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Andrés Garcia
Internal Revenue Service
Room 6526
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Washington, DC 20224

Submitted via email: pra.comments@irs.gov
OMB Number: 1545-1503—Public Comments Request Notice

Comments on Revenue Procedure 2015-41

Dear Mr. Garcia:

Pursuant to a request made by the IRS in the Federal Register, Volume 89, No. 235 on December 6, 2024, the undersigned are providing comments concerning Revenue Procedure 2015-41.[1]

One of the undersigned, who has been retired for most of the last two decades, worked for over 32 years in international taxation for several of the major accounting firms both in the U.S. and abroad, giving tax advice to multinational corporations (MNCs) headquartered in the U.S. and other developed countries. In addition to preparing numerous submissions to Treasury, Congress, and the IRS and writing articles over the past decade on international taxation,[2] he has taught international taxation within the University of Washington School of Law Tax LLM program as an adjunct professor. The other undersigned is a transfer pricing practitioner, with approximately twenty-five years of experience, including serving for sixteen years in two major accounting firms, where he served as a Partner in the transfer pricing practice of each, including in London and New York. He has also written approximately two dozen academic and practitioner papers on transfer pricing, including several addressing cost sharing regulations, forensic approaches to transfer pricing enforcement, the importance of the Commensurate with Income (CWI) standard

[1] This submission updates an earlier submission dated January 3, 2022, made by the undersigned.
[2] For Jeffery M. Kadet, his articles and other documents, including various governmental submissions, are available at http://ssrn.com/author=1782073.

to transfer pricing enforcement, and in particular the periodic adjustment regulation of Reg. Section 1.482-7(i)(6).[3] The experiences and writings of both of the undersigned are directly relevant to the subject of this revenue procedure.[4]

Revenue Procedure 2015-41 provides guidance on the process of requesting and obtaining advance pricing agreements ("APAs") from the Advance Pricing and Mutual Agreement program ("APMA"). As such, it is broadly drafted to cover many sorts of intercompany transactions for which taxpayers may appropriately request APAs.

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[3] Stephen L. Curtis, "Forensic Approaches to Transfer Pricing Compliance and Enforcement," 8 *J. Forensic & Investigative Acct.* 359 (2016), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2786779; Curtis and Yaron Lahav, "Forensic Approaches to Transfer Pricing Enforcement Could Restore Billions in Lost U.S. Federal and State Tax Losses: A Case Study Approach," 12 *J. Forensic & Investigative Acct*. 285 (2020), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3528318; Stephen L. Curtis, "Facebook, the IRS, and the Commensurate With Income Standard," 169 *Tax Notes Federal* 1921 (December 21, 2020), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3800344. Nine additional more recent articles demonstrate this for eight specific MNCs. These are: (i) Stephen L. Curtis, "Facebook, the IRS, and the Commensurate With Income Standard", 169 *Tax Notes Federal* 1921 (December 21, 2020), available at http://ssrn.com/abstract=3800344, (ii) Stephen L. Curtis and David Chamberlain, "Apple's Cost Sharing Arrangement: Frankenstein's Monster", 172 *Tax Notes Federal* 1049 (Aug 16, 2021) [Part 1] and 1217 (Aug 23, 2021) [Part 2], available at http://ssrn.com/abstract=3931424, (iii) Stephen L. Curtis, "Google's Cost Sharing Arrangement: Bride of Frankenstein", 173 *Tax Notes Federal* 1623 (December 20, 2021), available at http://ssrn.com/abstract=4023744, (iv) Stephen L. Curtis, "eBay's Cost-Sharing Arrangement: Frankenstein's Progeny", 175 *Tax Notes Federal* 1655, (June 13, 2022), available at http://ssrn.com/abstract=4206019, (v) Stephen L. Curtis, "Cisco's Cost-Sharing Arrangement: Frankenstein Poker", 176 *Tax Notes Federal* 305 (July 18, 2022), available at http://ssrn.com/abstract=4206026, (vi) Stephen L. Curtis and Reuven S. Avi-Yonah, "Microsoft's Cost- Sharing Arrangement: Frankenstein Strikes Again", 178 *Tax Notes Federal* 1443 (March 6, 2023), available at http://ssrn.com/abstract=4433618, (vii) Stephen L. Curtis, "Frankenstein Calling: Qualcomm's Unenforced Periodic Adjustment", 180 *Tax Notes Federal* 1773 (September 11, 2023), available at http://ssrn.com/abstract=4607335, (viii) Stephen L. Curtis, "Frankenstein's Cloud—Is Oracle Due For a Monstrous Periodic Adjustment?", 182 *Tax Notes Federal* 1747 (March 4, 2024) [Part 1] and 182 *Tax Notes Federal* 1941 (March 11, 2024) [Part 2], available at http://ssrn.com/abstract=4773414, and (ix) Stephen L. Curtis, "Frankenstein's Implant: Is Stryker Due For a Monstrous Periodic Adjustment?", 185 *Tax Notes Federal* 423 (October 21, 2024) [Part 1] and 185 *Tax Notes Federal* 657 (October 28, 2024) [Part 2], available at http://ssrn.com/abstract=5046428.

[4] See relevant discussion in Avi-Yonah et al., "Commensurate with Income: IRS Nonenforcement Has Cost $1 Trillion", 179 *Tax Notes Federal* 1297 (May 22, 2023), at 1325*ff*. This article provides additional background on the use and consequences of CSAs. See also Elizabeth J. Stevens and H. David Rosenbloom, "Original Sin: Cost Sharing in the United States", 185 *Tax Notes Federal* 1197 (Nov. 11, 2024).

In this letter, we include comments and recommendations specifically focused on cost sharing arrangements ("CSAs") and the application of Revenue Procedure 2015-41 to CSAs. For a better understanding of CSAs and their effects, before we provide our CSA-related recommendations, we provide relevant history and background on CSAs and their use in profit-shifting arrangements. We then provide additional comments and recommendations on a broader scope beyond just CSAs that we believe would make the revenue procedure more effective for other transfer pricing situations that involve intangibles.

We wish it to be clear upfront that we are not paid advisors to any multinationals. We have no agenda to help multinationals secure beneficial APAs. Rather, our individual studies of specific multinationals and their profit-shifting structures have revealed to us the artificiality of too many such structures. They are achieving results that the law has never intended. Often, they are using (in reality abusing) transfer pricing rules as a key component of these artificial structures. In so many cases, it is clear that critical functions for a multinational's seamless worldwide unitary business are conducted within the United States, but the bulk of the profits of that business for sales or services to most foreign customers/clients/users are simply reported within a tax haven or otherwise low-taxed foreign group member. Sometimes this happens as well even for sales to U.S. customers/clients/users. In some cases, APAs have been granted that actually enable such profit-shifting structures. And the terms of those APAs may prevent the application of the mandatory CWI statute, which was added to section 482 by the Tax Reform Act of 1986. In short, our objective, our "agenda" if you will, is to provide ideas and approaches that will help the APMA both draft a better and more effective reissuance of Revenue Procedure 2015-41 and make better decisions in the future on the APAs they will reject, those they will approve, and the conditions that they may require for approval.

Our submission includes the following table of contents to help readers focus on the specific matters of most interest.

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Cost Sharing Agreements – Enabler of Profit Shifting

A Little Helpful History[5]

When U.S. businesses began expanding internationally after World War II, the business environments and communication technologies of the time generally required that overseas manufacturing and other operations be conducted on a stand-alone basis, with each operating subsidiary having its own management team locally directing sales, operations, finance, and other functions. That team of course took guidance from group management back in the United States, operated under group policies and standards, and made use of U.S.-owned intangibles. However, these subsidiaries were still very much independently operated businesses. There would typically be license agreements under which these subsidiaries would pay royalties to the U.S. group member owning the relevant intangibles. Also, unless there were local equity participation requirements, those subsidiaries were normally wholly owned.

Starting in the mid-1980s, some U.S. MNCs began moving portions of their domestic manufacturing to Asia and, in particular, to China, a country that at the time severely restricted levels of foreign ownership and mandated the legal form that investments must take. That trend accelerated in the 1990s and especially after the turn of the century. Legal and practical difficulties in China often prevented U.S. MNCs from owning and controlling manufacturing operations on the mainland. The competitive need for China's low-cost production forced U.S. MNCs to accept zero or minority ownership positions in the manufacturing operations that produced their goods. This use of uncontrolled contract manufacturers grew, and many U.S. MNCs became comfortable with these arrangements.[6]

That comfort level, along with advances in information technology, communications technology, and shortened logistical timelines, resulted in centrally managed supply chains and other new business model structures that were markedly different from the previous stand-alone independently operated subsidiaries. Using these new business models as a basis, U.S. MNCs placed intangible rights, which had been developed in the United States, and all commercial risks into entrepreneur subsidiaries, which were often located in tax havens or other low-tax jurisdictions. Operating subsidiaries, whether involved in production or in product distribution and whether located within or outside of the United States, were established on a limited risk and limited profit basis, thereby placing the bulk of the profits in the zero- or low-taxed entrepreneur

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[5] The following paragraphs on history were taken with some additions from Jeffery M. Kadet, "BEPS Primer: Past, Present, And Future, Part 1", 168 *Tax Notes Federal* 45, July 6, 2020, at 50. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3669899.

[6] After China joined the WTO in late 2001, it became possible to have wholly-foreign-owned Chinese subsidiaries. However, by this time, many U.S. MNCs had already integrated unrelated Chinese contract manufacturers into their business models and supply chains and had become comfortable with these arrangements.

subsidiary.[7] U.S. group members that conducted not only the central management of the group, but also the day-to-day decision-making and running of the supply chain and often day-to-day sales functions as well, were generally treated from the perspective of the entrepreneur subsidiary as mere independent contractors. And these U.S. group member "independent contractors" were often compensated on a cost-plus basis, which resulted in service fees far less than the real value their activities in fact generated.[8]

Separate from the above developments concerning tangible product supply chains, over the past several decades, new internet-based business models grew, becoming in some cases major U.S. MNCs. They adopted similar business models with zero and low-taxed entrepreneur subsidiaries holding relevant intangible rights and contracting directly with advertisers, users, and other customers for various cloud and other services. As with the above-described conduct by U.S. group members of operational management, supply chain, and sales functions in the case of tangible products, for these new internet-based models, the bulk if not all of the DEMPE functions (that is, development, enhancement, maintenance, protection, and exploitation) are conducted by U.S. group members. And similarly, these U.S. group members are compensated at far less than their real value.[9] These DEMPE functions include not only the bulk of research and development efforts, but the actual day-to-day management and operations of the digital platforms through which digital cloud and other services are provided and delivered to users, customers, and advertisers worldwide. U.S. group members are not only providing the advertising and other services directly to the foreign "entrepreneur" subsidiary's paying customers, but through the platform the U.S. group members are approving and processing the entrepreneur subsidiary's contracts with its advertisers and other customers. There is little to no participation in this process of any foreign entrepreneur personnel. Under the physical

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[7] A documented detailed example of this can be found in the Majority Staff Report issued in connection with the Senate Permanent Subcommittee on Investigations hearings on Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs (S. Hrg. 114-88, July 30, 2015). Available at https://www.hsgac.senate.gov/imo/media/doc/S.%20Hrg.%20114-88%20PSI%20July%2030,%202015%20Final%20Hearing.pdf. See in particular the discussion of Valeant Pharmaceuticals (now Bausch Health) beginning on page 12 of the Majority Staff Report (page 93 of the full hearing document).

