take place with a CFC in a non-low tax jurisdiction and an adjustment may also be required if the PCT is not arm's length.

Rather than focus appropriately on the platform contributions, taxpayers may focus on the limited rights provided in a technology license agreement ("TLA") and thereby select a method that will result in a lower PCT payment. To justify a lower PCT payment, taxpayers may assert a short useful life of the licensed intellectual property ("IP"), often focusing on the life of the current generation of products. Often, a significant issue is the proper useful life of the intangibles, as well as the other resources, capabilities, or rights. Taxpayers may also focus solely on the rights to make and sell products incorporating the current generation IP ("make-sell rights"), pointing to similar agreements with unrelated parties. These other agreements look similar, but generally are not.

Issue and Transaction Overview (cont'd)

Pricing of PCT in CSAs – Initial Transaction

PCT payments must always compensate for research rights in intangibles as well as all resources, capabilities, and rights from which the CFC is anticipated to benefit from in the CSA. Thus, aggregation of intangible transactions often becomes a significant issue. When examining the initial PCT transaction, consider whether there are any related transactions (e.g., a license, I.R.C. 367(d) transfer, etc.) that need to be aggregated with the PCT transaction. In addition, the taxpayer's reported PCT payments may be understated if assumptions regarding tax rates are incorrect or if improper discount rates are applied in the taxpayer's economic model (e.g. disparate discount rates between the cost sharing alternative and the licensing alternatives). An economist can assist with these issues.

It is also important to consider whether the actual conduct of the taxpayer and the controlled parties is consistent with the terms of the CSA and related agreements and transactions. In addition, all resources, capabilities, and rights reasonably anticipated to contribute to the CSA's development of cost shared intangibles need to be compensated. The examiner needs to determine the best method that provides the most reliable measure of an arm's length result for the PCT under the facts and circumstances.

Taxpayers may assert that the opinion in *VERITAS Software Corp. v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) ("*Veritas*"), a case that the IRS lost, is controlling, however, it is not. The Service issued Action on Decision ("A.O.D."), A.O.D. 2010-05 regarding *Veritas*, stating the Service believes that the Court's factual findings and legal assertions in *Veritas* are erroneous and does not agree with the result or reasoning of the decision. Further, *Veritas* was decided under the 1995 cost sharing regulations relating to "buy-in payments" and not the regulations governing PCT transactions. Counsel can assist where *Veritas* is raised by taxpayers.

Initial PCTs in CSAs are subject to detailed cost sharing regulations. Temp. Treas. Reg. 1.482-7T was effective as of January 5, 2009 and Treas. Reg. 1.482-7 (2011) became effective as of December 16, 2011. The Temp. Reg. provided for transitional grandfathering rules for certain CSAs and these rules have been preserved in the final regulations. The Supreme Court in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011) recognized that Treasury Regulations are entitled to deference as long as they are a reasonable interpretation of the underlying statute at issue. Id. at 713.

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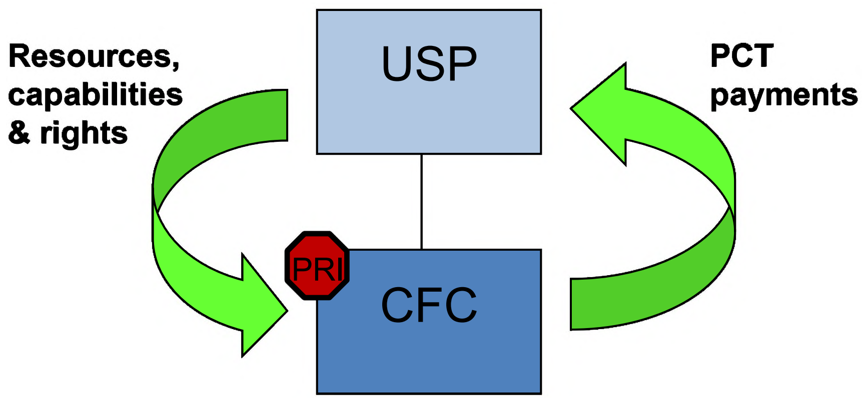
Transaction and Fact Pattern

