

**Office of Chief Counsel
Internal Revenue Service
memorandum**

Number: **202643014**

Release Date: 10/23/2026

CC:INTL:FO:SKarki
POSTU-105634-24

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 9411.01-05

date: May 08, 2026

to: Susan Liu
General Attorney (Tax)
(Litigation & Advisory)

from: Sushovan Karki
Special Counsel
(International)

Sam Hampton
Attorney, Branch 6
(International)

subject: Best method analysis applicable for evaluation of a Platform Contribution Transaction ("PCT") under Treas. Reg. § 1.482-7

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Target =

Foreign CSA Participants =

Taxpayer CSA Agreement =

Call Option Agreement =

POSTU-105634-24	2
Target Merger Agreement	=
Target PCT Agreement	=
Board Presentation Deck	=
Target PCT Report	=
Taxpayer Earnings Report	=
Taxpayer IDR Response	=
Taxpayer NOPA Response	=
Year 1	=
Year 2	=
Year 6	=
Year 7	=
Year 8	=
Target Incorporation Date	=
Option Agreement Date	=
Option Period Commencement Month	=
Board Presentation Date	=
Merger Agreement Date	=
Acquisition Date	=
Target PCT Date	=
Option Period Expiration Month	=
Amount x (to comparatively express financial values)	=

FACTS

Taxpayer, a U.S. corporation, is a cloud-based software provider . Taxpayer is a participant in a cost sharing arrangement (“CSA”) in accordance with Treas. Reg. § 1.482-7 with various non-U.S. Taxpayer-affiliated corporations (“Foreign CSA Participants”). This CSA (“Taxpayer CSA”) is memorialized in an agreement between Taxpayer and the Foreign CSA Participants (“Taxpayer CSA Agreement”), which has been amended and restated several times.

Target is a U.S. corporation. Target was incorporated in Year 1 on Target Incorporation Date. Target develops and provides software, which at all times integrated Taxpayer’s software

In Year 2, on Option Agreement Date, Taxpayer acquired a minority equity interest in Target in the form of preferred stock. Taxpayer simultaneously entered into a call option agreement (“Call Option Agreement”) with Target. Taxpayer paid Target \$18x¹ total for both the Call Option Agreement and the preferred shares. The price paid for the Call Option Agreement (“Call Option Consideration”) was not separately stated, but represented some portion of Taxpayer’s \$18x payment in Year 2.

The Call Option Agreement granted Taxpayer an exclusive and irrevocable right (“Call Option Right”) to acquire the remaining equity in Target through a compelled merger of Target with a wholly owned Taxpayer subsidiary. Exhibit A of the Call Option Agreement (the “Merger Term Sheet”) contained terms and conditions (including the purchase price) which were to be agreed upon by parties in a final merger agreement.² In the event Taxpayer exercised its Call Option Right, the Call Option Agreement prescribed a method to calculate the purchase price. Specifically, the exercise price of the Call Option Right (“Option Exercise Price”) was determined by a formula (“Exercise Price Formula”) based on (i) Target’s revenue over the twelve month period ending immediately prior to signing a merger agreement and (ii) Target’s revenue growth in that period as compared to the immediately preceding twelve month period, expressed as a

¹ All values are approximations, and we have further rounded them as presented here. They are provided for general illustration and comparison purposes only.

² The Merger Term Sheet describes itself as “preliminary,” and states: “*Except as specifically provided for in the [Call Option Agreement], [the Merger Term Sheet] does not express an agreement between [Taxpayer and Target] with respect to the subject matter hereof and is not meant to be binding upon [Taxpayer and Target] now, or at any time in the future, nor, except as provided for in the [Call Option Agreement], do [Taxpayer and Target] intend to be bound to proceed with a possible business combination or other transaction on the terms set forth in [the Merger Term Sheet] or otherwise unless and until they enter into definitive agreements with respect to such a business combination or other transaction*” (emphasis supplied). Although the Merger Term Sheet is characterized as preliminary or non-binding, it is incorporated in the Call Option Agreement, as both parties are obligated to “fully negotiate, in good faith, the terms and conditions of, and to execute counterparts to, a definitive Merger Agreement . . . that *is in accordance with the terms and conditions set forth in the [Merger Term Sheet]*” (emphasis supplied).