[8] See, for example, the Caterpillar inter-company service agreement, which shows a cost-plus 5% service fee. This agreement was disclosed in connection with the 2014 Senate Permanent Subcommittee on Investigations hearings into Caterpillar's Swiss Tax Strategy (Exhibit #52 (Fifth Amended and Restated Services Agreement, Schedule 3), Exhibits Part 2 of 2, Caterpillar's Offshore Tax Strategy, April 1, 2014. Available at https://www.hsgac.senate.gov/imo/media/doc/EXHIBITS-Part%202%20of%202%20(4-1-14%20Caterpillar%20Hrg).pdf.)

[9] *Supra* note 3, Curtis (2020), Curtis and Chamberlain (2021), and Curtis (2021). These articles deal respectively with Facebook, Inc. (now Meta Platforms, Inc.), Apple Inc., and Google Inc. (now Alphabet Inc.). Each represents an example of serious under-compensation of U.S. group members that are conducting services and other functions that often represent the actual conduct of critical portions of the foreign subsidiary's business. Throughout this submission, despite their name changes, Facebook and Google are referred to by their original names.

operational format of many of these U.S. MNCs, the business functions of personnel outside the United States (often within disregarded entity subsidiaries wholly owned by the entrepreneur subsidiary) are generally limited to routine sales and marketing, logistics, and other support functions, none of which will be directly involved in providing cloud and other services.[10]

As explained above, U.S. MNCs after World War II set up independently-run subsidiaries with their own separate managements and operations. However, with the technological and communication developments of the past three or four decades, foreign operations could be centrally managed and controlled, and to a large extent actually conducted from the U.S. As a result, full cadres of local management personnel were no longer needed. In its place, U.S. MNCs restructured and instituted the centrally-managed, U.S.-based supply-chain and internet-based business models that are so ubiquitous today. Consequently, over the past several decades, independently run foreign subsidiaries have almost disappeared. In their place, we find marketing, logistics support, production, and sales operations in various locations that do not operate as independent businesses with their own independent managements. Rather, they operate as mere cogs in one centrally-managed worldwide business structure.

Enter the CSA

It was noted above that the independently-run foreign subsidiaries of U.S. MNCs would often secure needed group technology through license agreements that required the payment of royalties. With such royalties normally being subject to withholding taxes on the gross amount of royalties paid, this was a matter of concern, especially where a U.S. MNC was in an excess foreign tax credit position. As a result, many U.S. MNCs were interested in any planning or mechanism that might reduce the level of foreign withholding taxes on royalties.

One such approach was the cost sharing arrangement. The concept was simple: Replace a royalty with a payment that could be characterized as a direct expense for research and development. With withholding taxes being applied only to royalties and not to such R&D expenses, the foreign withholding taxes were avoided. For any U.S. MNC with excess foreign tax credits, this was in a sense pure profit.

The economics of a royalty and a CSA are of course different. Under a CSA, the foreign subsidiary gains an ownership interest in the cost-shared intangibles. However, unless there are other outside factors, since all parties are within the same MNC group, the only real economic difference from the perspective of the MNC as a whole is the benefit of paying less withholding taxes.[11]

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[10] Once the check-the-box rules became available in 1997 and allowed the easy creation of disregarded entity subsidiaries, these non-U.S. personnel employed by these disregarded entities could be within the same foreign taxpayer entity for U.S. tax purposes. This was something that helped enable minimizing foreign taxes in countries where these mostly routine functions were performed, thereby maximizing profit in the tax haven or other low-taxed country of the entrepreneur.

[11] Ignoring the issue of whether there should be a buy-in payment at the initiation of a CSA, it's fair to say that paying a portion of group R&D expenses should be significantly smaller in

While neither of the undersigned have made any specific study of the use of CSAs in the 1980s and prior years, it is our understanding that a principal motivation for the use of CSAs in these early years was the reduction of foreign withholding tax. Later, though, with the expansion of the U.S. tax treaty network that included many treaties providing for zero source country royalty withholding tax, the need for such CSAs fell. However, the advent of the above-described new business models and intra-group tax-motivated structures that involved tax haven-located entrepreneur subsidiaries gave CSAs new life. Why? Because in any such tax-motivated structure, you had to move necessary intangibles into the entrepreneur subsidiary. And the CSA was a perfect vehicle for this.

CSAs Are an Enabler of Profit-Shifting Structures

Say that a U.S. MNC has two group members in identifiably separate businesses, with each member having its own management and operational personnel such that it conducts its own business separately from that of the other member. However, they both use in their respective business the same intangible. For example, say that one group member manufactures and sells mechanized hand-sized gardening equipment while the other manufactures and sells electric hand tools for woodworking. A particular electric motor is used both in one of the gardening products and in one of the hand tools. In such a case, it would make sense for the two group members to share any costs involved in the development and enhancement of this electric motor.

In contrast to this example, the bulk of CSAs today are used in MNC profit-shifting structures. The goal is not a sharing of costs by two group members, each of which desires to improve the intangibles used within its separate business. Rather, the goal is to provide a contractual basis for a zero or low-taxed group member, the entrepreneur subsidiary, to contract with and record revenues from third parties for products or services that are physically provided by other group members, which are most commonly U.S. group members.

The articles referenced in footnote 4 provide concrete examples of this.

- **Facebook, Inc. and Google Inc.** – Personnel in the United States manage and operate the internet platforms through which (i) users worldwide access the platform and its services, and (ii) advertisers and other customers access platform users and their data. Despite this, the CSA mechanism has allowed these groups' controlled foreign corporations (CFCs) as entrepreneurs to contract with--and record 100% of revenues from--advertisers and other customers located within the CFCs' defined market territories.

  To indicate how it is solely the CSA mechanism that has *enabled* this, consider that at the time of execution of their respective CSA arrangements, each group's foreign CSA participant was only a newly formed company (Google in 2003 and Facebook in 2010) with minimal personnel outside the United States (none of whom were "providing" the

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amount than what the royalty would have been. This was likely an attractive factor that motivated some number of countries to accept CSAs and accept the loss of withholding taxes. The lower R&D payments, of course, also meant higher local taxable profits.

digital services[12]). Under the CSA mechanism, these companies' respective CFC entrepreneurs were able to immediately contract with and begin collecting all revenues from advertisers and other customers within their territories. Prior to that execution, these revenues were recorded by U.S. group members.

Apparently effective from 2020, both Facebook and Google transferred relevant intangibles from their respective CFC entrepreneurs to U.S. group members. Neither MNC group has publicly indicated that they made any changes at all to their physical conduct of business. Operational changes that would be consistent with such a transfer of intangibles would be to transfer actual personnel from offices outside the United States and functions conducted outside the United States into U.S. offices. Despite this apparent lack of any operational changes, the tax footnote in the Form 10-K for each MNC shows the stark change in each MNC's domestic/foreign income relationship. For example, the following are from the December 31, 2021, Form 10-Ks for each MNC.

Facebook:

The components of income before provision for income taxes are as follows (in millions):

	Year Ended December 31,		
	2021	2020	2019
Domestic	$ 43,669	$ 24,233	$ 5,317
Foreign	3,615	8,947	19,495
Income before provision for income taxes	$ 47,284	$ 33,180	$ 24,812

Google:

Income from continuing operations before income taxes consisted of the following (in millions):

	Year Ended December 31,		
	2019	2020	2021
Domestic operations	$ 16,426	$ 37,576	$ 77,016
Foreign operations	23,199	10,506	13,718
Total	$ 39,625	$ 48,082	$ 90,734

It can be seen how abruptly and stark the change is from reporting so much income as being foreign to its now being mostly domestic. With no reported or otherwise apparent

[12] Over time, each of these MNCs has increased the number of its foreign-based personnel. These personnel, however, are primarily engaged in routine sales and marketing, customer support, administration, and other functions that are ancillary in nature to the high value, centralized exploitation (i.e. the performance of digital services, the sale of digital and physical products, etc.), which is conducted by the relevant U.S.-based personnel and assets through the each group's worldwide internet-based platform. It will be noted with respect to income from services that the principles of Reg. section 1.861-4(b) focus on where services are performed and not, for example, on the location of sales and marketing personnel. See also Reg. section 1.937-3(e), Example 5, which involves an application service provider and which relies on Reg. section 1.861-4 to determine the taxpayer's source of income. See also Jeffery M. Kadet, "Sourcing Cloud Transactions Economically—the Right Way", 171 *Tax Notes Federal* 1555, June 7, 2021, available at https://ssrn.com/abstract=3880006.

change in physical operations, this strongly suggests that during the many years (from 2010 through 2019 for Facebook and from 2003 through 2019 for Google) while the intangibles were nominally held through each group's CSA by a foreign group member entrepreneur, the actual business of performing services for the entrepreneurs' customers, advertisers, and other users of each of these two MNC groups was physically conducted within the United States and not by the foreign entrepreneurs or their disregarded entity subsidiaries.[13]

- **Apple Inc.** – Personnel in the United States control, manage, and conduct on a day-to-day basis the group's supply chain, which produces products that are sold by both Apple U.S. group members into its Americas territory and Apple's CFC entrepreneur (Apple Operations International (AOI), an Irish subsidiary, which includes for federal tax purposes its disregarded entity subsidiaries) into its "rest-of-world" territory. Further, U.S.-based personnel are involved in negotiating and concluding AOI's sales to important foreign cellular carriers and major resellers of Apple products. In addition, U.S.-based personnel operate and maintain the internet-based stores through which customers worldwide purchase Apple and other third-party products. AOI personnel in Ireland and elsewhere outside the United States are not involved to any material extent in either these internet-based sales or in operating Apple's supply chain.

  Regarding the supply chain, U.S.-based personnel negotiate and conclude two sets of contracts with raw material suppliers, component vendors, and contract manufacturers. One set is in the name of one or more U.S. group members for sales into the Americas territory. The other set is in AOI's name (or the name of a disregarded entity subsidiary of AOI) and provides the contractual basis for AOI's "production" of inventory property, which is then sold by AOI into its "rest-of-world" territory. (The Apple group also earns significant revenues from advertising and other cloud services in a manner similar to that described above for Google and Facebook. It is understood that AOI records the revenues from advertisers and customers located within its territory despite these services being provided primarily by personnel within the United States who operate and maintain the internet-based platforms.)

In the absence of the CSAs (or another form of intangible transfer[14]) for these three U.S. MNCs, the U.S. group members that are performing these revenue-generating functions (i.e., provision

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[13] See Jeffery M. Kadet and David L. Koontz, "Transitioning from GILTI to FDII? Foreign Branch Income Issues", *Tax Notes Federal*, July 1, 2019, p. 57 (available at http://ssrn.com/abstract=3428540). This article notes how this situation applies to Qualcomm, which similarly terminated its profit-shifting structures with no known change in its business operations. See *supra*, note 4, article (vii) for a detailed analysis by Curtis of Qualcomm.

