Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Transaction Unit

Shelf		Business Outbound		
Volume	1	Outbound Income Shifting	UIL Code	9411
Part	1.2	Intangible Property Transfers w/ Cost Sharing	Level 2 UIL	9411.01
Chapter	1.2.1	Determination of Buy-In/Buy-Out Amounts	Level 3 UIL	9411.01-01
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Unit Name	Cost Sharing Arrangements (CSA) vs. Licensing Alternative

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Issue and Transaction Overview

CSA vs. Licensing Alternative

The treasury regulations provide supplemental guidance on analyzing the best method for evaluating the reliability of a platform contribution transaction (“PCT”) by considering the following: (i) method must be applied in accordance with Treas. Reg. § 1.482-1(a) and Treas. Reg. § 1.482-1(e); (ii) consistency with upfront contractual terms and risk allocation – the investor model; and (iii) consistency of evaluation with realistic alternatives.

This practice unit applies the concept of the realistic alternative to a common fact pattern involving a U.S. Parent corporation (USP) that enters into a cost sharing agreement (CSA) with its wholly owned controlled foreign corporation (CFC) and contributes its valuable technology to the CSA in exchange for (PCT) payments. The realistic alternative is a licensing alternative where USP could have developed the technology and licensed it to the CFC if successful.

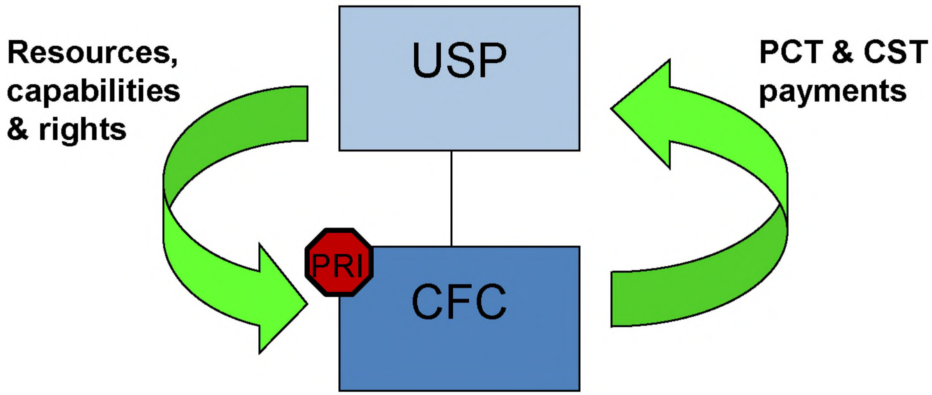
The rules of the realistic alternative are detailed in Treas. Reg. § 1.482-7(g)(2)(iii)(A). That section generally provides that the reliability of an application of a PCT method depends on the degree of consistency of the analysis with the best realistic alternative. The best realistic alternative is the one which yields the highest present value result. The theory is based on the assumption that uncontrolled taxpayers dealing at arm’s length would have evaluated the terms of the transaction and would have only entered into it if no alternative is preferable.

Accordingly, this condition is not met for a controlled participant if 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. See Treas. Reg. § 1.482-7(g)(2)(ii).

CONSULTATION: For PCT valuation reviews, you should consult with an economist to assist with the assumptions and methodology, if necessary.

Transaction and Fact Pattern

CSA vs. Licensing Alternative

Diagram of Transaction	Facts
	▪ United States Parent (USP) wholly owns controlled foreign corporation (CFC). ▪ CFC is located in a low tax jurisdiction and provides routine manufacturing and distribution functions for the controlled group. Note: This IPS Unit uses a CFC in a low tax jurisdiction for illustrative purposes but this scenario can also exist with CFCs in non-low tax countries. ▪ USP and CFC enter into a CSA to develop a widget device (the "product") based on their reasonably anticipated benefits (RAB) in which USP is assigned the territory of the U.S. and CFC is assigned the territory for the rest of the world (ROW). ▪ Under the arrangement, USP will undertake all R&D, manufacturing and marketing in the U.S. ▪ CFC will make cost sharing transaction (CST) payments to USP for its appropriate share of USP's R&D costs, and manufacture and market the product in ROW. ▪ USP owns existing intellectual property that is reasonably anticipated to contribute to the development of the product.

