



UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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Room 5203  
Internal Revenue Service  
PO Box 7604  
Ben Franklin Station  
Washington, DC 20044

**Reference: Comments on Temporary Cost Sharing Regulations**

To the Department of the Treasury and the Internal Revenue Service:

We are pleased to submit the following comments on behalf of the United States Council for International Business (USCIB) on the Temporary Cost Sharing Regulations.

USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Our members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations such as the International Chamber of Commerce, the International Organization of Employers and the Business and Industry Advisory Committee to the OECD, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

Sincerely,

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## Comments on Temporary Cost Sharing Regulations

A centerpiece of the Temporary Cost Sharing Regulations (the “Temporary Regulations”) is the “supplemental guidance” provided at Treas. Reg. § 1.482-7T(g). This guidance applies with respect to the various specified methods for evaluating the arm’s length payments to be charged in a “platform contribution transaction” (“PCT”). Noting that each of these methods is to be assessed in light of the best method analysis of Treas. Reg. § 1.482-1(c), the Temporary Regulations set forth several additional principles that are relevant to the selection of the best method for evaluating PCTs. Several of these principles are holdovers from the proposed cost sharing regulations,<sup>1</sup> such as the “Investor Model.” That principle, as well as others, has generated criticism from many quarters in the business community.

The United States Council for International Business (“USCIB”) shares the concerns that others have expressed over the Investor Model (as well as over certain other aspects of the Temporary Regulations). The purpose of the comments USCIB hereby submits on the Temporary Regulations is to express the views of its members on another of the several supplemental principles that are to guide the best method analysis. Treas. Reg. § 1.482-7T(g)(2)(x) states that the specified valuation methods under Treas. Reg. § 1.482-7T(g) must be applied such that the “arm’s length amount of a PCT Payment...is the value of the PCT Payment itself,” determined “without regard” to the tax effects the PCT Payment may have on either the PCT Payor’s or Payee’s tax liability. In order to follow this principle, the valuation methods must be applied, with suitable adjustments if needed, “to determine PCT Payments on a pre-tax basis.” The impact of this rule is to require the PCT Payor to compensate the PCT Payee for taxes to be paid by the Payee upon its receipt of the PCT Payment.

USCIB objects to the pre-tax valuation requirement of Treas. Reg. § 1.482-7T(g)(2)(x) because it contradicts fundamental principles of valuation and the arm’s length standard, as applied to related-party sales of assets. The Internal Revenue Service’s (“Service’s”) adoption of such a requirement for valuations of intangibles or other contributions made to cost sharing arrangements (“CSAs”) is thus disconcerting not only to USCIB’s members that engage in cost sharing. It is also troubling to USCIB’s members that do not engage in cost sharing, because the approach taken in the Temporary Regulations is contrary to, and hence undermines, the internationally accepted arm’s length standard. USCIB believes that this pre-tax valuation requirement should not be a criterion available to the Service to judge a taxpayer’s method for valuing intangibles. Accordingly, USCIB requests that Treas. Reg. § 1.482-7T(g)(2)(x), the most

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<sup>1</sup> 70 Fed. Reg. 51116 (August 29, 2005).

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prominent expression of this requirement, be excised when the Temporary Regulations are made final.

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The best method rule of Treas. Reg. § 1.482-1(c) provides the general principles by which taxpayers are required to select the transfer pricing method that provides the “most reliable measure of an arm’s length result.” The best method rule implements the arm’s length standard, which is defined at Treas. Reg. § 1.482-1(b) and which directly bears on the issues raised by the pre-tax valuation requirement of the Temporary Regulations. The Regulation states: “In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).”

Interpreting this requirement in any given case presents challenging questions regarding the economic significance of particular facts and circumstances. The analysis can be especially difficult in cases involving valuations of intangible property, particularly the intangibles that are involved in PCTs in CSAs. However, a large number of cases and other authorities establish that the arm’s length price is equivalent to “fair market value” – “an arm’s length price is simply a different label for the fair market value of the goods or services to which the price relates.” E.I. DuPont de Nemours and Co. v. United States, 78-1 U.S. Tax Cas. (CCH) P9374, 20 (Ct. Cl. 1978). “Fair market value,” in turn, is generally defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.” DHL Corp., 76 T.C.M. (CCH) 1122 (1998) (quoting United States v. Cartwright, 411 U.S. 546, 551 (1973)).<sup>2</sup>