[14] Of course, Google, Facebook, and Apple, as an alternative to a CSA, could have chosen to license or otherwise transfer relevant intangibles to their respective CFCs. Had they done so, it seems likely that the low-value-add of the CFCs to their own profitability in comparison to the high-value-add of the intangibles and the actual business functions performed by the U.S. group members on behalf of the CFCs would have been much more visible. Likely, this would have

of advertising and other cloud services, operation of the supply chain, and selling products) would be directly contracting with third-party advertisers/customers/users and recording the related revenues. (This is what has happened from 2020 for both Google and Facebook following their repatriation back to the U.S. of relevant intangibles.) These U.S. group members would then be paying relatively small service fees to their CFCs for the mostly if not wholly routine sales and marketing services, customer support, logistics, and other functions the CFCs factually perform. Overall, without the CSA, the bulk of the profits would have been recorded by U.S. group members. And this is exactly what happened from 2020 for both Google and Facebook following the repatriation of their intangibles and apparent elimination of their CSAs.

It is recognized that these three U.S. MNC groups (Facebook, Google, and Apple, as well as the other multinationals examined in the articles listed in footnote 3), even under their CSAs, would be subject to transfer pricing adjustments under transfer pricing regulations other than Reg. section 1.482-7 for other transfer pricing transgressions. For example, Reg. section 1.482-9 is clearly applicable given that the referenced articles point out the blatant under-valuation of the "services" that are provided by each group's U.S. members in support of their respective CFC entrepreneur's business. However, it is clear from the levels of foreign profits reported by these three high-profile groups over periods lasting multiple decades that transfer pricing enforcement under other transfer pricing regulations has not worked to reverse this profit shifting.

From the above, it is clear that the CSA mechanism itself has been an *enabler* of profit-shifting structures that has cost the U.S. Treasury hundreds of billions of dollars…and probably more considering the number of MNCs that have used these structures over what is now multiple decades.[15] This CSA *enabler* status reflects:

- The ease of executing the CSA mechanism to create a CFC entrepreneur (or non-CFC entrepreneur when an inverted MNC or other foreign-owned MNC is involved[16]) often with little or no substance in a zero or other low-tax country;
- The ease of shifting income through contractual arrangements under which a foreign group entity (i.e., the CFC entrepreneur instead of a U.S. group member) contracts with third-party customers, suppliers, vendors, contract manufacturers, etc., thereby allowing

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attracted more IRS attention. Using the CSA structures, Apple and Google's situations appear to have gone mostly if not wholly unnoticed, in contrast to the Facebook situation which did attract IRS attention. Note that Google terminated its cost sharing arrangement at the end of 2019, and as shown in the text subsequently reported an almost instantaneous doubling of its U.S. pretax income and halving of its foreign pretax income in 2020 (an estimated profit shift of around $20 billion), with no material change in its business operations or in the ratios of U.S. versus foreign revenues, assets, or personnel. That these profits can be shifted so easily without any material change in functions illustrates the artificiality of these CSA-based arrangements. Facebook had done the same.

[15] See *supra*, note 4, Avi-Yonah et al.

[16] Throughout this discussion, "CFC" is used for simplicity and convenience. However, when applicable, all of this discussion will apply as well to relevant non-CFCs in the event of foreign-owned MNCs.

the shifting of all gross profit from U.S. group members to their group CFC entrepreneur with only inadequate service fees being paid back to the U.S. group members that conduct the bulk, if not all, of the revenue generating functions; and

- The evident fact that application of CSAs has effectively masked other transfer pricing transgressions, which is reflected by how the IRS has attempted to deal with CSA structures that they have chosen to target on examination.[17]

The "Frankenstein Regulation" – And the Mechanism that Can Reverse Its Effect

Reflecting how CSAs have been such an effective enabler of profit shifting, several of the referenced articles in footnote 3 labeled the CSA regulation as "a Frankenstein regulation." The article focused on Apple, after some extensive discussion, concluded by saying:

> The situation at Apple highlights the many unintended consequences of the reg. section 1.482-7 cost-sharing regulations — a beast of a regulation whose flawed design produces exactly the opposite of its intended effects in a way that perfectly personifies a Frankenstein regulation.[18]

The IRS has attacked a number of profit-shifting structures that have used CSAs. However, in addition to attacks on the manner of calculating and dividing cost-shared intangibles, these attacks have primarily focused on the value of the buy-in payment under Reg. section 1.482-7A(g) (from January 1, 1996, through January 4, 2009) or the amount of the PCT Payment under Reg. section 1.482-7(g) (from January 5, 2009). *Importantly, these forms of attack all assume that the CSA structure itself is legitimate.* As a result, even if the IRS sustains its adjustment and collects some additional tax, the CSA and the profit-shifting structure that it enables remain viable for all future years, during which time significant profits will be shifted each and every year under the structure out of the U.S. and into the tax haven or other low-tax country.[19]

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[17] Despite the artificiality of many CSA structures (e.g. the foreign CSA participant conducts or controls little or none of the physical exploitation of the cost-shared intangibles), the IRS has normally accepted them as valid CSA structures. As noted in the following text, the IRS then examens and potentially questions the calculation of the RAB shares of intangible development costs or the amount of any buy-in payment or the value of any platform contribution transaction. It has not been apparent that the IRS has questioned, for example, the amounts paid under intercompany service agreements by a foreign CSA participant for the services conducted by U.S. group members. Nor has the IRS applied periodic adjustments, which it may do under Reg §§1.482-4(f)(2) or -7(i)(6).

[18] *Supra*, note 4, Curtis and Chamberlain (Part 1), page 1062.

[19] It will of course be appreciated that any shifted profits will be included in GILTI. However, even if that GILTI is fully subject to U.S. tax (despite the cross-crediting of foreign tax credits that is available within the section 904(d) GILTI basket), that U.S tax is normally at just half the normal U.S. corporate rate due to the section 250 GILTI deduction (and also significantly less than the effective tax rate allowed to income under the FDII regime). As a result of this, the GILTI regime continues the high motivation for profit shifting that existed in previous years under the pre-2018 deferral system.

Once a CSA-enabled structure has been effectively legitimized (whether through IRS inaction or through an IRS attack such as one on the amount of the buy-in or PCT Payment) and recognizing the relatively few transfer pricing adjustments for the above-noted "other transgressions," the only transfer pricing mechanism available to truly reverse the bulk of the shifted profits is the "periodic adjustment" mechanisms as found in Reg. sections 1.482-4(f)(2) and 1.482-7(i)(6). To date, the undersigned are unaware of any instance in which the IRS has asserted a periodic adjustment under either of these sections. We can only hope that periodic adjustments will become a commonly used mechanism in the future.[20]

In brief, what does the periodic adjustment do economically? Focusing on Reg. section 1.482-7(i)(6), which applies specifically to CSAs, it's a two-step process. The following several paragraphs assume that a CFC, which is a participant in a CSA with its U.S. parent, has recorded high profits and is the focus of this periodic adjustment calculation.

The first step is a trigger calculation[21] to determine if the periodic adjustment rules will apply at all. This trigger calculation looks at historical information and determines the actual rate of return that a CSA participant (i.e., the CFC) has realized on its investment in the CSA. This rate of return, termed the "actually experienced return ratio" (AERR), will either be within or outside a range, termed the "periodic return ratio range" (PRRR), which is defined in the regulation. If, for example, the AERR is above the PRRR, then the economic implication is that too much profit has been recorded within the CFC, meaning that the "commensurate with income" standard may have been violated.

The second step is the calculation of the periodic adjustment,[22] which is the amount that will be treated as a transfer pricing adjustment, effectively moving taxable profits from the CFC to the U.S. parent CSA participant.[23] This calculation is only applied to a CSA participant that has earned too much profit under the trigger calculation.

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[20] We have been greatly encouraged by the mention of "periodic adjustments" in the 2021-2022 Priority Guidance Plan released on September 9, 2021 (International section E.4.) and the additions to Part 4.61.3 of the Internal Revenue Manual concerning "Development of IRC 482 Cases" in January 2023. These are very positive developments.

[21] The trigger calculation and its components are found in Reg. section 1.482-7(i)(6)(i), (ii), and (iii).

[22] This calculation is found in Reg. section 1.482-7(i)(6)(v). Examples of its application are found in Reg. section 1.482-7(i)(6)(vii).

[23] Note that the regulation in Reg. section 1.482-7(i)(6)(i) allows the Commissioner the discretion to impose a periodic adjustment or to not impose an adjustment as calculated under the regulation. The guidance is: "In determining whether to make such adjustments, the Commissioner may consider whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances, including any information known as of the Determination Date." It is worth noting that while the committee reports accompanying the 1986 enactment of the "commensurate with income" standard specifically intended that periodic adjustments would not be required for minor variations in future income from the

Economically, this calculation establishes:

(i) how much a CFC should make from the *routine* functions it factually performs; and

(ii) the CFC's share of the total *non-routine* profits it has recorded.

Further details of these two economic calculations are included in the below two bullet points.

Note that the total non-routine profits a CFC has recorded is equal to the total profits recorded by the CFC less the routine profits calculated in (i). Note also that these calculations are made on a cumulative basis including all years after the defined CSA Start Date up through the Adjustment Year. *Importantly, although the Adjustment Year must still be an open year, the cumulative feature of the calculation means that shifted profits from closed years (often going back to 2009) are recaptured, so to speak, in the Adjustment Year.*[24]

- (i) Return from *routine* functions performed. Normal transfer pricing concepts and applicable regulations under section 482 determine the return for these functions. For example, if a CFC performs, say, routine sales and marketing, customer support, and logistics functions, then an arm's length return will be determined under normal transfer pricing rules. By way of simple illustration, Example 1 in Reg. section 1.482-7(i)(6)(vii) assumes that the return for comparable functions undertaken by comparable uncontrolled companies is 8% of certain expenses.

- (ii) CFC's share of total *non-routine* profits. At the initiation of the CSA, each of the CFC and the U.S. parent brought to the CSA certain platform and operating contributions. Based on the relative contributions of platform and operating contributions from the CFC and the platform contributions from the U.S. parent, an "adjusted residual profit-split method" is applied to split total non-routine profits recorded by CFC between the CFC and its U.S. parent.

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transferred intangibles, they did not suggest at all that the Commissioner should have discretion to ignore periodic adjustments based on any arm's length pricing concept.

[24] The calculated periodic adjustment will be recognized as income by the U.S. parent in the Adjustment Year, which is whichever open year of the U.S. parent to which the IRS chooses to apply the adjustment. Thus, for example, in the articles referenced in *supra*, note 3, regarding nine MNCs (Facebook, Google, Apple, eBay, Cisco, Microsoft, Qualcomm, Oracle, and Stryker), the calculated periodic adjustment is generally applied to 2017 as the Adjustment Year. This was because of the expectation that 2017 would still be open for these MNCs and because 2017 is the last pre-TCJA year, meaning that the 35% tax rate still applies. Since all cumulative shifted profits in 2017 and earlier years will have given a 35% benefit to the taxpayer, it makes sense to make 2017 the Adjustment Year so that the recaptured income through the periodic adjustment mechanism is taxed at the same 35% rate. The periodic adjustment regulation includes rules for applying the adjustment to each year subsequent to the Adjustment Year. As a result, for example, the article on Apple calculates periodic adjustments to be recognized in 2017, 2018, 2019, and 2020. The 2017 year periodic adjustment would be taxed at the 35% rate while the following years would be taxed at the TCJA rate applicable to each year.