Pricing of PCT in CSAs – Initial Transaction

Diagram of Transaction



Facts

- USP is a multi-national high tech company that has successfully developed resources, rights, and capabilities, including valuable technology IP .
- On January 1, 2012, USP formed CFC in Country X, a low tax jurisdiction.
- On March 1, 2012, USP entered into a CSA with CFC to further develop all of its technology related intangibles. Development costs are shared 40 – 60 based on reasonably anticipated benefits ("RAB") in the parties' respective territories.
- USP's territory is the US and CFC's territory is the rest of the world ("ROW"). The term of the CSA is 3 years but it is renewable at will based on agreement of the parties.
- On the same date USP and CFC entered into a TLA for IP which will be used in the intangible development area within the CSA ("platform rights.") The TLA also covers a license of rights to exploit existing IP in the CFC's territory ("make-sell rights.")

Transaction and Fact Pattern (cont'd)

Pricing of PCT in CSAs – Initial Transaction

Facts

Exhibit A to the TLA states that in consideration for the rights granted under the TLA, the CFC shall pay the USP an arm's length royalty based upon the determination of an independent accounting firm of the appropriate arm's length consideration. Such determination will be set-forth in a transfer pricing study.

USP's transfer pricing study concluded the following:

- The income method under Treas. Reg. 1.482-7(g)(4) is the best method for determining the arm's length price of the PCT payments.
- The platform IP has a useful life of five years based on the average technology product life.
- The proper discount rate for the cost sharing alternative was 13% and the appropriate discount rate for the licensing alternative is 6%.
- The present value of the expected PCT payments over the life of the TLA is $120 million ($640 million cost sharing alternative less $520 million licensing alternative).

Effective Tax Rate Overview

Pricing of PCT in CSAs – Initial Transaction

ETR of Company

- When a U.S. taxpayer successfully transfers a significant amount of its income producing intangibles outside of the U.S. into a low tax jurisdiction (including contributing valuable rights, resources, and capabilities to the CSA), for inadequate consideration, then the taxpayer's worldwide effective tax rate ("ETR") may decrease substantially. This occurs because the income streams from these intangibles remain offshore where they may indefinitely escape U.S. taxation.

ETR Impact of Adjustment

- An adjustment to increase the PCT payments pursuant to IRC Section 482 will increase taxable income for the U.S. taxpayer and will therefore increase the ETR. The ETR impact may affect one or more taxable years depending in part on how the PCT payment was structured by the taxpayer (e.g. lump sum, installment, or contingent royalty).

Summary of Potential Issues

Pricing of PCT in CSAs – Initial Transaction	
Issue 1	Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?
Issue 2	Do the platform contributions have a longer useful life than the average useful life of USP's current products?
Issue 3	Is it more reliable to aggregate USP's make-sell rights with its platform contributions for purposes of determining the arm's length price of the PCT payments based upon the facts and circumstances?
Issue 4	Did USP apply the proper discount rates to both the cost sharing and licensing alternatives for computing the arm's length price of the PCT payments using an income method approach?

All Issues, Step 1: Initial Factual Development

Pricing of PCT in CSAs – Initial Transaction

All controlled participants must commit to, and in fact engage in PCTs to the extent that there are platform contributions. In a PCT, each other controlled participant (PCT Payor) must make arm's length payments (PCT payments) to each controlled participant (PCT Payee) that provides a platform contribution. An Initial PCT payment must be made upon commencement of cost sharing or as soon as it is reasonably anticipated that a platform contribution will be anticipated to assist in development.

Fact Element	Resources	6103 Protected Resources
▪ Did a controlled party to the CSA make platform contributions reasonably anticipated to benefit the CSA?	▪ Treas. Reg. 1.482-7(a)(2), (b)(1)(ii), (c), and see (j)(3)(ii) – Requirements for PCTs ▪ TLA and all facts ▪ Transfer pricing studies ▪ Employee interviews ▪ Treas. Reg. 1.482-7(k)(4) Required CSA Annual Statement	
▪ Verify whether or not the taxpayer rebutted the presumption that the platform contributions are exclusive to the CSA.	▪ Treas. Reg. 1.482-7(c)(2) – Rebuttable presumption that platform contributions benefit only the CSA Activity and the parties to the CSA ▪ TLA and all facts	

Issue 1, Step 2: Review Potential Issues

Pricing of PCT in CSAs – Initial Transaction

Issue 1

Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?