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<sup>2</sup> Other cases that link the arm’s length standard and fair market value include Peck v. Commissioner, 752 F.2d 469, 472 (9th Cir. 1985) (upholding the Service’s reallocation of income under § 482 where rent was above fair market value); Motors Security Co. v. Commissioner, 11 T.C.M. (CCH) 1074, 1082 (1952) (refusal to reallocate income under 26 U.S.C. § 45, the predecessor to § 482, because the notes at issue had been transferred at their fair market value). This connection is also reflected in IAS 32 (defining “fair market value” as “[t]he amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”) Commentators have also recognized this link. *See, e.g.*, Harold McClure, “Alternative Approaches to Determining an Arm’s Length Royalty Rate,” 43 J. L. & Tech. 111, 111 (2002) (“This arm’s length standard is consistent with the fair market value standard.”); Wayne Gazur, “The Forgotten Link: “Control” in Section 482,” 15 Nw. J. Int’l L. &

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Given the equivalency between the arm's length standard and the hypothetical willing-buyer, willing-seller standard, it is important to elaborate on the latter principle. Neither the Temporary Regulations nor the Preamble offers a theoretical justification for the idea that, at arm's length, the PCT Payor would be willing to compensate the PCT Payee for taxes to be paid by the PCT Payee with respect to the payment. The reasoning may be that the contributor of a platform intangible to a CSA will be able to extract PCT Payments that are grossed up for taxes because the other participants in the CSA are in a relatively weak bargaining position relative to the PCT Payee. Under this line of thinking, in order to enjoy the benefits of the CSA, the other participants are forced either to pay the higher PCT Payments that are grossed up for taxes or to develop the platform intangible themselves, perhaps at much greater expense than agreeing to the higher PCT Payments. Since, under this theory, the second option is not economically attractive, the PCT Payment should reflect this gross-up for taxes that the PCT Payee is able to extract.

The problem with such reasoning is that it violates the arm's length standard and the underlying willing-buyer, willing-seller principle. The arm's length standard assumes that the buyer is *willing* and thus is under no compulsion to trade. The conclusion that PCT Payments should be grossed up apparently assumes that the buyer is under a compulsion to achieve the deal at any price and hence is willing to pay a premium over and above the fair market value of the platform intangible. The value of the platform intangible, however, should reflect its capacity to generate future economic rents, not the tax burden of transfer of rights. The economic qualities of the *intangible* derive from such future income-producing capacity, not from the assumed bargaining positions of the parties. Indeed, the arm's length standard and fair market value concepts expressly assume equal bargaining positions of the buyer and seller so as to eliminate the need for a factor representing relative bargaining strength.

This focus on determining the value of the platform intangible highlights a subtle shift in Treas. Reg. § 1.482-7T(g)(2)(x) from the valuation of a *platform contribution* –

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Bus. 1, 66 (1994) (“Essentially, section 482 is a valuation provision, which seeks to place a fair market valuation on transactions considered as outside the market mechanism because they are between controlled or related actors.”); Gordon V. Smith & Russell L. Parr, VALUATION OF INTELLECTUAL PROPERTY AND INTANGIBLE ASSETS 391 (2000) (noting that fair market value “captures the essence” of an arm's length transaction). A number of additional authorities do not use the precise term “fair market value,” but instead invoke analogous formulations of value as satisfying the arm's length standard. *See, e.g., Fegan v. Commissioner*, 71 T.C. 791, 805 (1979) (equating an arm's length rent with a “fair” rent); *Your Host, Inc. v. Commissioner*, 58 T.C. 10, 28 (1972), *aff'd*, 489 F.2d 957 (2d Cir. 1973) (finding that the terms on which a subsidiary dealt with its parent did not meet the arm's length standard because they were not “fair and reasonable”); *Friedlander Corp. v. Commissioner*, 25 T.C. 70, 77 (1955) (court refused to reallocate income pursuant to 26 U.S.C. § 45 because the property was sold at its “full fair” value).

