Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482–7: Sharing of costs.

T.D. 8670

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Revision of Section 482 Cost Sharing Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to qualified cost sharing arrangements under section 482 of the Internal Revenue Code. These regulations reflect technical changes to the requirements for qualification as a controlled participant under the final cost sharing regulations published in the **Federal Register** on December 20, 1995.

DATES: These regulations are effective May 13, 1996.

These regulations are applicable for taxable years beginning on or after January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Lisa Sams of the Office of Associate Chief Counsel (International), IRS (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 482 was amended by the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085, 2561, et. seq. (1986–3 C.B. (Vol. 1) 1, 478). On January 30, 1992, a notice of proposed rulemaking concerning the section 482 amendment in the context of cost sharing was published in the **Federal Register** (INTL–0372–88, 57 FR 3571).

Written comments were received with respect to the notice of proposed rulemaking, and a public hearing was held on August 31, 1992.

On December 20, 1995, final regulations were published in the **Federal Register** (INTL–0372–88, 60 FR 65553) as Treasury Decision 8632. These final regulations amend the regulations contained in Treasury Decision 8632 by making technical changes to the requirements for qualification as a controlled participant contained in §1.482–7(c).

The agency has decided not to issue a second notice of proposed rulemaking with respect to the modifications to TD 8632 contained in these final regulations. The rules to which the modifications relate (concerning qualification as a controlled participant) were the subject of the notice of proposed rulemaking published on January 30, 1992, and comments on those rules were received in connection with those proposed regulations. Therefore, a further comment period on these rules is unnecessary. Taxpayers need prompt guidance on how to conform their arrangements to the rules set forth in TD 8632, which is effective for taxable years beginning on or after January 1, 1996, and which provides a one year transition period for amending arrangements. The modifications contained in these final regulations will aid taxpayers in that regard, and any delay caused by a second notice of proposed rulemaking would be impracticable and contrary to the public interest. Unsolicited comment letters were received in connection with TD 8632 and are available for public inspection in the FOIA reading room.

Explanation of Provisions

The purpose of these regulations is to rectify problems in qualifying as a controlled participant caused by the technical requirements of the active conduct rule of §1.482–7(c). This rule provided that a controlled taxpayer may be a controlled participant only if it uses or reasonably expects to use covered intangibles in the active conduct of a trade or business.

Under the 1992 proposed cost sharing regulations, a member of a group of controlled taxpayers could participate in a qualified cost sharing arrangement on behalf of, and could satisfy the active conduct rule based on activities performed by, one or more other members of the group (a cost sharing subgroup). The participating subgroup member would then transfer or license the intangibles developed under the arrangement to the nonparticipating subgroup member(s). The proposed regulations would have measured benefits in such case on the basis of the benefits of the entire subgroup from exploiting the intangibles. TD 8632, in streamlining the participation rules, omitted the subgroup rules. Taxpayers commented that the change would force them to amend existing arrangements to include as a participant every operating company that predictably would be using covered intangibles.

These regulations further streamline the participation rules. The principal reason for the active conduct rule was to ensure that a controlled participant stands to benefit from the use of covered intangibles in a manner that can be reliably measured. The Treasury and Service have concluded that this purpose can be accomplished without the active conduct rule. No distinction need be made based on the nature of a participant's use of covered intangibles, so long as its benefits from such use (whether from directly exploiting the intangibles or from transferring or licensing them to others) can be reliably measured.

Accordingly, these regulations eliminate the active conduct rule of §1.482–7(c) as a requirement for qualification as a controlled participant in a qualified cost sharing arrangement. Section 1.482–7(c)(1) of these regulations substitutes a general rule that a controlled taxpayer may be a controlled participant in a cost sharing arrangement only if it reasonably anticipates that it will derive benefits from the use of covered intangibles. In addition, §1.482–7(f)(3)(ii) provides that if a controlled participant transfers covered intangibles to another controlled taxpayer, the participant's benefits will be measured with reference to the transferee's benefits rather than with reference to any consideration paid by the transferee. (This gives rise to results similar to those under the subgroup rules of the proposed regulations by different mechanics.) Finally, §1.482–7(f)(3)(ii) continues to provide that the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants.