Explanation of Issue	Resources	6103 Protected Resources
Treas. Reg. 1.482-7(g)(2) provides guidance on selecting the best method for purposes of evaluating a PCT, explaining that each method must be applied within the provision of Treas. Reg. 1.482-1(c) (the best method rule), 1.482-1(d) (comparability analysis) and 1.482-1(e) (arm's length range), unless modified in Treas. Reg. 1.482-7(g). Under the best method, a method must be applied that provides the most reliable measure of an arm's length result. The two primary factors are (1) degree of comparability and (2) the quality of the data and assumptions used in the analysis. Treas. Reg. 1.482-7(g)(2) provides other best method factors specific to PCTs including: (1) consistency with upfront contractual terms and risk allocation--the "investor model"; (2) consistency of evaluation with realistic alternatives; (3) aggregation;(4) discount rates; (5) financial projections; (6) accounting principles; and (7) valuation of subsequent PCTs. Based on these rules, it is extremely important to complete a detailed functional analysis to develop the relevant facts for purposes of determining the best method for the initial PCT transaction and show why other non-chosen methods are less reliable.	▪ Treas. Reg. 1.482-1(c) – Best method rule ▪ Treas. Reg. 1.482-1(d) – Comparability ▪ Treas. Reg. 1.482-1(e) – Arm's length range ▪ Treas. Reg. 1.482-7(g)(1) – Methods applicable to PCTs ▪ Treas. Reg. 1.482-7(g)(2) – Best method analysis applicable for evaluation of a PCT	

Issue 1, Step 2: Review Potential Issues (cont'd)

Pricing of PCT in CSAs – Initial Transaction		
Issue 1		
Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
The CSA regulations specify the following six methods for determining the arm's length amount charged in a PCT: (i) comparable uncontrolled transaction method ("CUT"); (ii) the income method; (iii) the acquisition price method; (iv) the market capitalization method; (v) the residual profit split method ("RPSM"); and (vi) unspecified methods. The CSA regulations detail additional best method analysis considerations for all of these methods. For instance, additional best method considerations for the income method include tax rates assumptions and coordination with the rules for comparability and reliability considerations for a CUT (if licensing alternative is evaluated using a CUT); and the comparability and reliability considerations for a comparable profits method ("CPM") (if the licensing alternative is evaluated using a comparable profits method).	▪ Treas. Reg. 1.482-7(g)(1) – Methods applicable to PCTs ▪ Treas. Reg. 1.482-7(g)(2) – Best method analysis applicable for evaluation of a PCT pursuant to a CSA ▪ Treas. Reg. 1.482-7(g)(4)(vi) – Best method analysis considerations applicable to income method ▪ Treas. Reg. 1.482-1(c) – Best method rule	

Issue 1, Step 2: Review Potential Issues (cont'd)

Pricing of PCT in CSAs – Initial Transaction		
Issue 1		
Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
Here, USP selected the income method as the best method for determining the arm's length price of the PCT from CFC. Therefore, to confirm whether the income method is the most reliable method based on the facts, both the additional best method considerations for the income method must be taken into account in addition to analyzing the best method factors applicable to all transfer pricing methods and the best method analysis applicable for evaluation of a PCT.	▪ Treas. Reg. 1.482-4(c)(2) – Comparability and reliability considerations for CUT ▪ Treas. Reg. 1.482-5(c) – Comparability and reliability considerations for CPM	

Issue 1, Step 3: Additional Factual Development

Pricing of PCT in CSAs – Initial Transaction

Issue 1

Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?

Fact Element	Resources	6103 Protected Resources
▪ What are the functions performed, risks assumed, and assets employed for USP and CFC?	▪ Transfer Pricing Studies ▪ Annual Reports and references ▪ Interview key employees ▪ SEC Filings ▪ Press Releases – Joint efforts with foreign parent ▪ Capital IQ – Research Market Studies as well as competitors ▪ Internet Searches on taxpayer and industry ▪ CSA checklist Revised 2008	
▪ What significant nonroutine contributions are the controlled participants providing to the CSA?	▪ Transfer pricing study ▪ Technology License Agreement ▪ Cost Sharing Agreement ▪ Economist/Engineer/Outside Expert ▪ Valuation study ▪ Annual Reports / SEC filings	

Issue 1, Step 3: Additional Factual Development (cont'd)

Pricing of PCT in CSAs – Initial Transaction

Issue 1

Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?