Transaction and Fact Pattern (cont'd)

CSA vs. Licensing Alternative

Facts

- CFC'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 intellectual property from USP.
- Reasonably reliable estimates indicate that USP could self-develop and license the product for a royalty of 25% of sales outside of the U.S.
- Based on reliable financial projections that include all future development costs and licensing revenue that are allocable to the ROW market, and using a discount rate appropriate for the riskiness of USP's role as a licensor, the net present value of the licensing alternative (measured as of the date of the PCT) to USP for the ROW market is anticipated to be $100 million.
- The discount rate for the licensing alternative will be different from the discount rate for the CSA alternative due to the different risk profile of the two alternatives for both USP and CFC.

Effective Tax Rate Overview

CSA vs. Licensing Alternative

ETR of Company

- When a U.S. taxpayer successfully transfers significant income producing intangibles outside of the U.S. to a CFC in a low tax jurisdiction for little or no compensation, the taxpayer's worldwide effective tax rate may decrease substantially. This occurs when the income from these intangibles is deemed to be permanently reinvested offshore for U.S. GAAP financial statement purposes. If repatriated as a dividend, the accumulated offshore earnings would be subject to U.S. taxation.

ETR Impact of Adjustment

- A company's overall effective tax rate is the aggregate rate of its accrued tax expense on its worldwide income.
- In this example, the overall effective tax rate will be reduced if the PCT payments are priced less than arm's length.

Summary of Potential Issues

CSA vs. Licensing Alternative	
Issue 1	What is the best realistic alternative to USP if it does not enter into the CSA with CFC?
Issue 2	Does the application of USP’s methodology for pricing the PCT under the CSA alternative pass the “consistency of evaluation with realistic alternatives test” and the investor model test?

All Issues, Step 1: Initial Factual Development

CSA vs. Licensing Alternative

A taxpayer may enter into a CSA to shift income outside the United States. It is important to establish the facts to determine the taxpayer's best realistic alternative if it did not enter into the CSA and to compare the expected present value from each alternative.

Fact Element	Resources	6103 Protected Resources
▪ What types of resources, capabilities, and rights is USP contributing to the CSA? ▪ Does Form 5471 represent that CFC has made PCT payments to USP? ▪ Did USP file required CSA disclosures? ▪ Is there a written CSA that meets the regulatory requirements under Treas. Reg. 1.482-7(k)?	▪ Transfer Pricing Studies ▪ Organizational Chart ▪ Contracts ▪ CSA, License Agreements and any other related agreements ▪ Functional Analysis ▪ Taxpayer's Financial Statements ▪ Review CSA Disclosures with CFCS filed with return	
▪ Did USP previously license the technology to unrelated parties? ▪ Does the licensing alternative take into account the underlying research rights for future products in addition to any make-or-sell rights of current products. ▪ Is the best realistic alternative reliable?	▪ Form 5471, Line 20 or 25 ▪ Unrelated Party Agreements ▪ Treas. Reg. 1.482-7(k)	

Issue 1, Step 2: Review Potential Issues

CSA vs. Licensing Alternative

Issue 1

What is the best realistic alternative to USP if it does not enter into the CSA with CFC?

Explanation of Issue	Resources	6103 Protected Resources
Besides cost sharing, there are other realistic alternatives that a controlled participant should consider before determining the arm's length price of the PCT payments. The realistic alternative concept applies regardless of the method used to compute PCT payments. Thus, evaluation of the arm's length charge for the PCT should take into account the principle that uncontrolled parties would have evaluated the terms of a transaction at arm's length, and would only enter into a specific transaction if no alternative is preferable.	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(A) ▪ Treas. Reg. § 1.482-7(g)(2)(ii)	
Here, the facts indicate that USP and CFC entered into a CSA, and CFC is making a PCT payment to USP. Besides this alternative arrangement, it is important to understand what other alternatives are available to USP and CFC. For instance, are there reasonably reliable estimates and projections where USP could develop the product without assistance from CFC and license the technology at an arm's length royalty rate?	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(B)(Example 1)	
If there are no reliable estimates for the licensing alternative for USP, then the CFC's estimates would be used for the licensing alternative if they are reliable. This may involve compensating the CFC for the routine functions it performs.	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(B)(Examples 2 and 3)	

Issue 1, Step 3: Additional Factual Development

CSA vs. Licensing Alternative		
Issue 1		
What is the best realistic alternative to USP if it does not enter into the CSA with CFC?		
Fact Element	**Resources**	**6103 Protected Resources**
▪ Is there a reliable realistic licensing alternative?	***Request and/or Review the following:*** ▪ Organizational Chart ▪ Transfer Pricing Studies ▪ Discount rates and projections ▪ Relevant Intercompany Agreements ▪ Third party royalty agreements ▪ Transfer Pricing Roadmap ▪ Form 10K – Especially the sections on Intangibles ▪ Industry Analysis ▪ Transfer Pricing Roadmap	
▪ If there is no reliable licensing alternative, is there another alternative method to calculate a reliable realistic alternative?	▪ Transfer Pricing Studies ▪ Contracts ▪ Intercompany Agreements ▪ Functional analysis of CFC's routine and non-routine functions, assets, and risks assumed	

Issue 1, Step 4: Legal Analysis

CSA vs. Licensing Alternative

Issue 1

What is the best realistic alternative to USP if it does not enter into the CSA with CFC?