percentage.³ The Option Exercise Price was subject to a price floor and ceiling.⁴ Taxpayer represents that, as of Option Agreement Date, Taxpayer and Target agreed that the Exercise Price Formula was a reasonable means to value Target.⁵

The Call Option Right was subject to other restrictions, including that it must be exercised within a specific period ("Option Period"). The Option Period began in the first quarter of Year 6 and ended two years later in Year 8. In the event the parties fail to execute a final merger agreement, the Call Option Agreement provided procedures for extension of time to reach an agreement. The Call Option Agreement also provided that disputes between the parties as to the amount of net revenues are to be resolved by a binding determination by a third-party accounting firm. Should the parties completely fail to reach an agreement (even after the time extension), there are no general limitations on remedies. Both Taxpayer and Target acknowledged in the Call Option Agreement the necessity of specific performance and injunctive relief to remedy a party's breach, and both parties waived their defenses with respect to such remedies.

From Year 2 through Year 7, Target experienced rapid revenue growth and overall business success. In Year 6, Taxpayer started to conduct due diligence as to whether it should exercise its Call Option Right. As a part of the due diligence, Taxpayer performed several analyses to determine the enterprise value of Target.⁶ Two such analyses valued Target using a discounted cash flow ("DCF") analysis based on financial projections of Target's future earnings as anticipated in Year 7. The first DCF analysis calculated the enterprise value based on Target's financial projections as a standalone enterprise ("Standalone Valuation"). The second DCF analysis was based on Target's financial results considering synergies from combining Target and Taxpayer's businesses ("Pro Forma Valuation").⁷ Under the Standalone valuation,

³ As per the Call Option Agreement, the Option Exercise Price is dependent on a Base Price, which is calculated by multiplying Target's Current Last Twelve Months ("LTM") Net Revenue by a Multiple. Target's Current LTM Net Revenue means Target's revenue over a twelve-month period ending on a specified date, which is generally the end of Target's last completed fiscal quarter prior to the signing of a merger agreement. The Multiple is the growth percentage in the Current LTM Net Revenue over the immediately preceding LTM Net Revenue. Taxpayer was unable to produce any documents contemporaneous to the Call Option Agreement that explained how this formula was determined, what its inputs attempt to reflect, or its relationship to Target enterprise value. See Taxpayer IDR Response (response to request 2b).

⁴ The Base Price is subject to a minimum "floor" amount of \$470x, and a maximum "ceiling" amount of \$940x.

⁵ See Taxpayer IDR Response (response to request 2b: "it is the case that, at the time the [Call Option Agreement] was negotiated and entered into, both of the parties agreed that the [Exercise Price Formula] represented a reasonable method for valuing — for purposes of a future acquisition — a company of the profile of [Target], based on then-existing comparable companies in the industry").

⁶ In addition to the discounted cash flow analyses described below, Taxpayer calculated the enterprise value of Target using revenue multipliers based on publicly available data on acquisition transactions. Specifically, Taxpayer obtained a range of revenue multipliers and applied those multipliers to either the LTM revenues or the next twelve months revenue to determine the enterprise value.

⁷ The projections used in the DCF analyses include ten years of financial information related to (i) categories of revenues and associated costs of revenues, (ii) operating expenses, categorized among sales and marketing, research and development, and general and administrative expenses, (iii)

Taxpayer calculated a range of enterprise values for Target between 1250x and 1870x, with a median of \$1500x; under the Pro Forma Valuation, the range of Target enterprise values was between \$1630x and \$2480x, with a median of \$1970x. Applying the Exercise Price Formula to the Target's revenue and revenue growth results, Taxpayer determined the Option Exercise Price was \$720x in the first quarter of Year 7.

On Board Presentation Date, about one year prior to the expiration of the Option Period and the lapse of Taxpayer's Call Option Right, Taxpayer's management gave a presentation to its board of directors ("Board") concerning potential acquisition of Target. As represented in the Board Presentation Deck, Taxpayer's management believed it had an enforceable Call Option Right,⁸ but that the "[p]urchase window [was] closing [because] Option expire[d] at the earlier of [an initial public offering] or [the end of the Option Period in Year 8]."⁹ The Board Presentation Deck included discussions of the financial projections used for the purposes of the DCF analyses, as well as the range of enterprise value based on the Standalone Valuation and Pro Forma Valuation.¹⁰ As Target's enterprise value significantly exceeded the Option Exercise Price, Taxpayer's management recommended that its Board approve the acquisition of Target.

