

# Insight

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## Cost Sharing Agreements An Effective Tax Planning Tool

Introduced in 1995, cost-sharing agreements, or CSAs, have been controversial from the start. A CSA is a contractual agreement between companies in the same multinational group which allows the companies to share the costs and risks of developing, producing, or obtaining assets. Typically companies with R & D or technology-related assets, such as pharmaceutical or software companies, have entered into this type of agreement.

In a CSA, each party to the agreement should 1) derive a mutual benefit, 2) have a defined interest in the project, and 3) share the benefits using an allocation method reflecting the costs incurred.

CSAs provide an effective tax planning tool for many companies. These arrangements are particularly beneficial when global development activities would otherwise require global cross-licensing arrangements which are difficult to administer and can result in additional tax burden in the form of withholding taxes as well as additional scrutiny from tax authorities.

U.S.-based multinationals also use CSAs to migrate intangibles off-shore by having new participants buy in to the existing intangible property and thereby gain the rights to a portion of the income attributable to the intangible property.

### RECENT DEVELOPMENTS

In the past few years the IRS has expressed concern over what it perceives as abusive practices by taxpayers with regard to moving intellectual property to low tax jurisdictions. To address the issue, in 2005, the U.S. Treasury released proposed regulations which included substantial revisions to the current Internal Revenue Code (IRC) Section 482 regulations governing CSAs.

The IRS is particularly concerned with the methods used to value existing intangibles for purposes of determining the buy-in payments. The IRS believes that taxpayers have been undervaluing existing intangibles, thereby understating the buy-in payments due to the U.S. taxpayer.

### VALUATION OF INTANGIBLES

The proposed regulations introduce the concept of the “investor model.” The investor model considers what an arms-length investor would be willing to invest in the CSA. The model outlines the following pricing methods: income, market capitalization, the acquisition price method, and the residual profit split method.

The basic principle of the investor model is that each cost sharing participant is viewed as making an aggregate investment attributable to both cost contributions and pre-existing intangibles brought to the arrangement. Under the investor model, the IRS has indicated that it is appropriate to determine both 1) what an investor would pay at the outset of a CSA for an opportunity to invest in the arrangement, and 2) what a participant with external contributions would require as compensation at the outset of a cost sharing agreement to allow an investor to join in the investment. The impact of

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the investor model is that it essentially guarantees a return to the intangibles developer for its efforts. The investor model also assumes that the existing intangibles will have a perpetual life, and thus significantly increase the resulting buy-in payments. The following case studies illustrate the role of valuation in CSAs.

*“Due to the proposed regulations, it is important to obtain a valuation that can withstand IRS scrutiny.”*

### CASE STUDIES

1) ABC Energy is a multinational group in the alternative energy business with manufacturing plants in the U.S. and Ireland (ABC Ireland) which distributes its products throughout the world. ABC has a new initiative which focuses on the development of wind energy products. Rather than use its historical approach of funding all R & D out of the U.S., ABC has decided to enter into a cost sharing arrangement for the development of the wind energy technology. Historically, ABC collects royalties from ABC Ireland based on its use of the alternative energy technology which was developed in the U.S. Under a cost sharing arrangement, ABC Energy U.S. and ABC Ireland will share in the development costs based on future anticipated benefits. VRC is available to assist in the determination of the appropriate sharing arrangement under the cost sharing arrangement. As a result of the cost sharing arrangement, the U.S. group will earn revenues only on its U.S. sales whereas ABC Ireland will earn revenues based on all non-U.S. sales, without the payment of royalties to the U.S. company.

2) Video Game Technologies (VGT) has been in the electronic game business for 15 years. VGT has been expanding its operations and sales activities throughout the world. VGT and its five main software development subsidiaries have been participants in a cost sharing arrangement for a number of years. Accordingly, the cost sharing participants share in all development costs related to new games and new technologies and earn revenues/benefits in the geographic regions as defined in the cost sharing arrangement. VGT has just acquired a company in the same business and wishes to have this new company, RPG Technology, become a participant in the cost sharing arrangement. As a new participant to the cost sharing arrangement, RPG will be required to make a buy-in payment for its access to the existing technology. VRC is available to assist VGT in the determination of both the buy-in payment and the future cost sharing allocations based on the revised future anticipated benefits.

### REGULATIONS NOT FINAL

Although the regulations from the IRS are not final yet, the IRS has released a coordinated issue paper, giving further support for the investor model method. Due to the proposed regulations, it is important to obtain a valuation that can withstand IRS scrutiny. At Valuation Research, our professionals average more than 20 years of experience. Our professional staff has the knowledge and expertise to handle the most complex tax engagements. For more information, contact your Valuation Research representative.

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