



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

Number: **200013010**
Release Date: 3/31/2000
CC:INTL:Br6
TL-N-5868-98
UILC: 482.09-00, 482.11-08

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: December 16, 1999

MEMORANDUM FOR

FROM: Steven A. Musher
Branch Chief CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum dated August 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Corporation X

Corporation Y

Corporation Z

Year 1

Years 1-3

ISSUE

Whether, under the facts below, Corporations Y and Z are participants in a bona fide/qualified cost sharing arrangement.

CONCLUSION

More factual development is necessary in order to determine whether Corporations Y and Z anticipated to receive benefits from the cost sharing arrangements by virtue of being in a consolidated group with entities that anticipated receiving benefits. If Corporations Y and Z, or members of their consolidated group, did not anticipate receiving any benefits from the cost sharing arrangements, then Corporations Y and Z can not be considered cost sharing arrangement participants. It must then be determined whether Corporations Y and Z, in substance, developed and owned the intangibles or whether, in substance, they only provided research services with respect to the development of the intangibles. If, in substance, they merely provided research services, then they must be paid an arm's length fee for those services by the owners of the developed intangibles.

FACTS

The taxpayer, Corporation X, is a U.S. corporation. Corporations Y and Z are (indirectly) wholly owned, domestic subsidiaries of Corporation X, and they file a consolidated return with Corporation X. Corporation X also has a number of other subsidiaries, domestic and foreign. Corporations Y and Z develop technology and provide technical services for the good of the Corporation X group of companies.

In Year 1, Corporations Y and Z entered into two technical services and cost sharing agreements with other Corporation X subsidiaries (mostly foreign corporations). Apart from the fact that there were more parties to the first agreement than the second, the agreements were substantially alike. The agreements referred to Corporations Y and Z as the Provider/Developer, and to the other parties as Recipients/Participants. The agreements noted that the Recipients/Participants could request the Provider/Developer to perform various Technical Services, either on an individual or a project basis. The agreements also stated that certain types of technology would be developed by Provider/Developer and made available to Recipients/Participants, either on an individual or on a project basis. Each Recipient/Participant would receive a non-exclusive, non-transferable restricted right to use any developed technology in its "own operations" (i.e., in its own geographic area).

The agreements stated that all direct and indirect costs related to technical services and developed technology would be estimated and billed to the Recipients/Participants. It was expressly agreed that these costs would include the costs of any failed, unworkable or impractical technology started but subsequently abandoned by the Provider/Developer.

The agreements noted that the method for sharing or charging out costs among the Recipients/Participants would be agreed by the parties. The agreements read as follows:

FUNDING OF COSTS. Billing procedures and cost recovery methodologies shall be agreed to between the Parties. In certain instances, technology will be developed for strategic purposes and will be funded by the Corporation without involvement of other Recipients/Participants. In other instances, the Provider/Developer shall meet with the Recipients/Participants to identify and propose a range of research or study programs. The Recipients/Participants will review the projects proposed by the Provider/Developer and may execute a Project Agreement for those projects which the Recipients/Participants elects to support financially. There are a number of funding arrangements which can be accommodated by the Project Agreement.

The agreements also stated that cost shares were to be adjusted annually to insure that they reflected each participant's benefits over time.

In practice, the agreements apparently operated as follows. With respect to the development of technology, Corporations Y and Z produced a list of proposed research projects, with cost estimates for each project, each year. The Recipients/Participants reviewed this list and indicated the projects which they would support. The costs were allocated among the companies (it is unclear how), and the estimated costs were charged out, one twelfth each month.

With respect to technical services, each Recipient/Participant would estimate the amount of technical services needed in the coming year. Service charges would then be billed on one of three bases: direct (e.g., for items purchased for a specific Recipient/Participant), "service rate" (e.g., on a unit basis such as per lab test or per class given), or "labor rate" (all remaining costs). The hourly labor rate charge (for technology projects and services) was determined by taking an average salary rate, adding in the cost of other forms of compensation (e.g., medical and pension costs), adding on miscellaneous costs (e.g., information technology costs, rent, management and staff costs), and dividing the total by the estimated number of productive hours. Rates were changed, as necessary, to insure full cost recovery by the end of the year.

Corporations Y and Z also undertook long-range basic research, not directly related to the activities of any particular Recipient/Participant. The cost of that research was not charged out. Corporations Y and Z appear to have been responsible for determining which research would be charged out and which would not.

In examining the technical services and cost sharing agreements for Years 1-3, the Service has concluded that Corporations Y and Z received no benefit from

the agreements. Therefore, a question has arisen about whether Corporations Y and Z are participants in a bona fide/qualified cost sharing arrangement.