Days after the recommendation to the Board, around three months prior to Acquisition Date, Taxpayer entered into the Target Merger Agreement to acquire Target. On Acquisition Date,¹¹ Taxpayer's subsidiary merged with and into Target pursuant to the terms of the Target Merger Agreement ("Target Acquisition Transaction"). In exchange for their Target Shares, Target's shareholders collectively received \$720x (the "Target Acquisition Price"), the same amount as the Option Exercise Price determined by Taxpayer and presented to its Board.

Two months after Acquisition Date, Taxpayer contributed certain Target resources, capabilities, and rights ("RCRs") to the Taxpayer CSA. Taxpayer determined that this transaction constituted a platform contribution necessitating a PCT under Treas. Reg. § 1.482-7(b)(1)(ii). Taxpayer valued this PCT ("Target PCT") based on a purported application of the APM. Taxpayer calculated the Target PCT Payment as \$30x, the product of (i) the percentage reflecting Foreign CSA Participants' aggregate shares of reasonably anticipated benefits ("RAB") under the Taxpayer CSA, and (ii) an adjusted

projected synergies (i.e., additional revenue or reduced costs and expenses) from the integration of Taxpayer and Target businesses, and (iv) effective cash tax, discount, and growth rate assumptions.

⁸ "[Taxpayer] negotiated a purchase option for [Target] when investing in [Target preferred stock] in [Year 2]." Board Presentation Deck Moreover, in Year 7

, an officer of Taxpayer commented that its prior investment in Target led to the opportunity to acquire Target on favorable terms.

⁹ Board Presentation Deck

¹⁰ Board Presentation Deck

¹¹ Acquisition Date is the closing date per the Target Merger Agreement.

acquisition price for Target of \$130x, determined by making certain adjustments to the Target Acquisition Price of \$720x.¹²

Taxpayer's third-party advisor prepared a transfer pricing report documenting the Target PCT ("Target PCT Report"). The Target PCT Report concludes that the APM under Treas. Reg. § 1.482-7(g)(5), as applied by the Taxpayer with the adjustments, is the best method. However, the Target PCT Report does not disclose that the Target Acquisition Price used to apply the APM was itself based on the Exercise Price Formula. Rather, the Target PCT Report simply notes that the Target Acquisition Price reflects the total purchase price for Target and concludes that the APM under the U.S. transfer pricing regulations is the best method to evaluate the arm's length value of RCRs contributed to the Taxpayer CSA. The Target PCT Report does not make any reference to the Call Option Agreement or the specific terms of the Target Acquisition Transaction. The Target PCT Report also rejects all other specified methods under Treas. Reg. § 1.482-7(g) and does not identify any unspecified method to evaluate the Target PCT.¹³

Taxpayer disputes the legal force of the Call Option Agreement and maintains Taxpayer's acquisition of Target was independent of the Call Option Agreement, stating:

[T]he "call option" described in the [Call Option Agreement] did not necessarily constitute a legal right on behalf of [Taxpayer] to affirmatively and unequivocally compel [Target's] shareholders to sell their shares at a price determined solely through the application of the mathematical formula contained therein . . . Indeed, the [Call Option Agreement] requires that [Taxpayer and Target] use their reasonable best efforts to negotiate in good faith a merger agreement in accordance with the non-binding term sheet . . . The resulting application of [the Exercise Price Formula] functioned to a large degree as a starting point for negotiations between the parties. The existence of the [Call Option Agreement] should in no way be construed as to have resulted in anything other than an arm's-length transaction for the acquisition of [Target].¹⁴

¹² Taxpayer made adjustments related to: (i) tangible assets not transferred under the PCT (less associated liabilities), (ii) purported Target liabilities assumed by Taxpayer concerning future compensation of Target employees, (iii) net operating losses, (iv) certain Taxpayer-retained make-sell rights, (v) a "control premium," and (vi) the value of what Taxpayer determined as the "routine" portion of Target's expected earnings. This memorandum does not address the validity or accuracy of those adjustments.