The periodic adjustment transferring profits from the CFC to its U.S. parent is equal to CFC's total profits less its calculated routine profits and its share of total non-routine profits. Again, these computations are on a cumulative basis from the CSA Start Date up through the Adjustment Year.

In many CSAs, especially where a CSA is executed with a newly established CFC, the CFC itself will have neither any platform contributions nor any operating contributions. The only such contributions come from the U.S. parent. Where this is the case, under the adjusted residual profit-split method, a CFC's share of total non-routine profits will be zero. This of course means that the only profit left within the CFC will be its arm's length return from the routine functions that it has factually performed. On the other hand, where a CFC with a pre-existing CSA at January 5, 2009, or an existing operating CFC on or after that date executes a new CSA with one or more other group members and *truly comes to the table with its own platform and/or operating contributions*, then it will earn a ratable portion of the total non-routine profits.

We believe that the drafters of Reg. section 1.482-7 were right to create this approach. It gets to a sensible and economically correct result that reflects the "investor model".[25] If the CFC had no contributions that benefit the CSA activity beyond routine functions, then it should not realize any future profits from future developed cost-shared intangibles. If it has made such contributions, then it should benefit ratably.

Should the IRS Be Applying Periodic Adjustments?

We strongly believe that the IRS should be using these periodic adjustment mechanisms, especially the one found in Reg. section 1.482-7(i)(6) where the factual situation causes it to apply.[26] One of the undersigned has made the case for this regulation's clear applicability and its practical application in the nine referenced articles that concern Facebook, Apple, Google, eBay, Cisco, Microsoft, Qualcomm, Oracle, and Stryker. The drafters of Reg. section 1.482-7(i)(6) are to be applauded for devising in paragraph (i)(6)(v) a calculation that:

- Is true to the 1986 Congressional mandate to use *ex post* profitability;[27] and

[25] See the Explanation of Provisions section for an explanation of the "investor model" in REG-144615-02, 70 Fed. Reg. 51116, August 29, 2005.

[26] The Reg. section 1.482-4(f)(2) periodic adjustment mechanism, which applies to any intangible transfer and not just CSAs, was written in such vague and seemingly contradictory terms that it has by all accounts never been enforced. Based on the experience of one of the undersigned in attempting to provide examples of how this Reg. section 1.482-4(f)(2) periodic adjustment mechanism could be applied to specific taxpayers (i.e. public companies where there is sufficient information in the public domain), this proved too difficult to accomplish. As such, it seems that it could be difficult if not impossible to apply this regulation in practice. We are hopeful that mention of "periodic adjustments" in the 2021-2022 Priority Guidance Plan means that the Reg. section 1.482-4(f)(2) periodic adjustment mechanism will be appropriately amended to allow it to be a viable tool for the IRS to apply. See Avi-Yonah et al., *supra*, note 4.

[27] It is worth noting that the legislative history for the 1986 Tax Reform Act addition to section 482 of the "commensurate with income" language was clear and unambiguous. The impossibility

- At the same time, allows a calculation that effectively covers not only shifted profits arising solely from the CSA, but also from any existing "other transgressions."

CSAs – The Opposite of Arm's Length Results

The above establishes that in practice CSAs are misused and are enablers of profit-shifting structures. However, ignoring this misuse and the resulting loss of tax revenues, there is an innate problem with CSAs. This innate problem is that an economic effect of the Reg. section 1.482-7 cost sharing regulation is that it actually reverses the "arm's length standard".

Take, for example, a subsidiary company existing on paper only, with no employees or value-creating operations, that owns no valuable intangible or tangible assets, makes no operational contributions, and does not manage or control any exploitation activities. At arm's length, such a subsidiary company should not have any bargaining power or competitive advantage that would enable it to force the much larger and more capable parent company to pay over a substantial portion of its future profits in exchange for:

(i) a platform contribution payment (very likely grossly understated), and

(ii) a simple annual cash contribution for a fraction (i.e., the "reasonably anticipated benefits" (RAB) share) of its yearly R&D costs, i.e. the "cost sharing payment".

It's important to recognize that, depending on the industry and the particular company, the cost-shared R&D costs may be just a small portion of the corporation's overall operating expenses with respect to the CSA Activity.

The regulation effectively treats the R&D function as paramount, ignoring in particular the exploitation function that will often represent the bulk of other operating expenses following the execution of a CSA. This paramount focus on the R&D function has allowed the CSA to become a taxpayer tool, aggressively used to implement profit-shifting structures. There is no basis for this in any economics literature; nor are there known examples of CSA structures being executed between unrelated parties.

Take Apple Inc.'s results as an example. Research and development expenses have historically been about 24% of total operating expenses. Under the CSA regulation, Apple's Irish-incorporated CFC, Apple Operations International (AOI), is allowed to record all revenues and earn all gross profit from transactions with customers in its defined rest-of-world territory.

From the cited analysis of Apple Inc.'s publicly available financial information (*supra* note 3), the principal cost to AOI has been its RAB share of this 24% of operating expenses. There has not been any evidence of AOI's having borne any significant portion of the exploitation and

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of valuing transferred intangibles on an *ex ante* basis fully warranted the *ex post* use of actual profits earned. Further, it is also worth noting that the legislative history provides no basis for the discussion of exceptions in the 1988 White Paper, the regulatory exceptions to periodic adjustments included in Reg. sections 1.482-4(f)(2)(ii) and 1.482-7(i)(6)(vi), or the provision in Revenue Procedure 2015-41, section 6.03, that an APA may provide that the periodic adjustment mechanisms will not apply "during or after the APA term."

other costs that Apple Inc. has surely expended on both its own and AOI's behalf. Apple Inc. and other U.S. group members, for example, appear to manage and conduct all worldwide production functions (aside from the physical production of products that is primarily conducted by unrelated Asian contract manufacturers). AOI appears to conduct no production functions through its own personnel (including the personnel of disregarded entity subsidiaries with the exception of certain limited production conducted in Ireland), despite the fact that from a contractual perspective AOI (through its disregarded entity subsidiaries) is directly sourcing its inventory property under contracts with suppliers, component vendors, and contract manufacturers…contracts that were negotiated by Apple U.S. group member personnel. Accordingly, AOI should be paying an arm's length service fee to relevant U.S. group members for these supply chain and production functions. (Even if these functions were covered by the CSA, then AOI should be bearing its RAB share of these costs.) There would of course be many other corporate services and management functions, the costs of which AOI should bear.[28]

While it is without question highly important, the IP development process is patently not the key source of Apple's year-in and year-out annual growing profits. Rather, according to experts, Apple's supply chain is the principal source of its large and consistent profits. The group has been voted the most efficient and profitable company in the world for several years running. Under the CSA regulatory structure, aside from perhaps a portion of compensation and other expenses as covered by Reg. section 1.482-9, the CSA as an economic mechanism assumes that there is no value to the supply chain or, for that matter, to Apple's management structure, including top executives such as its founder and creator of the iPhone, Stephen Jobs, or the current chief operating officer, Tim Cook, who created Apple's U.S. and China-based iPhone supply chain following his hiring in the late 1990s. Steve Jobs, Tim Cook, and Cupertino-based management also spent years working toward the opening of the China market to Apple products, the benefits of which have presumably gone solely to AOI since China would be within AOI's rest-of-world territory.[29]

Effectively, MNC use of CSAs in accordance with the cost sharing regulation (along with IRS non-enforcement of periodic adjustments) has created *economic results that override the arm's length principle*. *These regulations are fundamentally flawed to the point of being catastrophic*

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[28] This discussion is focusing on the production side. In addition to production, publicly available information indicates that Apple U.S. group members are active in sales and marketing activities for which AOI records the sales revenues. U.S. personnel activities include participation in the negotiation and conclusion of contracts with large foreign cellular carriers and major resellers. U.S. personnel also manage and operate on a day-to-day basis the internet-platform stores through which AOI earns revenue from product sales and cloud services. AOI should be paying an arm's length charge to Apple Inc. for these services as well.

[29] The following is quoted from Connie Guglielmo, "Apple's Cook Says iPhone China Mobile Deal Is the Beginning of a Beautiful Friendship," *Forbes*, Jan. 15, 2014: "The three visits in 13 months that Cook undertook after becoming CEO are part of the reason Apple was able to ink a deal in December with China Mobile. That ended six years of negotiations, according to The Wall Street Journal, which has a recap of the most recent meeting between Cook and China Mobile Chairman Xi Guohua. Those negotiations were started in 2008 by Jobs."

to America's tax administration. One of the undersigned estimated in his articles (*supra*, note 3) that assessment of periodic adjustments on just nine MNCs would result in roughly $600 billion of taxes, interest, and penalties. This calculation only covered profits from 2009 due to the Reg §1.482-7(i)(6) periodic adjustment computation being only in effect from January 5, 2009. However, not only are there many more than just these nine MNCs that have implemented CSA-based profit-shifting structures, but CSAs have been around for decades prior to 2009. They would have proliferated especially from 1997 when the check-the-box regulations were promulgated. As such, it would seem that the total loss of government revenues from CSA-based profit-shifting must be well in excess of a trillion dollars.

It was noted earlier that unrelated parties do not execute structures that reflect the terms that are defined by the CSA regulation and that so many MNCs have executed solely between group members. In contrast to these related party CSAs, in a conventional joint development agreement among unrelated parties, *each party* brings to the table non-routine, high-value assets that when combined create synergies. The arrangement is almost always structured as a profit split, generally aligned with the bargaining power or the relative value of the contributions by each party.

An excellent example of this is a joint development and commercialization agreement involving Bayer AG and CuraGen Corporation in 2001, in which the latter was responsible for identifying a number of gene and protein targets for which Bayer would then develop small molecule compounds that could bind to these targets. Both parties also engaged in commercialization efforts, with profits split in proportion to the costs represented by these widely divergent but non-routine contributions.[30] Note that:

- The respective operational contributions by each party were different and non-overlapping, but included all related development and commercialization activities;
- The different activities by each party were non-routine and not easily replicated by the other party or by competitors; and
- Each party made valuable intangible development and exploitation contributions to the arrangement.