Fact Element	Resources	6103 Protected Resources
▪ Is the income method the most reliable method to determine the arm's length price of the PCT payments paid from CFC to USP? – comparability – quality of data – reliability of assumptions (tax rates, discount rates, projections, etc.) – sensitivity of results to possible deficiencies – consistency with upfront contractual terms and risk allocation--the investor model – consistency of evaluation with realistic alternatives – CUT or CPM assumptions regarding licensing alternative	▪ Transfer Pricing Study ▪ Economist Report ▪ Valuation Study ▪ Technology License Agreement ▪ Cost Sharing Agreement ▪ Financial statements and disclosures for all controlled participants	

Issue 1, Step 4: Develop Arguments

Pricing of PCT in CSAs – Initial Transaction

Issue 1

Is the income method the "best method" for determining the arm's length price of the PCT payments from CFC to USP based upon the facts and circumstances?

Explanation of Approach	Resources	6103 Protected Resources
Develop the unique facts of the initial PCT transaction through a functional analysis and adopt the transfer pricing method that provides the most reliable measure of an arm's length result under those facts. Apply the factors in best method rule under Sections 1.482-1(c) and 1.482-7(g)(2) to determine if the income method is the most reliable method in this case. Also, consider the additional best method considerations under Section 1.482-7(g)(4)(vi). Critique all other non-chosen methods to show why they are less reliable than the best method. Determining the best method requires collaboration between the IE, economist, and counsel as all skill sets are complementary for developing complex PCT issues.	▪ Treas. Reg. 1.482-1(c) – Best method rule ▪ Treas. Reg. 1.482-7(g)(2) – Best method analysis applicable for evaluation of a PCT ▪ Treas. Reg. 1.482-7(g)(4)(vi) – Best method analysis considerations ▪ *VERITAS v. Commissioner*, AOD IRB No. 2010-49 (Dec. 6, 2010)	

Issue 2, Step 2: Review Potential Issues

Pricing of PCT in CSAs – Initial Transaction		
Issue 2		
Do the platform contributions have a longer useful life than the average useful life of USP's current products?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
The conventional concept of useful life in intangibles looks to the period of time economic benefits are derived from the current technology. The useful life is therefore helpful in determining the period of analysis for valuing an existing resource, capability, or right without further development (*i.e.*, make-sell rights). However, the value of the make-sell rights of the current technology or product does not take into account all of the resources, capabilities, and rights made available to a CSA. The make-sell rights do not take into account the benefits associated with the future products or technology that build upon the current version. Successful efforts and experience need to be considered. At arm's length, parties will analyze their investments given all the future income to be generated from those investments. Determining resources, capabilities, or rights reasonably anticipated to contribute to developed intangibles requires that future income beyond the current generation of product or technology be considered. Therefore the value of the make-sell rights does not satisfy the required PCT payment. The value of all platform rights must also be considered. The valuation for the make-sell rights and platform rights must be aggregated, if aggregation provides the most reliable result. (See Issue 3 for discussion of aggregation)	▪ Treas. Reg. 1.482-7(c)(1) ▪ Treas. Reg. 1.482-7(c)(4)	

Issue 2, Step 2: Review Potential Issues (cont'd)

Pricing of PCT in CSAs – Initial Transaction		
Issue 2		
Do the platform contributions have a longer useful life than the average useful life of USP's current products?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
Despite the different models that many taxpayers have regarding useful life, it remains important to fully rebut and analyze the taxpayer's method and useful life analysis. In evaluating the useful life, it is important to consider the principles of the investor model--that arm's length parties enter into transactions that are consistent with the upfront contractual terms and risk allocation. Based on this concept, unrelated parties evaluate investments according to the expected rate of return over the period of the investment given its riskiness. A party will then only enter into the investment if no other alternative investment is preferable to it. The valuation of an initial PCT should be evaluated considering these principles.	▪ Treas. Reg. 1.482-7(g)(2)(ii) ▪ Treas. Reg. 1.482-7(g)(2)(iii)	

Issue 2, Step 3: Additional Factual Development

Pricing of PCT in CSAs – Initial Transaction

Issue 2

Do the platform contributions have a longer useful life than the average useful life of USP's current products?