¹³ The Target PCT Report does not mention the DCF analyses or the financial projections used to prepare them. The Target PCT Report rejects the income method under Treas. Reg. § 1.482-7(g)(4) for the following reasons: "Given the early development stage of [Target's] business, there were no reliable financial projections for the full profit and loss . . . (beyond the revenue projections) for the international business to serve as the basis for the . . . valuation . . . Given that we are able to identify another more reliable method which is less sensitive to these financial projections, we rejected the income method as the best method." Target PCT Report at 33–34.

¹⁴ Taxpayer IDR Response (response to request 2a).

Taxpayer further asserts that the “Base Price was not necessarily the result of any ‘calculation’ or ‘equation’ or ‘input’. Rather, the ultimate purchase price was the result of good faith negotiations as to the true value of the outstanding shares of [Target].”¹⁵ However, in connection with this assertion, Taxpayer identifies and produces two calculations of Base Price that are explicitly based on the Exercise Price Formula.¹⁶

LAW AND ANALYSIS

Background

A CSA is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their respective RAB shares.¹⁷ A platform contribution means “any [RCR] that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the [CSA]) that is reasonably anticipated to contribute to developing cost shared intangibles.”¹⁸ In a PCT, each PCT Payor is obligated to, and must in fact, make arm's length PCT Payments to each PCT Payee that provides a platform contribution.¹⁹

The arm's length standard applies to determine taxpayers' true taxable income from a controlled transaction, including a PCT.²⁰ The methods for the purposes of evaluating the arm's length amount charged in a PCT are provided in Treas. Reg. § 1.482-7(g). Treas. Reg. § 1.482-7(g)(1) provides that each PCT valuation method “must yield results consistent with measuring the value of a platform contribution by reference to the future income anticipated to be generated by the resulting cost shared intangibles.” Further, each method must be applied in accordance with the provisions of the best method rule of Treas. Reg. § 1.482-1(c), the comparability analysis of Treas. Reg. § 1.482-1(d), and the arm's length range of Treas. Reg. § 1.482-1(e).²¹

¹⁵ Taxpayer IDR Response (response to request 2a).

¹⁶ In the Taxpayer IDR Response, Taxpayer's response to 2a reads in part: “Please see our response below to item #3 for additional information responsive to this request.” Request 3 was to “[p]rovide calculations, including equations and inputs, of [a component of Exercise Price Formula].” Taxpayer's response to request 3 reads: “Please see [two workbooks] accompanying this response. The former represents the calculation prepared by [Taxpayer], while the latter was prepared by [Target]; they collectively represent the ‘application’ of the [Exercise Price Formula] to which reference is made in our response to item 2a, above.” Taxpayer IDR Response. Based on these documents, the Exercise Price Formula, rather than negotiations between otherwise uncommitted parties, seems to be driving the determination of the Target Acquisition Price.

¹⁷ Treas. Reg. § 1.482-7(b).

¹⁸ Treas. Reg. § 1.482-7(c).

¹⁹ Treas. Reg. § 1.482-7(b)(1)(ii).

²⁰ Treas. Reg. §§ 1.482-1(b)(1), 1.482-7(a)(2).

²¹ See, e.g., Treas. Reg. § 1.482-7(g)(4)(vi)(A), (5)(iv) (incorporating Treas. Reg. § 1.482-4(c)(2)).

The APM applies the CUT method of Treas. Reg. § 1.482-4(c) to provide an arm's length valuation of a PCT in reference to an uncontrolled transaction.²² Specifically, the APM applies when the uncontrolled transaction is "the stock or asset purchase of an entire organization or portion thereof."²³ The APM "is ordinarily used where substantially all the target's nonroutine contributions . . . made to the PCT Payee's business activities are covered by a PCT or group of PCTs."²⁴ Under the APM, "the arm's length charge for a PCT or group of PCTs covering [RCRs] of the target is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares."²⁵

The adjusted acquisition price is calculated by making certain adjustments to the acquisition price.²⁶ The adjusted acquisition price is "acquisition price of the target increased by the value of the target's liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target's tangible property on that date and by the value on that date of any other resources, capabilities, and rights not covered by a PCT or group of PCTs."²⁷ Treas. Reg. § 1.482-7(g)(5)(iii) provides for no other adjustments to the acquisition price.