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i.e., an intangible, taken for these purposes broadly as any resource, capability, or right contributed to the CSA (as per Treas. Reg. § 1.482-7T(c)(1)) – to the tax effects of the *PCT Payment* itself. By doing so, the Temporary Regulations seem to be distinguishing between an arm’s length, fair market value of an intangible and the PCT Payment that, in Service’s view, should be based on a grossed-up value of the intangible. Any possible regulatory logic that might be invoked to justify grossing up PCT Payments for taxes, however, does not justify grossing up the value of the intangible above its fair market value. Tax effects might influence the value of PCT Payments. However, the value of intangibles in the marketplace will be determined by other factors, and to the extent that the tax effects of payments for the purchase or use of an intangible even enter into the thinking of one or both of the parties, certainly neither of them will recognize the tax effect faced by the other as a reason to agree to a certain price. In requiring that PCT Payments be valued on a pre-tax basis, the Temporary Regulations thus lose sight of intangibles (platform contributions) as the proper subjects of valuation and on the factors that properly come into play in determining their fair market value.

The basic proposition that the pre-tax value requirement is inconsistent with fair market value and thus with the arm’s length standard is also supported by considering recognized practices and standards of valuation and economic analyses. These are particularly reflected in the Service’s remarks on the “income method” – a variant on the discounted cash-flow (“DCF”) method – expressed in the Temporary Regulations.

There is no question that it is appropriate to use the discounted cash flow method to value intangibles. According to the preamble to the 2006 proposed cost sharing regulations under § 482:

Commentators proposed that the Treasury Department and the IRS adopt discounted cash-flow analysis (DCF) as a specified method for analysis of contributions. The Treasury Department and the IRS find it unnecessary to do so because they already recognize DCF as one of several approaches that may be reliably applied to evaluate intangible property.<sup>3</sup>

A DCF analysis “is a financial model that comprehensively captures all of the elements that create value by converting forecasts of net cash flow into a present value. The conversion is accomplished by using a discount rate that reflects the riskiness of the expected cash flows. The DCF model considers the up-front expenditures that are

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<sup>3</sup> T.D. 9278 (July 31, 2006). *See also* Internal Revenue Manual § 4.48.5.2.4(7)(C) (July 1, 2006) (calling the DCF method a “fundamental method” used for valuing intangibles).

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required to undertake a new venture and the cash flows to be derived in the future. It also considers the timing associated with the receipt of cash flows.”<sup>4</sup>

For purposes of determining fair market value, the standard, time-tested approach employed by valuation and appraisal professionals is to apply a DCF analysis on an after-tax basis, because “[t]he economic benefits that should be discounted into the future are best represented by the cash that is generated by the business on a debt-free basis after allowance for income taxes.”<sup>5</sup> Under the DCF method, the fair market value price necessarily does not provide compensation to the seller for taxes to be paid upon the sale. This is, of course, consistent with reality: unrelated buyers do not pay unrelated sellers for the taxes to be paid by the sellers.

We recognize that, theoretically, the income method may also be applied on a pre-tax basis by discounting operating income. However, if this approach is taken, it is critical to maintain consistency between the income flow that is being discounted and the rate that is used to discount that income flow to present value. Just as the DCF method must be applied by discounting a cash flow (i.e., a post-tax flow) using a *post-tax* discount rate, so must a pre-tax valuation method discount a flow of operating income (i.e., a pre-tax flow) using a *pre-tax* discount rate.

Indeed, an important principle of valuation is that the income method applied to determine the value of an asset on a post-tax basis should produce the same value for that asset as the income method applied on a pre-tax basis.<sup>6</sup> Although a pre-tax flow of operating income will be nominally higher than a post-tax cash flow, the higher discount rate applied to the pre-tax flow will result in a discounted value that is equal to the lower post-tax cash flow discounted at the lower rate. This is as it should be, given that the pre- and post-tax discount rates will reflect the different levels of risk in the two different flows.

Although this theoretical equivalency might suggest that Temporary Regulations could provide for valuation of PCT Payments using pre-tax income and pre-tax discount rates, the practical reality is that the DCF method is not carried out on a pre-tax basis

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<sup>4</sup> Russell L. Parr, INTELLECTUAL PROPERTY INFRINGEMENT DAMAGES: A LITIGATION SUPPORT HANDBOOK 125 (1993).

<sup>5</sup> Gordon V. Smith & Russell L. Parr, VALUATION OF INTELLECTUAL PROPERTY AND INTANGIBLE ASSETS 278 (2000); *see also* David Laro & Shannon P. Pratt, BUSINESS VALUATION AND TAXES 182-83 (2005).

<sup>6</sup> International Accounting Standards Board, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) 2008, at 1859 (2008).