This "real world" joint development agreement differs significantly from a common intercompany cost sharing agreement under Reg. section 1.482-7 in which only one party commonly performs all or virtually all of both the intangible development and the exploitation activities, while the other participant contributes nothing or close to nothing aside from cost sharing payments and typically only routine support functions. Highly important contributions to profits (in particular, management and operation of the supply chain and group internet-based

[30] This contract is available at: https://www.lawinsider.com/contracts/X9v0CaMEB0k2muwRu2IsT/curagen-corp/0/2001-03-28. See also J. Schohl, "Working Together in the Pharmaceutical, Biotech and Medical Device Industries: Contractual Terms and Conditions," Independent Study Project, Northwestern University, August 2004.

platforms) are effectively ignored or given less than cursory recognition by many taxpayers despite such important contributions being subject to other relevant section 482 regulations. Getting back to Apple as an example, it appears that AOI, its foreign cost sharing participant, paid almost nothing for the various routine and non-routine commercialization functions performed within the U.S.[31]

Too often in intercompany CSA arrangements but also in non-CSA contexts (such as intercompany licensing arrangements), the foreign related participants in these transactions can earn the majority of profits from the arrangement while undertaking few of the operational or financial contributions and related expenses that in fact generate the foreign affiliate's revenues.[32] Periodic adjustments were meant to enable the IRS to reverse this tax avoidance. This was already a major issue in the years preceding the 1986 enactment of the "commensurate with income" standard. Over more than thirty years, the Treasury has found it impossible to repair these cost sharing regulations to produce economically arm's length outcomes. It should be no surprise that some academics and practitioners have been calling for the repeal of cost sharing regulations for years.[33]

At its core, cost sharing is nothing more than a narrow formulary apportionment method applied to split certain costs based on each participant's RAB share. This method comes, though, with a massive externality in which the choice of this method results in the wholesale transfer of the foreign territory revenues and gross profits instantly to the foreign cost sharing participant – which can be nothing more than a shell or holding company – even if the intangible development

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[31] See *supra*, note 3, Curtis and Chamberlain (2021), pages 1052-1055 and 1060-1061.

[32] Recent examples of this include Pfizer, which reported ($43) billion in U.S. pre-tax losses and $190 billion in foreign pre-tax income from 2008 through 2020, AbbVie Inc., which reported $76 billion in foreign pre-tax profits and ($20) billion in U.S. losses from 2011 through 2020, and Medtronic plc (formerly Medtronic Inc. prior to 2015), which reported ($300) million in U.S. losses and almost $16 billion in foreign profits between 2017 and 2019. Some of these excesses in the pharmaceutical industry have attracted Congressional attention. See "Wyden Hearing Statement on Big Pharma's Tax Avoidance Schemes", 2023 TNTI 92-19 (May 11, 2023) and "Wyden Releases New Findings in Ongoing Pharma Tax Investigation", 2023 TNTI 92-18 (May 11, 2023).

[33] See R. Avi-Yonah and I. Benshalom, "Formulary Apportionment: Myths and Prospects-Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative," *World Tax Journal* 3(3) (2011): 371-98; Y. Brauner, "Cost Sharing and the Acrobatics of Arm's Length Taxation," University of Florida Legal Studies Research Paper No. 2010-19 (2010); Naegele (2010); R. Avi-Yonah, K.A. Clausing and M. C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review* 9(5) (2009): 497-553; J.C. Fleming, Jr., R. J. Peroni and S.E. Shay, Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig? 36 Mich. J. Int'l L. 1 (2015) and "Getting Serious About Cross Border Earnings Stripping: Establishing an Analytics Framework," *North Carolina Law Review* (93) (2015): 673-740 & BYU Law Research Paper No. 15-11. See also Reuven S. Avi-Yonah, David G. Chamberlain, Stephen L. Curtis, and Jeffery M. Kadet, "Commensurate with Income: IRS Nonenforcement Has Cost $1 Trillion", 179 *Tax Notes Federal* 1297 (May 22, 2023).

function is not the most important contributor to profits.[34] These regulations override the arm's length principle and depend largely on the honesty of taxpayers to ensure that the regulations are not exploited to achieve non-arm's length outcomes. Sadly, the nine referenced articles in footnote 3 and research data from former Deputy Assistant Secretary Clausing's[35] suggest that "honesty" in this regard is not alive and well within MNC taxpayers.[36]

In late 2008, Treasury made two important changes in the new CSA regulation that were effective from January 5, 2009. The first was the Temp. Reg. section 1.482-7T(m) transition rules, clearly designed to avoid the grandfathering of existing "no substance" cost sharing arrangements, such as those with shell or holding companies that made only cash contributions to the cost sharing arrangement and those that performed only routine functions that did not constitute the exploitation of the cost-shared intangibles. The effect of not qualifying for grandfathering was to be subject to the second change, which was the addition of the Temp. Reg. section 1.482-7T(i)(6) periodic adjustment rules. These rules implemented a CSA-specific "commensurate with income" rule, which placed an objectively calculated limitation on the amount of profits that could be transferred offshore via a cost sharing arrangement. These two developments represented a watershed that could improve the capability of the IRS to finally prevent the use of CSA arrangements to implement aggressive tax-motivated profit shifting – if they are ever enforced.

Common Features of CSA-Based Structures: Partnership Status and ECI

Before leaving this discussion of CSAs as an *enabler* of profit-shifting structures, it must be noted that CSAs have encouraged U.S. MNCs and their perhaps mercenary advisors to create structures in which the CFC entrepreneur is clearly subject to direct U.S. taxation on its effectively connected income (ECI). Somehow in their zeal for lower effective tax rates, U.S. MNCs and their advisors have outright ignored or discounted the IRS ability to apply the ECI rules.

The basic concept behind ECI in rough terms is that a foreign taxpayer (including a CFC) should be taxable in the same manner as any domestic taxpayer to the extent that that foreign taxpayer earns profits from the conduct of a trade or business within the United States. Given the structures used and their integrated and centrally-managed-and-conducted nature (those

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[34] A product that results from R&D can of course lead to revenues from the manufacturing and selling of that product. However, whether the company can make a profit on these sales often has plenty to do with other factors outside the R&D function, such as product strategy and positioning, the efficiency of the enterprise and the supply chain, competitive advantage, bargaining power, etc.

[35] *See* Kimberly A. Clausing, "5 Lessons on Profit Shifting From U.S. Country-by- Country Data", 169 *Tax Notes Federal* 925 (November 9, 2020), at 933*ff*, available at https://ssrn.com/abstract=3736287.

[36] See also Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively," Part 1 at 151 *Tax Notes* 1831 (June 27, 2016) and Part 2 at 152 *Tax Notes* 85 (July 4, 2016), available at http://ssrn.com/abstract=2811267 and http://ssrn.com/abstract=2811280.

described in the nine referenced articles are excellent examples), it is clear that a CFC entrepreneur will often be engaged in a U.S. trade or business (section 864(b)) and will earn some amount of income that will be ECI under section 864(c). Often, the integrated and centrally-conducted nature of actual operations means that the U.S. group members and the CFC entrepreneur are conducting a joint business that constitutes a separate entity for federal tax purposes, which will be classified as a partnership under the entity classification default rule in the absence of an active election to be treated as an association (Reg. sections 301.7701-1 and -3). The existence of a partnership makes the application of ECI taxation much easier given section 875(1), the calculation of ECI at the partnership level, and the fact that the relevant ECI regulations have not yet been updated for modern business models.[37]

This ECI issue is only raised briefly here to provide a basis for one of the recommendations made below in the "Other Recommendations" section for the future update of Revenue Procedure 2015-41.

CSA-Related Recommendations

Withdraw Reg. section 1.482-7 and Eliminate Cost Sharing Arrangements

Overall, we recommend that Reg. section 1.482-7 be withdrawn, and that CSAs no longer be allowed between related parties. Summarizing the above discussion, we recommend this due to:

- The oversized role that CSAs have played in profit-shifting structures,
- The fact that true CSAs are seldom if ever found between unrelated persons,[38] and
- CSAs provide economic results that are not arm's length.

This recommendation is consistent with what some academics and transfer pricing experts have been recommending for many years.[39] See in particular some concise discussion of what CSAs have wrought in the recent *Tax Notes Federal* piece, Avi-Yonah et al., "Commensurate with Income: IRS Nonenforcement Has Cost $1 Trillion", 179 *Tax Notes Federal* 1297 (May 22,

[37] See Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures and Unexpected Partnership Status", 151 *Tax Notes* 335 (April 18, 2016), available at http://ssrn.com/abstract=2773574. Also, see below where this matter is discussed further.

[38] Some practitioners believe that CSAs are consistent with common uncontrolled transactions (for example, see Tyler M. Johnson, John Hildy and John W. Horne, "Cost Sharing Is a Tax Shelter Now. Wait, What?" *Tax Notes Federal*, Sept. 18, 2020, p. 2193). However, Curtis, (2020) and Curtis and Chamberlain, (2021), *supra*., note 3, discuss how this is simply false, beginning on pages 1890 and 1068 respectively. The latter also discusses how cost sharing arrangements are inconsistent with the arm's length standard, beginning on page 1064.

[39] See in particular Reuven S. Avi-Yonah, "Amazon vs. Commissioner: Has Cost Sharing Outlived Its Usefulness?" U of Michigan Law & Econ Research Paper No. 17-003 and U of Michigan Public Law Research Paper No. 551, (May 1, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2961235; and Yariv Brauner, "Cost Sharing and the Acrobatics of Arm's Length Taxation," University of Florida Legal Studies Research Paper No. 2010-19 (2010), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1651334.

2023), at 1325*ff*. See also the recent piece from Elizabeth J. Stevens and H. David Rosenbloom, "Original Sin: Cost Sharing in the United States", 185 *Tax Notes Federal* 1197 (November 11, 2024).

While the recommendation is being made that Reg. section 1.482-7 should be withdrawn and not be replaced, this should be done if and only if certain transition provisions are put in place and Reg. section 1.482-4 and other relevant regulations are amended to strengthen them and implement within them the principles on which Reg. section 1.482-7 was based. These transition provisions and amendments would include:

- Transition Provision 1. As of the date that Reg. section 1.482-7 is withdrawn, it would be necessary to determine the relative percentage interest in a CSA's cost-shared intangibles that each participant owns. For any cases where the foreign CSA participant has itself contributed to the development of cost-shared intangibles and has itself exploited those intangibles, transition rules issued in connection with the withdrawal should provide a methodology for determining each CSA participant's percentage interest in the cost-shared intangibles. Given that most CSAs have been implemented as a crucial element of a profit-shifting structure where the foreign CSA participant contributed nothing (aside from funding) to the development of cost-shared intangibles and conducts itself little, if any, of the exploitation of those intangibles, the Treasury Decision that withdraws Reg. section 1.482-7 should specify a rebuttable presumption that a foreign participant in a CSA with a U.S.-headquartered multinational will have no ownership of any cost-shared intangibles. As such, unless the presumption is rebutted, the comparable profits method as specified in Reg. section 1.482-4(a)(2) would be used to determine the level of royalty in the future. Where the presumption is successfully rebutted so that the foreign participant is treated as owning a share of the cost-shared intangibles, then the profit-split method specified in Reg. sections 1.482-4(a)(3) and 1.482-6 would be used in the future.