The reliability of the APM is reduced when "[a] substantial portion of the target's nonroutine contributions to the PCT Payee's business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued."²⁸ Similarly, the reliability of the APM is reduced when "[t]he date on which the target is acquired and the date of the PCT are not contemporaneous."²⁹ As an application of the CUT method, the reliability criteria of Treas. Reg. § 1.482-4(c)(2) also apply to the APM.³⁰ The APM is most reliable "when the uncontrolled transaction involves the same intangible property under the same, or substantially the same, circumstances."³¹ Comparable intangible property must "[b]e used in connection with similar products or processes within the same general industry or market," and "[h]ave similar profit potential."³² In relation to whether circumstances are the same or substantially the same, the relevant factors are noted in Treas. Reg. § 1.482-4(c)(2)(iii)(B)(2).

²² Treas. Reg. § 1.482-7(g)(5)(i). The CUT "method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction." Treas. Reg. § 1.482-4(c)(1).

²³ Treas. Reg. § 1.482-7(g)(5)(i).

²⁴ Treas. Reg. § 1.482-7(g)(5)(i).

²⁵ Treas. Reg. § 1.482-7(g)(5)(ii).

²⁶ Treas. Reg. § 1.482-7(g)(5)(i), (iii).

²⁷ Treas. Reg. § 1.482-7(g)(5)(iii).

²⁸ Treas. Reg. § 1.482-7(g)(5)(iv)(A).

²⁹ Treas. Reg. § 1.482-7(g)(5)(iv)(C).

³⁰ Treas. Reg. § 1.482-7(g)(5)(iv).

³¹ See Treas. Reg. § 1.482-4(c)(2)(ii).

³² Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1).

Analysis

Taxpayer purported to apply the APM, selecting the Target Acquisition Price as the acquisition price for determining the arm's length value of the RCRs contributed to the Taxpayer CSA. Taxpayer's selection and application of the APM is unreliable, as the Target Acquisition Price does not reflect an arm's length price of the RCRs contributed to the Taxpayer CSA in Year 7. The taxpayer's APM is therefore not the best method to value the Target PCT, based on the information available to us, including the contemporaneous internal projections and enterprise valuations relied on by Taxpayer in making business decisions, discussed further below.³³

The Target Acquisition Price is the formulary result of the Exercise Price Formula agreed upon in Year 2 in the Call Option Agreement. Both Taxpayer and Target were contractually bound by the Call Option Agreement, including using the Option Exercise Price as determined by the Exercise Price Formula, in determining the acquisition price, if Taxpayer exercised the option. Accordingly, the Target Acquisition Price was equal to the Option Exercise Price. Given Taxpayer's ability to exercise its Call Option Right in Year 7, the Target Acquisition Transaction was not subject to meaningful, arm's length negotiation at the time of the acquisition. The negotiations between the uncontrolled parties took place five years earlier in Year 2 when Taxpayer and Target executed the Call Option Agreement. At that time, the parties did not reach any price—only the Exercise Price Formula. That formula required revenue and growth inputs not then known to compute the future price, if any, and logically would also have reflected Taxpayer's risk of losing a prior investment. Taxpayer's exercise was not certain when the formula was agreed to, nor was the timing of that exercise. Therefore, the circumstances of the Target Acquisition Transaction are such that the Target Acquisition Price is not an arm's length price for Target in Year 7.³⁴

Taxpayer asserts that it did not have “a legal right . . . to affirmatively and unequivocally compel [Target's] shareholders to sell their shares at [the Option Exercise Price]” because the parties' obligation upon Taxpayer's exercise of the Call Option Right was to apply “reasonable best efforts to negotiate in good faith a merger agreement in accordance with the [Term Sheet],” which itself is “non-binding.”³⁵ Taxpayer concludes that since there was some negotiations as to the terms of the merger agreement, the Target Acquisition Price is “the true value of the outstanding shares of [Target].”³⁶ Whether Taxpayer lacked an “unequivocal” right to compel acquisition of the Target, as Taxpayer states, is irrelevant, as Taxpayer clearly possessed the Call Option Right, and it was clearly enforceable. Taxpayer accurately describes the agreement as requiring

³³ See Treas. Reg. § 1.482-7(g)(2)(vi) (“projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements” of Treas. Reg. § 1.482-7 related to financial projections).

