

**Client Alert**

March 5, 2009

**Advance Pricing Agreements: A Defense against Periodic Adjustments under New Cost Sharing Regulations****Areas of Interest****Tax Transactions****Tax Controversy****United States**

Under long-anticipated regulations published by the US Internal Revenue Service (IRS) at Section 1.482-7T,<sup>1</sup> cost sharing arrangements (CSAs) remain an effective tool that multinational taxpayers can use to efficiently develop and manage ownership of valuable intangible property among subsidiaries. Taxpayers familiar with CSAs, however, will see that valuations of pre-existing, "platform" intangibles contributed to CSAs will be scrutinized by the IRS going forward.

The new regulations expand upon principles and methods found in the IRS's cost sharing guidance promulgated over the last three years, creating a complex set of rules for determining whether the compensation received by the licensor (often a US parent) in these "platform contribution transactions" (PCTs) is arm's length.

Moreover, just as it had under the former Section 1.482-4 regulations, the IRS has the authority to enforce the arm's length standard through "periodic adjustments," which will be triggered if a participant's (usually a foreign subsidiary's) profitability is too high relative to its PCT payments (or "buy-in" payments under the former Section 1.482-7 regulations) for the rights it acquires to develop the pre-existing intangible pursuant to the CSA. The consequences of tripping this trigger are significant: in many potential cases, substantially all of the foreign subsidiary's income arising from the CSA could be allocated back to its US parent. A misstep in the PCT valuation could thus nullify many of the advantages of cost sharing.

However, the -7T regulations include a carrot that can mitigate the harshness of the periodic-adjustment stick. The preamble announces that guidance will be forthcoming in the form of a revenue procedure detailing how an Advance Pricing Agreement (APA) could provide an exception to periodic adjustments. In recent public comments, IRS representatives have encouraged taxpayers to consider applying for APAs under the existing revenue procedure (Rev. Proc. 2006-9), even before this promised supplemental guidance is published. In light of the possible consequences of triggering the periodic adjustment rules of the -7T regulations, there is thus even more reason now to apply for an APA as part of a robust cost sharing strategy.

The periodic adjustment rules are not the only aspect of PCT valuations under the -7T regulations that command attention. Certain provisions are generally favorable to taxpayers, such as the principle that discount rates should reflect "market-correlated risks of activities or transactions" and may differ between flows being discounted and forms of payment (e.g., a royalty on profits versus a royalty on sales). However, other aspects are controversial.

In addition to retaining the "investor model" as a principle to guide the selection of the "best method" for valuing a PCT, the regulations provide that "suitable adjustments" should be made such that PCT

payments are determined on a pre-tax basis. In other words, if PCT payments are determined on a post-tax basis, they must be grossed-up in order to obtain the “value of the PCT payment itself”<sup>2</sup> — a controversial position given that neither the preamble nor the regulations themselves make any effort to square this requirement with customary appraisal practice or the arm’s length standard. The regulations also require taxpayers to develop facts showing that the useful life of the contributed platform intangible is finite; the IRS will not simply accept the claim that the platform intangibles will eventually be “substituted” altogether by the intangibles developed under the CSA.

These and other principles under the -7T regulations introduce an uncertainty into the valuation of PCTs that can make the periodic adjustment rules all the more disconcerting. The general rule is that the IRS may make periodic adjustments for any open taxable year, and for all subsequent taxable years for the duration of the CSA, if it determines that the ratio of the licensee’s (often the foreign subsidiary’s) profits to the value of its “investment” in the CSA (*viz.*, its cost sharing payments and its PCT payments) surpasses a given threshold. If this happens, the periodic adjustment trigger is then tripped, which gives the IRS authority to make periodic adjustments according to a complex set of rules that can result in a substantial amount of profit being allocated back to the licensor.

Although IRS representatives have said publicly that tripping the periodic trigger will not automatically lead to an adjustment (but rather only invites a “discussion” with the taxpayer), taxpayers are likely to find this less than reassuring. Also, there is an exception to the periodic adjustment rules if the trigger is tripped due to “extraordinary events” that “could not reasonably have been anticipated” at the outset of the CSA. However, this must be established “to the satisfaction of the [IRS] Commissioner...”<sup>3</sup>

The heightened scrutiny that tripping the periodic trigger will engender points to several reasons in favor of obtaining an APA to cover a PCT. There is, of course, the advantage of obtaining protection from periodic adjustments and from the uncertainty that in any given year the periodic trigger could be tripped. There are also advantages to obtaining an APA in terms of venue. When shepherded by an advisor with experience in obtaining APAs for potentially high-profit intangibles, the APA Office would be a generally more collaborative environment in which to discuss the complex issues affecting a PCT valuation, such as how subtleties in functions and risks should be reflected in the appropriate discount rate. The experience of examiners in the field with CSAs is less likely to be as deep as that of APA team members, thus leading to possibly more protracted and contentious audits. Moreover, the breadth of the documentation that has to be prepared as part of the CSA administrative requirements under the -7T regulations already puts one well on the way to preparing what is required for an APA submission.

Multinational taxpayers looking to manage their worldwide ownership of intangible property will want to lock in the benefits they obtain through cost sharing from being lost unexpectedly under the periodic adjustment rules. APAs are an effective and attractive means of doing so.

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<sup>1</sup> T.D. 9441. The effective date of the regulations is January 5, 2009, the date on which they were published in the Federal Register (74 Fed. Reg. 340).

<sup>2</sup> Section 1.482-7T(g)(2)(x).

<sup>3</sup> Section 1.482-7T(i)(6)(vi)(A)(2).

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