- Transition Provision 2. As of the last day that a CSA is in effect, taxpayer groups would be required to apply the periodic adjustment rules of Reg. section 1.482-7(i)(6) to establish whether a Periodic Trigger has occurred because of an AERR outside the PRRR. Where a Periodic Trigger has occurred for one or more foreign CSA participants, then a periodic adjustment would be calculated for each such CSA participant under paragraph (i)(6)(v) and included in the income of the relevant U.S. group member CSA participant. (This requirement for a Periodic Trigger computation and inclusion in income of a periodic adjustment where there's been a Periodic Trigger would also be required even where a group has terminated its CSA prior to the effective date of the withdrawal of Reg. section 1.482-7.[40])

[40] This application to terminated CSAs is justified based on the continued exploitation by one or more CSA participants of cost-shared intangibles. See Reg. sections 1.482-7(i)(6)(i) and (v) and the definition of CSA Activity in paragraph (j)(1)(i).

- Amendment of Existing Regulations to Reflect the Investor Model and the Realistic Alternative Principle. Considerable thought and effort went into the drafting of Reg. section 1.482-7 to reflect both the investor model and the realistic alternative principle. Despite their promulgation first in Temp. Reg. section 1.482-7T (2009) and later in finalized Reg. section 1.482-7 (2011), other relevant transfer pricing regulations dealing with intangible transfers have not been updated to reflect these underlying principles. As a result of this, both the paragraph (g) ex ante pricing mechanisms and the paragraph (i)(6) "commensurate with income" periodic adjustment rules that apply ex post results are significantly more robust than the comparable ex ante rules of Reg. section 1.482-4(a) and the ex post "commensurate with income" rules of Reg. section 1.482-4(f)(2). Considering this, as of the date that Reg. section 1.482-7 is withdrawn, Reg. sections 1.482-4, 1.482-5, and 1.482-6 *must* be updated so that the comparable profits method of Reg. sections 1.482-4(a)(2) and 1.482-5 and the profit-split method of Reg. sections 1.482-4(a)(3) and 1.482-6 implement the investor model and the realistic alternative principle that was written into Reg. section 1.482-7. Further, the periodic adjustment rule of Reg. section 1.482-4(f)(2) must be aligned with the Periodic Trigger and periodic adjustment computations of Reg. section 1.482-7(i)(6). It is clearly critical that the regulations governing treatment of intangible transfers after withdrawal of Reg. section 1.482-7 be at least as robust as Reg. section 1.482-7 currently is.[41] It may be appropriately added that updating these regulations now would allow the considerable litigation experience of the last decade concerning intangible transfers to make these updated regulations stronger and more effective against taxpayer challenges.

- Elimination or Severe Scaling Back of Transactional Methods. Finley, in the paper referenced in note 41, notes grossly inappropriate efforts made by taxpayers to apply transactional pricing methods that would result in nonsensical pricing results.[42] Accordingly, amendments of Reg. section 1.482-4 must either specifically disallow any comparable uncontrolled transaction treatment for intangibles, or create a rebuttable presumption that the comparable uncontrolled transaction method may not be applied in the absence of what is effectively an exact match of terms, conditions, timing, etc. In any case, the regulation must at a minimum make crystal clear that in the case of intangible transfers that transactional methods have no priority whatsoever.

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[41] See Ryan Finley, "Withdrawing Cost-Sharing Regulations Would Achieve Little", *Tax Notes Federal*, April 29, 2024, p. 781. The content of this paper is a veritable roadmap for updating these regulations and includes considerable detail on what is in Reg. section 1.482-7 that must be inserted into Reg. section 1.482-4 and other transfer pricing regulations in order to make them of equal or greater robustness. See also, Reuven Avi-Yonah, "Has Cost Sharing Outlived Its Usefulness?", *Tax Notes Federal* (forthcoming), and Mindy Herzfeld, "Protecting the U.S. Tax Base: Questions about Cost Sharing", *Tax Notes Federal*, April 22, 2024, p. 608.

[42] See, for example, Ryan Finley, "What's at Stake in the Medtronic II Appeal, Part 1", *Tax Notes Federal*, October 2, 2023, p. 23, and Ryan Finley, "What's at Stake in the Medtronic II Appeal, Part 2", *Tax Notes Federal*, October 9, 2023, p. 225.

We understand that this recommendation to completely withdraw Reg. section 1.482-7 along with the above critical transition provisions and updating of Reg. section 1.482-4 and related regulations might not be acted upon by Treasury and the IRS. With this understanding, we recommend in the following pages a number of actions, including many specific to Revenue Procedure 2015-41, regarding regulatory and other changes that would reduce the detrimental effects of CSAs. These recommendations are set out below.

Eliminate APAs for Cost Sharing Arrangements

Given this understanding that CSA are principally used by MNCs for profit-shifting structures, we recommend that Revenue Procedure 2015-41 be amended to expressly state that no APA will be issued for any CSA. If it is decided to continue issuing APAs for CSAs, then we recommend in the alternative that the revenue procedure includes a clear statement that APAs will only be issued with respect to CSAs in the circumstances, which are expected to be rare, where the taxpayer is able to establish the following to the satisfaction of the APMA:

(i) That there is a legitimate business need for the CSA;

(ii) That all participants meet the "individual exploitation" requirement described below;

(iii) That all participants meet the "participant" requirement described below; and

(iv) That the use of the CSA will not result in tax avoidance over the life of the CSA.

Re-Introduction of "Individual Exploitation" Requirement

Reg. section 1.482-7A, which was in effect from the beginning of 1996 until immediately prior to the January 5, 2009, effective date of Temp. Reg. section 1.482-7T,[43] included an "individual exploitation" requirement in paragraph (a)(1).

Reg. section 1.482-7A(a)(1) reads, in part:

> A cost sharing arrangement is 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. … [Emphasis added.]

This "individual exploitation" requirement was not included in Temp. Reg. section 1.482-7T or in Reg. section 1.482-7, which was finalized in 2011. Despite the exclusion of this specific language from the current regulation, its relevance remains clear through the many examples throughout Reg. section 1.482-7, *all of which include factual background situations that involve participants that conduct their own individual active businesses*. There is not even one example that suggests in any manner a CSA participant that would not use the cost-shared intangibles within its own business.

[43] These regulations under § 1.482-7T were effective on January 5, 2009. See T.D. 9441, 2009-7 I.R.B. 460, and were made final effective December 16, 2011. See T.D. 9568, 2012-12 I.R.B. 499.

This "individual exploitation" requirement should be re-inserted into Reg. section 1.482-7. Note in this regard that the regulation section in paragraph (j)(1)(i) defines "reasonably anticipated benefits" as follows:

> A controlled participant's reasonably anticipated benefits mean the benefits that reasonably may be anticipated to be *derived from exploiting cost shared intangibles*. For purposes of this definition, benefits mean the sum of additional revenue generated, plus cost savings, minus any cost increases *from exploiting cost shared intangibles*. [Emphasis added.]

Thus, if a putative CSA participant is not exploiting the cost-shared intangibles, it will have an RAB share of zero. It must be made clear that a participant may only exploit cost-shared intangibles through its own personnel and any agents or independent contractors that it factually directs and controls.

Along with adding the "individual exploitation" language, it would be very helpful to include examples showing that this requirement will not be met where any other person, whether related or not, conducts business functions that the putative CSA participant could not conduct itself or does not have the personnel and capacity to direct others to perform on its behalf. More specific examples of non-qualifying situations could include:

> (i) a CSA participant that putatively manufactures products where the production functions are performed by a related person, and
>
> (ii) a CSA participant that in contractual form conducts an internet-based business but where a related person actually operates the platform through which advertising and/or other digital cloud services are delivered to the participant's users, customers, and advertisers.

If this "individual exploitation" language is not added to the current regulation, we recommend that any future reissuance of Revenue Procedure 2015-41 expressly provide that an APA will only be issued for CSAs where all participants factually exploit the cost-shared intangibles within their own individually conducted businesses. The above suggested examples should be included as well.

Re-Introduction of "Participant" Requirements

An "active conduct" rule was originally included in Reg. section 1.482-7A(c) when the regulation was promulgated in T.D. 8632 in December 1995. Prior to its elimination by T.D. 8670 in May 1996, this rule read:

> (c) PARTICIPANT –
>
> > (1) IN GENERAL. For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) …. A controlled taxpayer may be a controlled participant only if it--

(i) Uses or reasonably expects to use covered intangibles in the active conduct of a trade or business, under the rules of paragraphs (c)(2) and (c)(3) of this section;

…

(2) ACTIVE CONDUCT OF A TRADE OR BUSINESS –

(i) TRADE OR BUSINESS. The rules of section 1.367(a)-2T(b)(2) apply in determining whether the activities of a controlled taxpayer constitute a trade or business. For this purpose, the term CONTROLLED TAXPAYER must be substituted for the term FOREIGN CORPORATION.

(ii) ACTIVE CONDUCT. In general, a controlled taxpayer actively conducts a trade or business only if it carries out substantial managerial and operational activities. For purposes only of this paragraph (c)(2), activities carried out on behalf of a controlled taxpayer by another person may be attributed to the controlled taxpayer, but only if the controlled taxpayer exercises substantial managerial and operational control over those activities.

(iii) EXAMPLES. The following examples illustrate this paragraph (c)(2):

Example 1. Foreign Parent (FP) enters into a cost sharing arrangement with its U.S. Subsidiary (USS) to develop a cheaper process for manufacturing widgets. USS is to receive the right to exploit the intangible to make widgets in North America, and FP is to receive the right to exploit the intangible to make widgets in the rest of the world. However, USS does not manufacture widgets; rather, USS acts as a distributor for FP's widgets in North America. Because USS is simply a distributor of FP's widgets, USS does not use or reasonably expect to use the manufacturing intangible in the active conduct of its trade or business, and thus USS is not a controlled participant.

EXAMPLE 2. The facts are the same as in EXAMPLE 1, except that USS contracts to have widgets it sells in North America made by a related manufacturer (that is not a controlled participant) using USS' cheaper manufacturing process. USS purchases all the manufacturing inputs, retains ownership of the work in process as well as the finished product, and bears the risk of loss at all times in connection with the operation. USS compensates the manufacturer for the manufacturing functions it performs and receives substantially all of the intangible value attributable to the cheaper manufacturing process. USS exercises substantial managerial and operational control over the manufacturer to ensure USS's requirements are satisfied concerning the timing, quantity, and quality of

the widgets produced. USS uses the manufacturing intangible in the active conduct of its trade or business, and thus USS is a controlled participant.

(3) USE OF COVERED INTANGIBLES IN THE ACTIVE CONDUCT OF A TRADE OR BUSINESS –

(i) IN GENERAL. A covered intangible will not be considered to be used, nor will the controlled taxpayer be considered to reasonably expect to use it, in the active conduct of the controlled taxpayer's trade or business if a principal purpose for participating in the arrangement is to obtain the intangible for transfer or license to a controlled or uncontrolled taxpayer.