³⁴ See Treas. Reg. § 1.482-1(d)(1) (“Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances”).

³⁵ See Taxpayer IDR Response (response to request 2a).

³⁶ See Taxpayer IDR Response (response to request 2a).

the parties to “use their reasonable best efforts to negotiate in good faith a merger agreement in accordance with the non-binding term sheet.” A commitment to use “reasonable best efforts” is enforceable in court.³⁷ The Call Option Agreement incorporated the Exercise Price Formula and provided Taxpayer remedies for breach, including arbitration of the computation of revenue necessary to determine the result of the Exercise Price Formula, and a specific reservation of a specific performance remedy, which could be invoked to compel a sale.

Taxpayer also asserts that Target Acquisition Price was *not* determined under the Exercise Price Formula.³⁸ First, whether the Target Acquisition Price was ultimately determined by exercise of the Call Option Agreement or separately negotiated without formal invocation of the option is irrelevant. Any negotiation would have been driven by the parties’ consideration that the option *could* be exercised, a consideration absent from the PCT, a transaction in which neither party held the leverage of a legally enforceable right to require best efforts of the other party to negotiate a transaction around a predetermined formula.³⁹

Second, considering the totality of the circumstances, Taxpayer’s assertion that the Target Acquisition Price was not determined under the Exercise Price Formula is not credible. The Call Option Agreement and the Option Exercise Price were the primary determinants to derive the Target Acquisition Price, which did not represent Target’s enterprise value in Year 7. Instead, the Target’s enterprise value in Year 7 is better reflected in Taxpayer’s contemporaneous valuations used by its Board in determining whether to exercise the option. Moreover, Taxpayer noted the interdependence of the Target Acquisition Price and the Option Exercise Price, stating that the Target Acquisition Price “represents the sum of the Base Price” and “two customary purchase price adjustments.”⁴⁰ While the “Base Price” appears to have been disputed between Taxpayer and Target based on different interpretations of the contractual provisions, ultimately both Taxpayer and Target used the Base Price to calculate the Option Exercise Price.⁴¹ In addition, _____, an officer of

³⁷ See, e.g., *Triple-A Baseball Club Assoc. v. Northeastern Baseball, Inc.*, 832 F.2d 214, 226 (1st Cir. 1987) (“Breach of a “best efforts” duty has been found where the promisor ceased performance or engaged in a number of misfeasances and nonfeasances”); *United Roasters, Inc. v. Colgate-Palmolive Co.*, 649 F.2d 985, 990 (1st Cir. 1981) (failure to fulfill contractual obligation to promote product constituted breach of “best efforts” agreement); *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 614 (2d Cir. 1979) (obligation to use “best efforts” to promote product and “maintain a high volume of sales” breached where trial court permissibly inferred the defendant “simply didn’t care about [the product’s] volume and was content to allow this to plummet so long as that course was best for [its] overall profit picture”).

³⁸ See Taxpayer IDR Response (response to request 2a); see also Taxpayer NOPA Response at 3.

³⁹ See Treas. Reg. § 1.482-1(d)(3)(ii)(A)(6) (“Collateral transactions or ongoing business relationships between the buyer and the seller” bear on comparability of a transaction); cf. *Framatome Connectors USA v. Commissioner*, 118 T.C. 32 at n. 42, *aff’d* 108 Fed. Appx. 683 (2d Cir. 2004) (non-exercise of co-owner’s veto powers likely reflected that those powers’ existence induced taxpayer to cooperate).

⁴⁰ See Taxpayer IDR Response (response to request 1).

⁴¹ See Taxpayer IDR Response (responses to requests 2a and 3 referencing calculations by Taxpayer and Target of the Option Exercise Price by reference to the Exercise Price Formula).