Fact Element	Resources	6103 Protected Resources
▪ Evaluate the nature of the resources, capabilities, and rights made available to the CSA	▪ Transfer pricing study ▪ Technology License Agreement ▪ Cost Sharing Agreement ▪ Interview key employees ▪ Functional analysis ▪ Economist/Engineer/Outside Expert ▪ Valuation study ▪ Annual Reports / SEC filings	
CONSULTATION: Consult with Economist, TPP, Counsel and/or Engineers as necessary		

Issue 2, Step 3: Additional Factual Development (cont'd)

Pricing of PCT in CSAs – Initial Transaction

Issue 2

Do the platform contributions have a longer useful life than the average useful life of USP's current products?

Fact Element	Resources	6103 Protected Resources
▪ Understand the anticipated use and expectations for the cost shared intangibles	▪ Transfer pricing study ▪ Interview key employees ▪ Functional analysis ▪ Economist/Engineer/Outside Expert ▪ Valuation study ▪ Annual Reports / SEC filings	
▪ Analyze the taxpayer's results for consistency with the future income anticipated to be generated by the resulting cost shared intangibles.	▪ Treas. Reg. 1.482-7(g)(1) ▪ Transfer pricing study ▪ Economist/Engineer/Outside Expert	

Issue 2, Step 4: Develop Arguments

Pricing of PCT in CSAs – Initial Transaction

Issue 2

Do the platform contributions have a longer useful life than the average useful life of USP's current products?

Explanation of Approach	Resources	6103 Protected Resources
Develop the facts of the initial PCT transaction through a functional analysis to fully understand the nature of the resources, capabilities, and rights made available to the CSA. When valuing the PCT, the selected method (See Issue 1 for discussion of Best Method) must consider all the future income anticipated to be generated by the resulting cost shared intangibles. Therefore, any projections used under the selected Best Method should extend out for the period of time the cost shared intangibles are expected to generate income. **CONSULTATION:** Consult with Economist, TPP, Engineer, and Counsel to develop arguments.	▪ Treas. Reg. 1.482-7(g)(1) ▪ Treas. Reg. 1.482-7(g)(2)(ii) – Investor Model ▪ Treas. Reg. 1.482-7(g)(2)(iii) – Realistic Alternatives ▪ *VERITAS v. Commissioner*, AOD IRB No. 2010-49 (Dec. 6, 2010)	

Issue 2, Step 4: Develop Arguments (cont'd)

Pricing of PCT in CSAs – Initial Transaction

Issue 2

Do the platform contributions have a longer useful life than the average useful life of USP's current products?

Explanation of Approach	Resources	6103 Protected Resources
Under these facts, the taxpayer's CSA has a three year term that is renewable at will. Since the contract is renewable at will, the CSA will not necessarily be expected to terminate after three years. The anticipated length of the CSA and the future income generated by the cost shared intangibles will depend on the facts and circumstances of each case. If the taxpayer anticipates continually developing the cost shared intangibles and does not expect the CSA to terminate, then income may be anticipated to be generated from the cost shared intangibles indefinitely.	▪ Treas. Reg. 1.482-7(g)(1) ▪ Treas. Reg. 1.482-7(g)(2)(ii) – Investor Model ▪ Treas. Reg. 1.482-7(g)(2)(iii) – Realistic Alternatives ▪ *VERITAS v. Commissioner*, AOD IRB No. 2010-49 (Dec. 6, 2010)	
CONSULTATION: Consult with Economist, TPP, Engineer, and Counsel to develop arguments.		

Issue 3, Step 2: Review Potential Issues

Pricing of PCT in CSAs – Initial Transaction

Issue 3

Is it more reliable to aggregate USP's make-sell rights with its platform contributions for purposes of determining the arm's length price of the PCT payments based upon the facts and circumstances?