Explanation of Approach	Resources	6103 Protected Resources
Determining the best reasonable alternative is based on the facts and circumstances of the case. First, establish that there is a valid CSA pursuant to Treas. Reg.§ 1.482-7. If so, determine the specific resources, capabilities, and rights that are contributed to the CSA, review financial projections, consider RAB calculation, and confirm the applicable discount and tax rates for each alternative. Calculate the anticipated present value of profits to USP under the CSA.	▪ Treas. Reg. § 1.482-7(g)(2)	
Next, determine the best reliable realistic alternative to USP other than CSA. In many instances, this will be a licensing transaction alternative where USP will develop the technology and license it to the CFC at an arm's length royalty rate. Apply the rules under Treas. Reg. § 1.482-4 to determine the best method for computing the arm's length price of the royalty payment.	▪ Treas. Reg. § 1.482-4	

Issue 1, Step 4: Legal Analysis (cont'd)

CSA vs. Licensing Alternative

Issue 1

What is the best realistic alternative to USP if it does not enter into the CSA with CFC?

Explanation of Approach	Resources	6103 Protected Resources
DECISION POINT: Determine the best realistic alternative to USP that is both reliable and has the highest anticipated present value to USP.	▪ Treas. Reg. § 1.482-7(g)(2)	
CONSULTATION: Consult with an economist before finalizing decision on realistic alternative and determination of present value, if necessary.		

Issue 2, Step 2: Review Potential Issues

CSA vs. Licensing Alternative

Issue 2

Does the application of USP's methodology for pricing the PCT under the CSA alternative pass the "consistency of evaluation with realistic alternatives test" and the investor model test?

Explanation of Issue	Resources	6103 Protected Resources
After calculating the present value of the profits of the best realistic alternative in a reliable manner, compare that amount to the present value of the anticipated profits under the cost sharing alternative. If the anticipated present value of profits from the realistic alternative is greater than the present value of profits from the cost sharing alternative, then there may be a method reliability issue with the PCT which may indicate the need to propose an adjustment with respect to the taxpayer's valuation result. This is because the present value of profits under the cost sharing alternative should equal or exceed the profits of the best realistic alternative because uncontrolled taxpayers would only enter into the CSA transaction if no alternative is preferable to it. Note that in this example, only the realistic alternatives for USP have been analyzed. In practice, the realistic alternatives for both CFC and USP should be analyzed.	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(A) ▪ Treas. Reg. § 1.482-7(g)(2)(ii)	

Issue 2, Step 2: Review Potential Issues

CSA vs. Licensing Alternative

Issue 2

Does the application of USP's methodology for pricing the PCT under the CSA alternative pass the "consistency of evaluation with realistic alternatives test" and the investor model test?

Explanation of Issue	Resources	6103 Protected Resources
In addition, the investor model applies to determine the reliability of the PCT methodology and result for controlled participants (USP and CFC) by requiring consistency with upfront contractual terms and risk allocation. The investor model further provides that a controlled participant's net investment in the CSA is reasonably anticipated to earn a rate of return appropriate to the riskiness of the controlled participant's CSA investment over the period of the CSA activity.	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(A) ▪ Treas. Reg. § 1.482-7(g)(2)(ii) ▪ Treas. Reg. 1.482-7(g)(2)	
CONSULTATION: You should consult with an economist to determine the expected present value of the profits from the cost sharing alternative and the present value of profits from the best realistic alternative, if necessary.		

Issue 2, Step 3: Additional Factual Development

CSA vs. Licensing Alternative

Issue 2

Does the application of USP's methodology for pricing the PCT under the CSA alternative pass the "consistency of evaluation with realistic alternatives test" and the investor model test?