LAW AND ANALYSIS

Both the 1968 and the 1995 cost sharing regulations apply to the years in issue. The 1968 regulations provide that if a member of a controlled group acquires an interest in intangible property as a participant in a bona fide cost sharing arrangement, the Service will not make allocations with respect to that acquisition except as necessary to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is defined as "an agreement, in writing, between two or more members of a group of controlled entities, providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced."¹

The 1995 regulations elaborated the concepts of the 1968 regulations. The 1995 regulations followed from the addition of the commensurate with income standard to section 482. The new regulations define a cost sharing arrangement as "an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement."² The 1995 regulations constitute a clarification, rather than a change in, prior law.³ The 1995 regulations provide that in order to be a qualified participant in a cost sharing arrangement, an entity must reasonably anticipate that it will derive benefits (i.e., receive additional income or save costs) from the use of covered intangibles.⁴

Thus, under the rule of the 1968 regulations, and under the general rule of the 1995 regulations, Corporations Y and Z would not qualify as participants in the cost sharing arrangements because they do not receive any interests in intangible property or anticipate receiving any benefits from the use of covered intangibles. However, there is a special rule in the 1995 regulations pertaining to consolidated groups. The regulations note that for the purposes of the "qualified participant"

¹Treas. Reg. § 1.482-2A(d)(4) (1968 regulations).

²Treas. Reg. § 1.482-7(a)(1) (1995 regulations).

³See Section 482 White Paper on Intercompany Pricing, Notice 88-123, 1988-2 C.B. 458, 472.

⁴Treas. Reg. § 1.482-7(c)(i) (1995 regulations).

test, all members of the same affiliated group that join in the filing of a consolidated return shall be treated as one taxpayer.⁵ Therefore, because Corporations Y and Z join other U.S. affiliates in filing a consolidated return with Corporation X, Corporations Y and Z may be considered to benefit from the cost sharing arrangement if other U.S. affiliates are Recipients/Participants. Although this rule technically only applies to the years covered by the 1995 cost sharing regulations, it should be applied here to all of the years in question because the 1995 regulations constitute a clarification of prior law.

If no U.S. affiliates are Recipients/Participants, then Corporations Y and Z are not cost sharing participants. The rights of Corporations Y and Z, and those of the other members of the agreements, must be determined under the developer-assister rules of Temp. Treas. Reg. § 1.482-4T(e)(3) and Treas. Reg. § 1.482-4(f)(3).

Under Temp. Treas. Reg. § 1.482-4T(e)(3), when two or more members of a controlled group undertake the development of an intangible, the “developer” is determined by considering all of the facts and circumstances. The factor given the greatest weight is the extent to which each member bears the direct and indirect costs and risks of developing the intangible, and makes available, without adequate compensation, property or services likely to contribute to developing the intangible. However, in determining whether an allocation should be made, Temp. Treas. Reg. § 1.482-1T(d)(3)(ii) notes that “the district director will ordinarily respect the terms of contractual arrangements between controlled taxpayers if such terms are consistent with the substance of the underlying transactions and the actual conduct of the parties.” Therefore, given that the agreements identify Corporations Y and Z as the “Provider/Developer”, and given that Corporations Y and Z may have made available property or services, without adequate compensation, that were used to develop the intangibles, Corporations Y and Z might be considered the developers of the intangibles. On the other hand, Corporations Y and Z do not appear to have borne many of the costs of developing the intangibles.

Under the 1995 final section 482 regulations, the rules are much the same. Treas. Reg. § 1.482-4(f)(3) provides that the legal owner of a right to exploit an intangible ordinarily will be considered the owner for purposes of the regulations. However, the district director may impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement. See Treas. Reg. § 1.482-1(d)(3)(ii)(B) (Identifying contractual terms). Moreover, in the case of intangible property that is not legally protected, the developer/owner will be the entity that bore the largest portion of the direct and indirect costs of developing the intangible.

⁵Treas. Reg. § 1.482-7(c)(3) (1995 regulations).

Allocations must be made for assistance provided to the developer/owner in connection with the development or enhancement of intangible property. Temp. Treas. Reg. § 1.482-4T(e)(3)(iii); Treas. Reg. § 1.482-4(f)(3)(iii). Therefore, if Corporations Y and Z are the owners of the intangibles, they must pay the “Recipients/Participants” for their assistance, i.e., their financing of the research. The “Recipients/Participants” would then need to pay Corporations Y and Z for the use of any intangibles. If Corporations Y and Z are not the owners of the intangibles, then they must be paid for the research services provided to the other entities. We think more factual development is necessary in order to determine whether Corporations Y and Z would be considered developers/owners or service providers with respect to the development of the intangibles.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

6 [REDACTED]

[REDACTED]

[REDACTED]

Please call if you have any further questions (202-874-1490).

STEVEN A. MUSER
Branch Chief

cc: Regional Counsel, Western Region

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