Explanation of Issue	Resources	6103 Protected Resources
Most, if not all taxpayers, compute the PCT payment pursuant to the TLA as a single agreement for singular compensation for both rights to exploit fully developed products (make-sell rights under Section 1.482-4) and also rights to do necessary research to develop new products (research rights) and other platform contributions under Section 1.482-7. As such, it may not be possible to segregate and value the make-sell rights in IP, research rights in IP, and other resources, capabilities, and rights. Accordingly, although make-sell rights are not platform contributions, the taxpayer's transaction must be necessarily examined in the aggregate. An aggregate valuation is required for best method analysis, if facts support that the transactions are so interrelated that a valuation method considering aggregation is most reliable for an arms length result.	▪ Treas. Reg. 1.482-7(a)(2), (b)(1)(ii), (c), and see (j)(3)(ii) -- Requirements for PCTs ▪ Treas. Reg. 1.482-7(c)(4) – Make-Sell Rights are not PCTs ▪ Treas. Reg. 1.482-7(g)(2)(iv) and 1.482-1(f)(2)(i) – Aggregation of Transactions ▪ Treas. Reg. 1.482-1(f)(2)(i) – Aggregation, generally, including transactions not in cost sharing	

Issue 3, Step 3: Additional Factual Development

Pricing of PCT in CSAs – Initial Transaction

Issue 3

Is it more reliable to aggregate USP's make-sell rights with its platform contributions for purposes of determining the arm's length price of the PCT payments based upon the facts and circumstances?

Fact Element	Resources	6103 Protected Resources
Confirm whether the TLA and all facts indicate that taxpayer has a single payment that encompasses make-sell rights pursuant to Section 1.482-4 and PCTs including research rights in intangibles as well as all resources, capabilities, and rights pursuant to Section 1.482-7	▪ Look to what the taxpayer purports to satisfy PCT requirements ▪ See TLA and all facts ▪ USP Transfer Pricing Study	
CONSULTATION: Consult with Counsel, Economist, IPN, and TPP		

Issue 3, Step 4: Develop Arguments

Pricing of PCT in CSAs – Initial Transaction

Issue 3

Is it more reliable to aggregate USP's make-sell rights with its platform contributions for purposes of determining the arm's length price of the PCT payments based upon the facts and circumstances?

Explanation of Approach	Resources	6103 Protected Resources
Based upon the facts, USP attempted to minimize its PCT focusing on the limited license of IP within the TLA and further focusing on only the make-sell rights in IP licensed with the TLA. (USP did not make a PCT payment for research rights in intangibles nor other resources, capabilities, and rights.) Exam will rather focus on all the facts and circumstances of the transaction in the aggregate.	▪ Treas. Reg. 1.482-7(a)(2), (b)(1)(ii), (c), and see (j)(3)(ii) -- Requirements for PCTs ▪ Treas. Reg. 1.482-7(c)(4) – Make-Sell Rights are not PCTs ▪ Treas. Reg. 1.482-7(g)(2)(iv) and 1.482-1(f)(2)(i) – Aggregation of Transactions ▪ Treas. Reg. 1.482-1(f)(2)(i) – Aggregation, generally, including transactions not in cost sharing ▪ *VERITAS v. Commissioner*, AOD IRB No. 2010-49 (Dec. 6, 2010)	

Issue 3, Step 4: Develop Arguments (cont'd)

Pricing of PCT in CSAs – Initial Transaction		
Issue 3		
Is it more reliable to aggregate USP's make-sell rights with its platform contributions for purposes of determining the arm's length price of the PCT payments based upon the facts and circumstances?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
CONSULTATION: Appropriate expertise must be utilized to develop the facts. The IPN can be a resource for these issues. Besides an economist, Counsel is necessary to review the TLA and any other agreements. Outside the four corners of the taxpayer's written documents, all additional facts including de facto benefits as the result of the CSA must be considered.		

Issue 4, Step 2: Review Potential Issues

Pricing of PCT in CSAs – Initial Transaction

Issue 4

Did USP apply the proper discount rates to both the cost sharing and licensing alternatives for computing the arm's length price of the PCT payments using an income method approach?