Taxpayer commented that its prior investment in Target led to the opportunity to acquire Target on favorable terms.⁴²

The Taxpayer and Target did engage in an uncontrolled transaction when Taxpayer paid Target for the preferred shares and the Call Option Agreement in Year 2. However, the Call Option Agreement is an unreliable CUT for the application of the APM to a PCT in Year 7. There is no uncontrolled transfer of Target's stock or assets⁴³ under the Call Option Agreement.⁴⁴ The actual exchange on entering into the Call Option Agreement in Year 2 was the Call Option Right, which granted Taxpayer the benefit of deciding whether to go through with the purchase under prearranged terms after substantial uncertainties had played out, for the Call Option Consideration, not an unconditional commitment to acquire Target.⁴⁵

Taxpayer's application of the APM assumes that (i) the Option Exercise Price can be a reliable acquisition price (in Year 7) because it considers Target's net revenues and revenue growth, and (ii) the Exercise Price Formula calculates an arm's length value of Target (in Year 7) because it was included in the Call Option Agreement, an uncontrolled transaction.⁴⁶ These assumptions are incorrect. When the Call Option Agreement was entered into in Year 2, both the future value and the Option Exercise Price of Target were unknown. Thus, Taxpayer's purported APM inappropriately conflates the Option Exercise Price (under the uncontrolled Call Option Agreement), which is the result of a prior risk allocation between parties, with an uncontrolled acquisition price.⁴⁷ Therefore, there is no indication that the Option Exercise Price is a reliable acquisition price to value the Target PCT in Year 7.

42

43 Taxpayer's potential exercise of its Call Option Right to acquire Target in Year 7 *pursuant to* the Call Option Agreement would be a separate transaction that, as of the time of Call Option Agreement (i.e., in Year 2), might or might not occur.

44 See Treas. Reg. §§ 1.482-4(c)(1) ("The [CUT] method evaluates whether the amount charged for a controlled *transfer of intangible property* was arm's length by reference to the amount charged in a [CUT] [i.e., an uncontrolled transfer of comparable intangible property]" (emphasis supplied)), 1.482-7(g)(5)(i) ("the [APM] applies the [CUT] method . . . to evaluate whether the amount charged in a PCT . . . is arm's length by reference to *the amount charged . . . for the stock or asset purchase of an entire organization*. . . in an uncontrolled transaction" (emphasis supplied)).

45 See Treas. Reg. § 1.482-1(d)(3)(ii) (comparability between controlled and uncontrolled transactions depends on the comparability of the contractual terms in the two transactions).

46 See Taxpayer NOPA Response at 4 ("[T]he investment and any associated rights were negotiated and agreed upon between two parties that were not under common control at the time of the investment. The terms were commercially reasonable and reflected the market conditions prevailing at the time. There is no basis to conclude that the price established in this arm's length transaction between unrelated parties did not reflect fair market value").

47 See Treas. Reg. § 1.482-1(d)(3)(ii) (comparability between controlled and uncontrolled transactions depends on the comparability of the contractual terms in the two transactions).

Furthermore, the reliability of the Call Option Agreement as a CUT is diminished when considering the criteria enumerated in Treas. Reg. § 1.482-4(c)(2) (comparability and reliability considerations for transfers of intangible property) and Treas. Reg. § 1.482-7(g)(5)(iv)(C) (reliability of APM reduced if acquisition not contemporaneous with PCT).⁴⁸ The parameters of the Exercise Price Formula were negotiated five years before Acquisition Date.⁴⁹ The circumstances in Year 2 and Year 7 are not the same.⁵⁰ In Year 2, Target was in its second year of existence. Target's products and market presence were still at a very early stage. Future prospects for product, technology, and market penetration were uncertain. Target's technology was relatively new in Year 2 as compared to Year 7.⁵¹ As such, the stage of development of the intangible was materially different between Year 2 and Year 7. Moreover, Target's revenue increased over the five-year period, and this resulted in a much higher enterprise value in Year 7 (as compared to the Option Exercise Price determined using the Exercise Price Formula agreed to in Year 2) as presented by Taxpayer to its Board. Based on Taxpayer's application of the two DCF analyses, Target's value was between \$1250x and \$2480x, while the ceiling on the Option Exercise Price was \$940x.⁵² This indicates the profit potential for Target's intangibles in Year 2 was not the same as in Year 7.