(ii) EXAMPLE. The following example illustrates the absence of such a principal purpose:

EXAMPLE. Controlled corporations A, B, and C enter into a qualified cost sharing arrangement for the purpose of developing a new technology. Costs are shared equally among the three controlled taxpayers. A, B, and C have the exclusive rights to manufacture and sell products based on the new technology in North America, South America, and Europe, respectively. When the new technology is developed, C expects to use it to manufacture and sell products in most of Europe. However, for sound business reasons, C expects to license to an unrelated manufacturer the right to use the new technology to manufacture and sell products within a particular European country owing to its relative remoteness and small size. In these circumstances, C has not entered into the arrangement with a principal purpose of obtaining covered intangibles for transfer or license to controlled or uncontrolled taxpayers, because the purpose of licensing the technology to the unrelated manufacturer is relatively insignificant in comparison to the overall purpose of exploiting the European market.

In October 2015, as part of the OECD/G20 BEPS process (within which the United States was an important and influential participant), new transfer pricing guidance was published with that guidance later being included in the July 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "Guidelines").

The following was reported immediately following the October 2015 issuance of the Actions 8-10 Final Report,[44] which contained the guidance relevant to this discussion of "participant" requirements.

[44] OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, available at http://dx.doi.org/10.1787/9789264241244-en.

> The Department of Treasury will likely not have to issue "substantial" changes to current transfer pricing regulations due to the OECD's Action Plan on Base Erosion and Profit Shifting, according to a senior official.
>
> "To the extent that we think these rules are kind of clarifying the arm's-length standard that are already embodied in our regulations, we are not anticipating having to make substantial changes" to current regulations on Internal Revenue Code Section 482, said Robert Stack, U.S. deputy assistant Treasury secretary for international tax affairs, in an Oct. 9 Deloitte Tax LLP webcast. "It's possible that as we dig through, we may see these clarifications as something that might need to be elucidated upon."[45]

The point of quoting this statement is to indicate that the below-discussed BEPS guidance is very much consistent with the above quoted regulatory language that was eliminated from Reg. section 1.482-7A in May 1996.

The new guidance is included in Chapter VIII (Cost Contribution Arrangements), section C.2. of the Guidelines. It focuses expressly on whether a controlled taxpayer could be a participant in a cost contribution arrangement.

A particular aspect of this new guidance concerning participants in a CCA (or CSA to use U.S. terminology) is that a controlled taxpayer may only be a "participant" if it meets certain criteria. These criteria include:

- The controlled taxpayer must benefit from the objectives of the subject activity. An example provided is "exploiting its interest or rights in the intangibles." The guidance goes on to say: "a party would not be a participant in a CCA if it is not capable of exploiting the output of the CCA in its own business in any manner." (Para 8.14.)

[45] Alex M. Parker, "Stack: No Big Changes to Transfer Pricing Rules From BEPS", International Tax News (BNA) (October 13, 2015). Also, Alex M. Parker, International Tax Policy Forum (October 12, 2015), available at https://itpf.org/itpf_blog?article_id=3601. For completeness, it is worth noting that the cited article goes on to quote Mr. Stack as saying that if there is "smart cash" within a group member, then that group member should not just receive a risk-free return. He said: "We think that once you can demonstrate the ability to control the funding risk—know what to do as an investor—then you should be entitled like anyone to that full return[.]" It seems very safe to say that in the case of the nine multinationals examined in the nine referenced articles (*supra*, note 3) that personnel within the relevant CFC group members would have factually exercised no control over the funding risks that those group members assumed. Rather, all such decisions would have been made solely at group headquarters in the United States. Google is a particularly good example of this given that it executed its CSA shortly after the formation of its Irish structure at a time when there were just a handful of low-level Irish personnel and one manager who had been transferred from the United States to supervise them.

- The controlled taxpayer must exercise control over the specific risks it assumes under the CCA (Para 8.15). The guidance explains that:

> … a CCA participant must have (i) the capability to make decisions to take on, lay off, or decline the risk-bearing opportunity presented by participating in the CCA, and must actually perform that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and must actually perform that decision-making function. While it is not necessary for the party to perform day-to-day risk mitigation activities in relation to activities of the CCA, in such cases, it must have the capability to determine the objectives of those risk mitigation activities to be performed by another party, to decide to entrust that other party to provide the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the arrangement, and must actually perform such assessment and decision-making.

- The controlled taxpayer must have the financial capacity to assume the risks (Para 8.15). This means that a party providing funding must have the functional capability to exercise control over the financial risk attached to its contributions to the CCA and it must actually perform these functions. The guidance explains (para 6.63):

> … exercising control over a specific financial risk requires the capability to make the relevant decisions related to the risk bearing opportunity, in this case the provision of the funding, together with the actual performance of these decision making functions. In addition, the party exercising control over the financial risk must perform the activities as indicated in paragraph 1.65 and 1.66 in relation to the day-to-day risk mitigation activities related to these risks when these are outsourced and related to any preparatory work necessary to facilitate its decision making, if it does not perform these activities itself.

In explaining the requirements for a controlled taxpayer to be a participant in a CCA, the guidance emphasizes that just providing funding is insufficient to be a participant (para 8.16). The guidance explains:

> To the extent that specific contributions made by participants to a CCA are different in nature, e.g. the participants perform very different types of R&D activities or one of the parties contributes property [such as cash] and another contributes R&D activities, the guidance in paragraph 6.64 is equally applicable. This means that the higher the development risk attached to the development activities performed by the other party and the closer the risk assumed by the first party is related to this development risk, the more the first party will need to have the capability to assess the progress of the development of the intangible and the consequences of this progress for achieving its expected benefits, and the more closely this party may need to link its actual decision-making required in relation to its continued contributions to the CCA to key operational developments that may impact the specific risks it assumes under the CCA. …

In addition to the above, past abuses require that guidance is needed for the following.

- A group member will not qualify as a participant if it subcontracts important elements of its exploitation process to another participant or to an independent contractor where another participant or a person under another participant's control is the party having the capability to direct and control the risks of the exploitation elements being performed by the independent contractor.

- It should normally not be possible for a newly formed group member to qualify as a participant under the standards recommended above. Recognizing this, the guidance should state clearly that a newly established group member would not qualify as a participant except under unusual factual circumstances. Rather, a controlled entity would itself have to already be conducting a business that would actually use the anticipated cost-shared intangibles in order to qualify as a participant.

Guidance on which taxpayers may be a "participant" to a CSA must be inserted into Reg. section 1.482-7. This guidance should reflect the above original language of Reg. section 1.482-7A, the BEPS project developments including the 2017 additions to the Guidelines, and the additional two bullet points.

If these "participant" requirements are not added to Reg. section 1.482-7 and APAs are to be continued to be issued for CSAs, guidance must be added to Revenue Procedure 2015-41 or elsewhere to make clear that a participant may only be treated as a participant to a CSA if it factually meets these requirements. This will help taxpayers seeking APAs and APMA personnel who are evaluating APA request submissions.

Elimination of Periodic Adjustment Exemptions from APAs

Section 6.03 of Revenue Procedure 2015-41 says that an APA may provide that the periodic adjustment mechanisms will not apply "during or after the APA term".

This potential exemption from periodic adjustments must be specifically eliminated from Revenue Procedure 2015-41 in the case of any CSA. (It is also recommended that this be eliminated as well for non-CSA intangible transfers. This is covered in the "Other Recommendations" section below.)

The drafters of Reg. section 1.482-7(i)(6) should be applauded for devising in paragraph (i)(6)(v) a calculation that serves two explicit purposes. These are:

- The calculation achieves the 1986 Congressional mandate to use *ex post* profitability to deal with intangible transfers; and

- The calculation effectively covers not only shifted profits arising solely from a CSA, but also transfer pricing problems arising from issues unrelated to the CSA itself.

As indicated in the earlier discussion, the referenced nine articles in footnote 3 show that transfer pricing enforcement has been unable to reverse what appears to be blatant cases of inappropriate, if not potentially fraudulent, transfer pricing in regard to amounts charged for critical business

functions performed by U.S. group members for related foreign group member entrepreneurs. Such transfer pricing abuse is likely endemic to hundreds of profit-shifting structures that are similar to those described in the articles.

Given this situation, the relatively objective-to-apply formula approach set out in Reg. section 1.482-7(i)(6)(v) is a unique tool that can be applied where a taxpayer's level of entrepreneur's profits exceeds the defined range (the PRRR) so that a periodic adjustment is triggered. Whether the excess profits that cause the trigger arise strictly from the use of the CSA or partly or wholly from other transfer pricing transgressions, the formula approach gets to the right economic answer with a minimum of difficulty.

As one example to alleviate any doubt, consider that in 2006 an APA was granted to Google Inc. for a CSA that the taxpayer exploited to avoid as much as $50 billion in U.S. corporate income taxes over the sixteen-year life of the CSA (2003 through 2019). During this long period, there has been no indication of (i) any IRS detection or enforcement of either the validity and status of the CSA itself from the January 5, 2009, effective date of Temp. Reg. section 1.482-7T; or (ii) the apparent blatant mispricing of certain inter-company transactions. These inter-company transactions importantly include Google U.S. group members conducting core business functions so that these U.S. group members, rather than Google Ireland itself, were actually providing advertising and other cloud services directly to Google Ireland's advertisers and other paying customers.[46]

A second example involves Apple Inc. Although it is unknown whether Apple ever secured an APA for its CSAs over the past forty years, it is clear that this taxpayer's use of its CSA since January 5, 2009, has allowed the group to avoid around $85 billion in taxes through 2020. As set out in the referenced article, this is something which the IRS must address.[47] These two examples demonstrate how important it is that the allowed exemption from future Reg. section 1.482-7(i)(6) periodic adjustments, presently found in Section 6.03 of Revenue Procedure 2015-41, must be eliminated in any future reissuance of this revenue procedure.

Congress was clear in its directions.[48] Periodic adjustments should be based on *ex post* information. The Joint Committee on Taxation's blue book summarizes well this congressional guidance:

> Congress did not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. Congress intended that consideration also be given to the actual profit experience realized as a consequence of the transfer. Thus, *Congress intended to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible . . . it will not be sufficient to consider only the evidence of value at the time of the transfer*.

[46] See Curtis (2021), *supra*, note 3.
[47] See Curtis and Chamberlain, (2021), supra., note 3.
[48] See H.R. Rep. No. 99-426, 1986-3 C.B. Vol. 2, at 420*ff*.

> Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible. In requiring that payments be commensurate with the income stream . . . *the profit or income stream generated by or associated with intangible property is to be given primary weight*.[49] [Emphasis added.]

To allow the inclusion in an APA of an exemption from any future application of a Reg. section 1.482-7(i)(6) periodic adjustment simply flies in the face of this clear and unambiguous Congressional guidance.

Make Periodic Adjustments under Reg. section 1.482-7(i)(6) Mandatory

Reg. section 1.482-7(i)(6) is solely a discretionary tool of the Commissioner. Despite a CSA participant having a Periodic Trigger where that participant's Actually Experienced Return Ratio is outside the Periodic Return Ratio Range (in the case of a foreign CSA participant, the AERR is above the PRRR), neither the Commissioner nor the taxpayer group is under any obligation to adjust results in accordance with the residual profit split method under the computation described in Reg. section 1.482-7(i)(6)(v).

The Congressional guidance in the Committee Reports that accompanied the enactment of the "commensurate with income" mandate in no way suggests that periodic adjustments should be discretionary with either the Commissioner or the applicable taxpayer. The House Committee Report included:

> Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty *without adequate provisions for adjustment as the revenues of the intangible vary*. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to *require* that the payment made on a transfer of intangibles to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. …[50] [Emphasis added.]