Explanation of Issue	Resources	6103 Protected Resources
Discount rates are a critical input to an income method analysis because they are the mechanism to convert projected income from cost shared intangibles to a present value. Discount rates quantify the systematic or market correlated risks and uncertainty associated with the projected income stream. Small changes in discount rates can lead to large changes in value, so it is important to fully analyze the discount rates being used. Under the income method appropriate discount rates must be determined for both the cost sharing and licensing alternatives. The risks associated with the cost sharing and licensing alternatives may differ (e.g. there may be less risk in licensing intangibles than entering into a CSA to develop those intangibles) and therefore each alternative could require a different discount rate.	▪ Treas. Reg. 1.482-7(g)(2)(v) – Discount rate considerations for best method of PCT ▪ Treas. Reg. 1.482-7(g)(4)(i)(F) – Discount rate appropriate to cost sharing and licensing alternatives ▪ Treas. Reg. 1.482-7(g)(4)(vi)(F) (1)– Discount rates reflecting similar risk profiles of cost sharing and licensing alternatives. ▪ FY11 LB&I Int'l CPE – Economic Analysis ▪ Finance Textbooks ▪ Treas. Reg. 1.482-7(g)(2)(v)(B)(2) – Implied discount rates ▪ Treas. Reg. 1.482-7(g)(4)(vi)(F)(2) – Use of differential income stream as a consideration in assessing the best method. ▪ Treas. Reg. 1.482-7(g)(4)(viii), Example 8	

Issue 4, Step 2: Review Potential Issues (cont'd)

Pricing of PCT in CSAs – Initial Transaction		
Issue 4		
Did USP apply the proper discount rates to both the cost sharing and licensing alternatives for computing the arm's length price of the PCT payments using an income method approach?		
Explanation of Issue	**Resources**	**6103 Protected Resources**
However, some taxpayers may exaggerate the differences in risk between the two alternatives to justify a lower discount rate for the licensing alternative and a higher discount rate for the cost sharing alternative. By doing this a taxpayer can drive the PCT value down significantly.		

Issue 4, Step 3: Additional Factual Development

Pricing of PCT in CSAs – Initial Transaction

Issue 4

Did USP apply the proper discount rates to both the cost sharing and licensing alternatives for computing the arm's length price of the PCT payments using an income method approach?

Fact Element	Resources	6103 Protected Resources
▪ Analyze the risks associated with the cost sharing and licensing alternatives.	▪ Functional analysis ▪ Transfer Pricing Studies ▪ Company weighted average cost of capital ("WACC") rate ▪ Bloomberg Professional	
▪ Conduct functional analysis of resources, capabilities, and rights made available to the CSA and the expected cost-shared intangibles.	▪ Taxpayer presentation ▪ Employee interviews ▪ Transfer Pricing Studies ▪ Valuation Studies ▪ Company WACC rate ▪ Board minutes	
CONSULTATION: Consult with the Economist, TPP, IPN, counsel.		

Issue 4, Step 4: Develop Arguments

Pricing of PCT in CSAs – Initial Transaction

Issue 4

Did USP apply the proper discount rates to both the cost sharing and licensing alternatives for computing the arm's length price of the PCT payments using an income method approach?

Explanation of Approach	Resources	6103 Protected Resources
The functional analysis of the resources, capabilities and rights made available and the expected cost sharing intangibles will assist in understanding the risks associated with each alternative. Under the facts, the 13% discount rate used for the cost sharing alternative and the 6% discount rate used for the licensing alternative must be analyzed by looking to the market for circumstances with similar amounts of risk. In comparing the risks of the two alternatives, understand that the risks are closely related to each other. This is because the financial projections will be the same for each alternative, except for the licensing payments under the licensing alternative and the PCT and CST payments under the cost sharing alternative.	▪ Treas. Reg. § 1.482-7(g)(2)(v) ▪ Treas. Reg. § 1.482-7(g)(4)(i)(F) ▪ Treas. Reg. § 1.482-7(g)(4)(vi)(F) ▪ Finance Textbooks	