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because “investors are interested in after tax rather than pre tax returns.”<sup>7</sup> The discount rates that are available in the marketplace are appropriate only for post-tax (cash) flows. Applying the DCF method on a pre-tax basis would require a pre-tax discount rate, which, however, cannot be constructed simply by grossing up a post-tax discount rate.<sup>8</sup> There is no linear relationship between the two rates.

These points cut directly against the gross-up valuation approach required by the Temporary Regulations. While the Temporary Regulations recognize that “[i]n principle, the present values of cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income,”<sup>9</sup> in the end they require that valuations be grossed up to compensate the party receiving a buy-in for taxes to be paid on receipt of the payment. However, the methodology for the gross-up is based upon, presumably, marginal tax rates, whereby the post-tax value is supposed to be grossed up by one less the tax rate. (Note that it is not clear from the language of the Temporary Regulations which of the PCT Payee’s or Payor’s tax rates is to be used, or whether the rate is supposed to be marginal or effective.) This implies that following the procedure in the Temporary Regulations of grossing up post-tax values will necessarily lead to pre-tax values that overstate the true value of the underlying assets, wholly apart from the point that, at arm’s length, a purchaser will not compensate a seller for taxes to be paid by the seller on the transaction. By this requirement, the Service thus seems to be dismissing the cornerstone of the valuation analysis that discounting pre-tax cash flows at a pre-tax discount rate and discounting post-tax cash flows at a post-tax discount rate should produce consistent results, since grossing up a post-tax value for taxes will always lead to a value that is greater than what would be obtained by discounting a pre-tax flow by the appropriate pre-tax discount rate.

The underlying logic of the foregoing remarks is found, to at least some degree, in the Service’s own guidance on valuation. The IRS Business Valuation Guidelines provide that valuations generally may be on a pre-tax or after-tax basis, noting that, in conducting a business valuation, “the valuator should select the appropriate benefit stream, such as pre-tax or after-tax income and/or cash flows and select appropriate discount rates, capitalization rates or multiples consistent with the benefit stream selected within the relevant valuation methodology.”<sup>10</sup> For example, if the DCF analysis is using cash flows before corporate taxes, the discount rate should be “a precorporate tax

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<sup>7</sup> Wayne Lonergan, THE VALUATION OF BUSINESSES, SHARES AND OTHER EQUITY 69-70 (2003).

<sup>8</sup> *See id.*

<sup>9</sup> Treas. Reg. § 1.482-7T(g)(4)(i)(G).

<sup>10</sup> Internal Revenue Manual 4.48.4.2.3 (July 1, 2006).

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discount rate as well.”<sup>11</sup> As noted above, however, the valuation profession has long recognized that the pre-tax discount rate cannot be obtained by grossing up the post-tax discount rate by a standard tax rate, and that values obtained on a pre-tax and post-tax basis would be consistent only if the pre-tax discount rate reflects appropriate adjustments for the specific amount and timing of the future tax flows, and “to match the definition of the economic income variable being discounted or capitalized.”<sup>12</sup>

The most reliable approach in most situations is to conduct valuation on a post-tax basis because the data to make such adjustments to pre-tax discount rates are rarely available. In fact, availability of reliable data is one of the main reasons for the general preference to use the net cash flow as the measure of economic benefit,<sup>13</sup> which also makes it the preferred approach under the best method rule – i.e., “the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.”<sup>14</sup>

In sum, following the well-accepted standard adopted by the valuation profession to conduct valuation analysis on a post-tax basis, and in light of the voluminous case law in support of this standard, USCIB believes that it is inconsistent with the internationally accepted arm’s length standard for the Temporary Regulations to employ the pre-tax valuation approach and require that a PCT Payor compensate the PCT payee for taxes. Accordingly, USCIB requests that Treas. Reg. § 1.482-7T(g)(2)(x), the most prominent expression of this requirement, be excised when the Temporary Regulations are made final.

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If you have any questions about these comments, please contact Lynda Walker ([lwalker@uscib-dc.org](mailto:lwalker@uscib-dc.org)) or Charles Triplett ([CTriplett@mayerbrown.com](mailto:CTriplett@mayerbrown.com)).

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<sup>11</sup> Aswath Damodaran, DAMODARAN ON VALUATION 80 (2006).

<sup>12</sup> Laro & Pratt, *supra* note 5, at 183-84.

<sup>13</sup> *Id.*

<sup>14</sup> Treas. Reg. § 1.482-1(c)(1).

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