Taxpayer has not applied any specified methods in Treas. Reg. § 1.482-7 other than the APM.⁵³ Based on all of the information available to us, (i) the APM is not the best method and is unreliable, for the reasons stated above, and (ii) the best method is one

⁴⁸ We note that Taxpayer's valuation of the Target PCT also implicates the reliability factor in Treas. Reg. § 1.482-7(g)(5)(iv)(A) (the reliability of the APM is reduced if a substantial portion of the target's nonroutine contributions to the PCT Payee's business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued). Under Taxpayer's valuation method, approximately 70 percent of the value of Target's assets were not contributed to the Taxpayer CSA, and Taxpayer has not provided a reliable allocation of the Target asset value, based on the Target Acquisition Price, among the transferred and retained RCRs.

⁴⁹ While Acquisition Date and Target PCT Date are close in time, the terms of the Target Acquisition Transaction were effectively set on Option Agreement Date, five years prior to Acquisition Date.

⁵⁰ See Treas. Reg. § 1.482-4(c)(2)(iii)(B)(2), (2)(ii) (comparability between controlled and uncontrolled transactions depends on comparability of circumstances, which include various factors such as "[t]he stage of development of the intangible . . . in the market in which the intangible is to be used").

⁵¹ See Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1) (comparability between controlled and uncontrolled transactions depends on comparability of the intangible property involved, including "having similar profit potential" which is "most reliably measured by directly calculating the net present value of the benefits to be realized"). The Exercise Price Formula does not directly measure the net present value or even the current profitability of Target's intangible, instead relying on net revenues and revenue growth rate. Moreover, there is no indication, other than Taxpayer's bare assertion, that the Exercise Price Formula was intended as a standalone, exercise-time valuation of Target.

⁵² In the Call Option Agreement, the Option Exercise Price considered Target's revenue and revenue growth. However, the Call Option Agreement caps the Option Exercise price to \$940x. Assuming that the Option Exercise Price as determined by the Exercise Price Formula is meant to reflect Target's enterprise value, this ceiling further supports that the formula agreed to in Year 2 does not fully consider the profit potential of the Target intangibles in Year 7.

⁵³ Taxpayer has not explained how the revenue multiples to derive an enterprise value fit under Treas. Reg. § 1.482-7 and has not evaluated comparability of those transactions with the Target PCT. See *Facebook, Inc. & Subsidiaries v. Commissioner*, 164 T.C. 194, 304 (2025) (rejecting proposed corroborating method that lacks support in cost-sharing regulations).

that uses data reflective of the facts and circumstances on Acquisition Date.⁵⁴ The data contained in Taxpayer's two DCF analyses is more reliable when contrasted with the information used in Taxpayer's APM because (i) the data in the DCF analyses is contemporaneous to the Target PCT, (ii) the DCF analyses were used to guide non-tax business decisions, and (iii) use of the data in the DCF analyses reduces a method's dependence on unreasonable assumptions about the Target Acquisition Transaction.⁵⁵ Taxpayer valued Target based on a DCF analysis using financial projections of Target's future earnings, as anticipated in Year 7, and by applying assumptions related to discount rates and growth rates. Therefore, an appropriate and reliable method of valuing the Target PCT—and the best method, based on the limited information available and Taxpayer proposing no other method—would be to use these financial projections as the base, modifying and supplementing as necessary for comparability considerations and as otherwise necessary to adhere to the parameters and requirements of the income method under Treas. Reg. § 1.482-7(g)(4).

Because Taxpayer's use of the APM by reference to the Option Exercise Price is an unreliable method and the relevant facts were not properly disclosed in the Target PCT Report, [REDACTED] applicable penalties.⁵⁶

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-3973 or (206) 946-3614 if you have any further questions.

⁵⁴ See Treas. Reg. § 1.482-1(c)(2)(ii) (whether method produces most reliable measure of arm's length results depends on "completeness and accuracy of the underlying data" and "reliability of the assumptions").

⁵⁵ See Treas. Reg. § 1.482-7(g)(2)(vi) ("projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements" of Treas. Reg. § 1.482-7 related to financial projections). Taxpayer's APM relies on the unreasonable assumption that negotiations in light of and consistent with the mechanically computed Option Exercise Price, using a formula agreed to five years prior, is indicative of an arm's length price for a PCT made in the absence of an option agreement.

⁵⁶ See I.R.C. § 6662(b), (h).