Training and Additional Resources

Chapter 1.1.1 Pricing of PCT in CSAs – Initial Transaction

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	▪ FY2012 Cost Sharing Transactions. ▪ FY2012 The Income Method. ▪ FY2013 Income Method II.	▪ Advanced Cost Sharing Issues and Current Developments ▪ Income Method ▪ Income Method – Part II
Issue Toolkits	▪ Transfer Pricing Checklist	
White Papers / Guidance	▪ IRM 4.61.3 Development of IRC section 482 Cases ▪ IRM 4.61.3-4 Functional Analysis Questionnaire	
Podcasts / Videos	▪ CENTRA-FY2012 International CPE-High Value Services	
Reference Materials – Treaties	▪ Bittker and Lokken , *Fundamentals of International Tax-Chapter 79*: Reallocation of Income and Deductions ▪ OECD Transfer Pricing Guidelines	
Other Training Materials	▪ International Examiner Phase II Training, Cost Sharing ▪ Economist Phase V Training – Legal Matters	

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
USP	United States Parent
PCT	Platform Contribution Transaction
RAB	Reasonably Anticipated Benefits
TPP	Transfer Pricing Practice
CSA	Cost Sharing Arrangement
CST	Cost Sharing Transaction
TLA	Technology License Agreement
IP	Intangible Property
NOPA	Notice of Proposed Adjustment
CUT	Comparable uncontrolled transaction
CPM	Comparable profits method
RPSM	Residual profits split method

Glossary of Terms and Acronyms (cont'd)

Acronym	Definition
ETR	Effective tax rate
IPN	Issue practice network
IRC	Internal Revenue Code
WACC	Weighted average cost of capital

Index of Related Issues

Issue	Associated UIL(s)	References
Arm's Length Standard	▪ 9411.07	▪ IPS Unit Arm's Length – The Standard for Value for U.S. Transfer Pricing ISO/CBB/V_1_03 (2014) Under Development
Arm's Length Standard	▪ 9422.09	▪ IPS Unit Arm's Length Standard ISI/9422.09_06 (2013)
Subsequent PCT - Acquisition	▪ 9411.01	▪ IPS Unit Pricing of Platform Contribution Transaction (PCT) in a Cost Sharing Arrangement (CSA) – Acquisition of Subsequent IP ISO/9411.01_02 (2013) Under Development
Cost Sharing vs. Licensing	▪ 9411.01	▪ IPS Unit Cost Sharing Arrangements versus Licensing Alternatives ISO/9411.01_03 (2013)
Reasonably Anticipated Benefits	▪ 9411.01	▪ IPS Unit Calculating Reasonably Anticipated benefits (RAB) in Cost Sharing Arrangements (CSA) ISO/9411.01_04 (2014) Under Development
Section 367 (d) and Cost Sharing	▪ 9411.01	▪ IPS Unit IRC 367 (d) transactions in Conjunction with Cost Sharing Arrangements (CSA) ISO/9411.01_05 (2014) Under Development
Change in Reasonably Anticipated Benefits and Exit PCT	▪ 9411.01	▪ IPS Unit Change in Participation in a Cost Sharing Arrangement (CSA) – Reasonably Anticipated Benefits (RAB) and Exit PCT ISO/9411.01_06 (2014) Under Development

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Annual Royalty Income and IRC 367 (d)	▪ 9411.02	▪ IPS Unit Deemed Annual Royalty Income Under IRC 367 (d) ISO/9411.02_01 (2013)
Sale, License and Other Transfer Distinctions	▪ 9411.02	▪ IPS Unit Distinguishing Between Sale, License, and Other Transfers of Intangibles to CFCs by U.S. Transferors ISO/9411.02_02 (2013)
Licensing Intangibles to Foreign Affiliate	▪ 9411.02	▪ IPS Unit License of Intangible Property from U.S. Parent to a Foreign Subsidiary ISO/9411.02_03 (2013)
Cost Pools in Cost Sharing Arrangements	▪ 9411.01	▪ IPS Unit Issues with Cost Sharing Pools in Cost Sharing Arrangements ISO/9411-02_06 (2014) Under Development
Functional Analysis	▪ 9411.07	▪ IPS Unit Comparability Analysis for Tangible Goods Transactions – Outbound ISO/PBB/V_1_01 (2014)