These changes ensure that a controlled participant must benefit from the arrangement, that the basis for measuring benefits must be consistent for all controlled participants, and that, in the event of intragroup transfers, there will be ''look through'' treatment for reliably measuring benefits. These rules allow a participant to exploit covered intangibles itself or through transferring or licensing them to others, so long as the benefits to be derived can be consistently and reliably measured for all controlled participants.

These regulations also clarify that the documentation requirements of §1.482–7(j)(2) will satisfy the principal document requirement of §1.6662–6(d)(iii)(B) with respect to a qualified cost sharing arrangement.

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Lisa Sams, Office of Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 1.482–0 is amended by revising the entries for §1.482–7(c) and (j) to read as follows:

§1.482–0 Outline of regulations under 482.

§1.482–7 Sharing of costs.

(c) Participant.
(1) In general.
(2) Treatment of a controlled taxpayer that is not a controlled participant.
(i) In general.
(ii) Example.
(3) Treatment of consolidated group.

(j) Administrative requirements.
(1) In general.
(2) Documentation.
(i) Requirements.
(ii) Coordination with penalty regulation.
(3) Reporting requirements.

Par. 3. Section 1.482–7 is amended as follows:

a. By revising paragraph (c)(1)(i).

b. By adding paragraph (c)(1)(iv).

c. By removing paragraphs (c)(2) and (c)(3) and redesignating paragraphs (c)(4) and (c)(5) as paragraphs (c)(2) and (c)(3), respectively.

d. By revising newly designated paragraph (c)(2)(ii).

e. By adding a sentence after the second sentence in paragraph (f)(3)(ii).

f. By revising *Example 8* of paragraph (f)(3)(iii)(E).

g. By redesignating the text of paragraph (j)(2) following the heading as paragraph (j)(2)(i) and adding a heading for newly designated paragraph (j)(2)(i).

h. By removing the language ‘‘(j)(2)’’ and adding ‘‘(j)(2)(i)’’ in its place in the first sentence of newly designated paragraph (j)(2)(i).

i. By adding a paragraph (j)(2)(ii).

The additions and revisions read as follows:

§1.482–7 Sharing of costs.

(c) (1)

(i) Reasonably anticipates that it will derive benefits from the use of covered intangibles;

(iv) The following example illustrates paragraph (c)(1)(i) of this section:

Example. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a cost sharing arrangement with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The cost sharing arrangement provides that USS will receive the rights to use the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to use this process in the United States, USS is not a qualified participant because it will not derive a benefit from the use of the intangible developed under the cost sharing arrangement.

(2)

(ii) *Example*. The following example illustrates this paragraph (c)(2):

Example. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R+D is not assigned any rights to exploit the intangibles. R+D's activity consists solely in carrying out research for the group. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS will be 66 2/3% and 33 1/3%, respectively, and the parties' agreement provides that USP and FS will reimburse 66 2/3% and 33 1/3%, respectively, of the intangible development costs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (c) of this section, because it will not derive any benefits from the use of covered intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of §1.482–4(f)(3)(iii). Such consideration must be treated as intangible development costs incurred by USP and FS in proportion to their shares of reasonably anticipated benefits (*i.e.*, 66 2/3% and 33 1/3%, respectively). R+D will not be considered to bear any share of the intangible development costs under the arrangement.

(f)

(3)

(ii) If a controlled participant transfers covered intangibles to another controlled taxpayer, such participant's benefits from the transferred intangibles must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement).

(iii)

(E)

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (*e.g.*, all participants might measure their benefits on the basis of operating profit).

(j)

(2) *Documentation*—(i) *Requirements*.

(ii) *Coordination with penalty regulation*. The documents described in paragraph (j)(2)(i) of this section will satisfy the principal documents requirement under §1.6662–6(d)(2)(iii)(B) with respect to a qualified cost sharing arrangement.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 2, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 9, 1996, 8:45 a.m., and published in the issue of the Federal Register for May 13, 1996, 61 F.R. 21955)