Fact Element	Resources	6103 Protected Resources
▪ Verify the present value of the anticipated profits to USP of the CSA alternative outside of the U.S. ▪ Request/Consider: – Transfer Pricing Studies – Functional analysis – Intercompany Agreements – Obtain the valuation report – Economist/Engineer/Outside expert – Bloomberg for discount rate computations	▪ Transfer Pricing Roadmap	
▪ Verify whether net present value of the anticipated profits to USP of the licensing alternative is $100 million outside of Country X as maintained by the taxpayer.	▪ Transfer Pricing Studies ▪ Functional analysis ▪ License Agreement ▪ Comparable 3rd party License Agreements ▪ Transfer Pricing Roadmap	

Issue 2, Step 4: Legal Analysis

CSA vs. Licensing Alternative

Issue 2

Does the application of USP's methodology for pricing the PCT under the CSA alternative pass the "consistency of evaluation with realistic alternatives test" and the investor model test?

Explanation of Approach	Resources	6103 Protected Resources
Establish the present value of the anticipated profits under the CSA alternative and compare it to the anticipated present value of profits under the realistic alternative. Based on these facts, the licensing alternative is the best realistic alternative with an anticipated present value of profits of $100 million outside of Country X. Because the expected present value of the licensing alternative exceeds the expected present value of the cost sharing alternative, the condition of consistency of evaluation with realistic alternatives is not met. In addition, the condition of the investor model is not met because USP is anticipated to earn a rate of return that is too low and not appropriate to the riskiness of its investment in the CSA over the period of the CSA. Similarly, CFC is anticipated to earn a return on its investment in the CSA which is too high and not appropriate to the riskiness of its investment in the CSA.	▪ Treas. Reg. § 1.482-7(g)(2)(iii)(A) (realistic alternatives test) ▪ Treas. Reg. § 1.482-7(g)(2)(ii) (investor model rules)	

Issue 2, Step 4: Legal Analysis

CSA vs. Licensing Alternative		
Issue 2		
Does the application of USP’s methodology for pricing the PCT under the CSA alternative pass the “consistency of evaluation with realistic alternatives test” and the investor model test?		
Explanation of Approach	**Resources**	**6103 Protected Resources**
Accordingly, because both the realistic alternatives and investor model tests are not met, the facts in this case suggest that the taxpayer either did not select the most reliable method for computing the PCT or perhaps did not apply it in an arm’s length manner.		
CONSULTATION: Make sure you utilize the Economist and/or Engineer’s report in your argument, if available. The facts for both reports should be the same and you should incorporate the relevant parts of the Economist/Engineer report into the law discussion. Please do not just state “see attached” when referring to these reports.		

Training and Additional Resources

Chapter 1.2.1 Determination of Buy-in/Buy-out Amounts

Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials	▪ International Examiner Phase II Training, Cost Sharing	International Examiner Phase II Training
Other Training Materials	▪ Economist Phase V Training – Legal Matters	Economist Phase V Training
Other Training Materials	▪ Bittker and Lokken Chapter 79: Reallocation of Income and Deductions	Bittker and Lokken
Other Training Materials	▪ OECD Transfer Pricing Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation.
CSA	Cost Sharing Arrangement.
CST	Cost Sharing Transaction
PCT	Platform Contribution Transaction.
RAB	Reasonably Anticipated Benefits
ROW	Rest of World
R&D	Research and Development
USP	United States Parent.
USS	A foreign-owned United States subsidiary.

Index of Related Issues

Issue	Associated UIL(s)	References
Cost Sharing Agreement – Initial Transaction	9411.01	Pricing of Platform Contribution Transaction (PCT) in Cost Sharing Arrangement (CSA) – Initial Transaction ISO/9411.01-01_01
Cost Sharing Agreement – Acquisition of Subsequent IP	9411.01	IPS Unit coming soon
IRC 367 (d) Intangibles vs. Sale	9411.01-02	IPS Unit Distinguishing Between Sale, License and Other Transfers of Intangibles to CFCs by U.S. Transferors ISO/9411.01_02
Licensing of Intangible property to Foreign Affiliate	9411.02-01	IPS Unit coming soon
Arms Length Royalty IRC 367 (d)	9411.02-02	IPS Unit Deemed Annual Royalty Income under Section 367 (d) ISO/9411.02_02
Functional Analysis	9422.07-01	IPS Unit Functional Analysis of an Inbound Distributor ISI/9422.07_01
Transfer Pricing Concepts	9411.07-01	IPS Unit Overview of IRC Section 482 ISO/9411.07.01_01
Arms Length Standard	9422.09	IPS Unit Arms Length Standard ISI/9422.09_06