This intention to "require" periodic adjustments as expressed in the Committee Report is consistent with the "shall" language in the statute (i.e. the second sentence in section 482).

Given the above and recognizing the practical IRS limitations caused by its finite resources that prevent any broad examination of CSA results, Reg. section 1.482-7(i)(6) should be amended as follows:

- Make the paragraph (i)(6) periodic adjustment mechanism an annual taxpayer obligation such that each year taxpayers must determine whether a Periodic Trigger has occurred, and if so, calculate and recognize as income the calculated periodic adjustment. Both the taxpayer's Periodic Trigger calculation and, where relevant, its periodic adjustment calculation would be subject to normal IRS audit examinations.

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[49] JCT, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 1016 (1987).
[50] H.R. Rep. No. 99-426, 1986-3 C.B. Vol. 2, at 425.

- In the event that the paragraph (i)(6) periodic adjustment mechanism is not made an annual taxpayer obligation, eliminate the present Commissioner discretion and make paragraph (i)(6) obligatory. Also, add to taxpayer documentation requirements in paragraph (k) the obligation to maintain and have ready for IRS examination annual Periodic Trigger calculations and the residual profit-split method calculations necessary to determine annual periodic adjustments. Even better would be to require that these calculations be annually submitted to the IRS as part of the annual reporting required by Reg. section 1.482-7(k)(4).

Include in APA Terms the Detail Necessary to Apply Future CSA Periodic Adjustments

Whether or not the recommendation to eliminate the potential exemption from periodic adjustments discussed above is accepted, it is recommended that any reissuance of Revenue Procedure 2015-41 includes a clear statement that the terms of any APA will include the basis on which the Reg. section 1.482-7(i)(6) periodic adjustment rule will be applied in future years. Such upfront agreement should prevent significant future disagreements and potential litigation.

Under the required use of the adjusted residual profit-split method, it is necessary to identify and establish values for the relative platform and operating contributions of each participant to a CSA.[51] We recommend that the APA include as express terms the identified contributions and either specific values for the contributions from each participant or, if the CSA has not yet been executed, the specific methodology for the valuing of each contribution.

We recommend also that the reissuance should make clear that in the case where a participant conducts solely routine functions and makes no platform or operating contributions at the time of the CSA's execution that any future application of the Reg. section 1.482-7(i)(6) periodic adjustment rule will attribute all non-routine profits to the PCT Payee. In the event that any newly established group member is determined to qualify as a participant, the guidance should make clear that such a participant will be treated as having made zero platform and operating contributions.

In this regard, it is recommended that any reissuance of Revenue Procedure 2015-41 and internal APMA policies and practices take into account some of the examples included in Temp. Reg. section 1.482-1T(f)(2)(i)(E).[52] For example, Example 6 in this temporary regulation concerns a newly established foreign subsidiary (S1) of U.S. parent P. At formation, P contributes certain intangibles to S1, treating the contribution as a transfer described in section 351 that is subject to section 367. At a later date within the same year, P and S1 execute a CSA with S1 treating its recently received intangibles as its platform contribution. As a result of having made this platform contribution, in the event that there is later a periodic adjustment calculation, this S1 platform contribution would provide a basis for S1 to claim a share of total non-routine profits under the required adjusted residual profit-split method.

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[51] See Reg. section 1.482-7(g)(7)(iii)(C).

[52] This temporary regulation expired in 2018. However, it still exists as a proposed regulation in REG-139483-13, Par. 14, 80 Fed Reg 55582 (September 16, 2015).

In a situation such as this, the guidance for taxpayers and APMA personnel must be clear that S1 will be treated as having made no platform contribution at the execution of the CSA.

Include in APA Terms the Requirement for Taxpayer Annual Preparation of Reg. section 1.482-7(i)(6) Trigger Calculation

It is recommended that when an APA involves a CSA that the APA as issued must include an express requirement that the taxpayer will compute and submit to the APMA annually a Reg. section 1.482-7(i)(6) trigger calculation. The taxpayer would also be required to submit this calculation at the commencement of any regular IRS examination to the IRS examining team.

Such a requirement to include this calculation within an APA is fully justified considering that any taxpayer desiring a CSA knows upfront that all of the conditions and requirements included in Reg. section 1.482-7 will apply to the CSA and the taxpayer. The Reg. section 1.482-7(i)(6) trigger calculation is an integral part of the full CSA regulation.

Other Recommendations

Elimination of Periodic Adjustment Exemptions from APAs

Section 6.03 of Revenue Procedure 2015-41 says that an APA may provide that the periodic adjustment mechanisms will not apply "during or after the APA term." Specifically, the procedure reads:

> … If a covered issue is the transfer of intangible property (which does not constitute a platform contribution transaction as defined in Treas. Reg. §1.482-7(b)(1)(ii)) within the meaning of Treas. Reg. §1.482-4, the APA may provide that such transfer will not be subject to periodic adjustments, during or after the APA term, under Treas. Reg. §1.482-4(f)(2) or (6). …

For the same reasons articulated above concerning CSAs and periodic adjustments under Reg. section 1.482-7(i)(6), it is recommended that this exemption be specifically eliminated in the case of any transfer of intangible property that does not constitute a PCT in connection with a CSA.

Include in APA Terms the Detail Necessary to Apply Periodic Adjustments

Whether or not the above recommendation to eliminate the potential exemption from periodic adjustments is accepted, it is recommended that any reissuance of Revenue Procedure 2015-41 included a clear statement that the terms of any APA will include the basis on which the Reg. section 1.482-4(f)(2) periodic adjustment rule will be applied in future years. Such upfront agreement should prevent significant future disagreements and potential litigation. This is particularly relevant given the present relatively vague guidance included in Reg. section 1.482-4(f)(2).

It is recommended also that the reissuance should make clear that in the case where the transferee of any intangibles conducts solely routine functions and holds itself no non-routine intangibles at the time of the transfer that any future application of the Reg. section 1.482-4(f)(2) periodic adjustment rule will attribute all non-routine profits to the transferor.

Extension of BEPS CCA Guidance to Licensing, Business Restructurings, and Intangible Development Arrangements other than CSAs

In "Re-Introduction of "Participant" Requirements" in the above CSA-related recommendations, certain recommendations regarding the qualification for a group member to be a participant were made. In that discussion, certain guidance from the OECD BEPS project on "cost contribution arrangements" was explained. Certain of that guidance is relevant to other intangible transfers.

For example, say intangibles are licensed from one U.S. group member to a foreign group member. The licensee foreign group member must be the party that will exploit the licensed intangibles. Important elements of the exploitation process cannot be subcontracted back to the licensor or to an independent contractor where the licensor or some other person under the licensor's control and not the licensee is the party having the capability to direct and control the risks of the activities being performed by the independent contractor.

It is recommended that guidance to this effect be inserted into Reg. section 1.482-4. It should also be integrated into any reissuance of Revenue Procedure 2015-41 so that it will be available to taxpayers seeking APAs and to APMA personnel who are evaluating APA request submissions.

Revocation and Reissuance of AM-2007-007

Chief Counsel Advice AM-2007-007 was issued in 2007, two years prior to the promulgation of Reg §1.482-7T, which included the new periodic adjustment rules applicable to CSAs. As a result, it was written with only the provisions of Reg §1.482-4(f)(2) in mind and provides no guidance specific to Reg §1.482-7 and its paragraph (i)(6) periodic adjustments provision. Such guidance is sorely needed by both taxpayers and IRS examining agents. As such, AM-2007-007 should be revoked, updated, and reissued as a new document.

An updated AM-2007-007 is importantly needed especially given the encouraging development of the new audit guidance at 4.61.3.4.9 and 4.61.3.4.10 of Internal Revenue Manual 4.61.3, "Development of IRC 482 Cases", concerning international examination guidelines.

Updating of Reg §1.482-4(a) and (f)(2)

Reg. § 1.482-4(a) (including related regulations such as Reg. §§1.482-5 and -6) and the very general Reg §1.482-4(f)(2) provision were promulgated long prior to the 2009 CSA regulation, which was based on the investor model and the realistic alternative principle, and which included pricing approaches in Reg. section 1.482-7(g) and the detailed periodic adjustment rule in Reg §1.482-7(i)(6). Reg. §1.482-7 reflects considerable thinking and analysis by the Treasury and the IRS regarding how to apply Congress' 1986 mandate to apply the "commensurate with income" standard to intangible transfers. With this in mind, Reg §§1.482-4 must be amended and updated to align both the ex ante pricing of intangible transfers and the currently vague paragraph (f)(2) periodic adjustment rule with Reg. section 1.482-7(g) ex ante pricing methods and the relatively objective and more detailed approach for periodic adjustments included in Reg §1.482-7(i)(6).

Elimination of Exceptions from Reg §1.482-4(f)(2) and Reg §1.482-7(i)(6)

Ryan Finley, a respected commentor on transfer pricing matters, has stated in regard to Congress' "commensurate with income" mandate:

> Taken together, the statutory text and the legislative history make clear that the actual income attributable to the transferred intangible takes precedence over other considerations when pricing a transfer of a controlled intangible — especially transactional comparables data. The statute's explicit reference to "income," reinforced by Congress's clearly expressed intent to deemphasize comparables' role in pricing intangible transfers, all but rules out any defensible argument that periodic adjustment provisions should give way to transactional evidence. … And nothing in the statutory text or legislative history suggests that transactional evidence has any role whatsoever in the periodic adjustment analysis. … *Not only are Treasury and the IRS not required to offer exceptions to periodic adjustments . . . their statutory authority for doing so is doubtful*.[53] [Emphasis added.]

Given this situation, Treasury and the IRS should reconsider all exceptions currently provided in Reg. §1.482-4(f)(2) and/or Reg. §1.482-7(i)(6) and eliminate any for which there is no strong policy reason for continuance.

In addition to the exceptions now included in Reg. §1.482-7(i)(6)(vi)(A), subclause (B)(*1*) includes a rule providing that there will be no Periodic Trigger -

> In any year subsequent to the 10-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR determined is within the PRRR for each year of such 10-year period."

Given the clearly stated congressional intent that "commensurate with income" mandate be implemented through periodic adjustments (see quoted portion of the House Committee Report in the above section headed "Make Periodic Adjustments under Reg. section 1.482-7(i)(6) Mandatory"), this 10-year exception should be eliminated.

Clarification of How Reg §1.482-7 Works

As recently explained in some detail,[54] Facebook's defense[55] against an IRS proposed Reg. §1.482-7(g) PCT adjustment includes an inappropriate argument that compliance with the paragraph (i)(6) trigger test precludes the IRS from making any paragraph (g) PCT adjustments. While we believe that this is a frivolous claim without merit, the fact of its having been made at all is good reason to amend Reg. §1.482-7 to make expressly clear that paragraphs (g) and (i)(6) operate independently of each other. The former applies to establish the value of each specific transferred intangible (i.e., each separate platform contribution transaction (PCT)) at the moment of transfer, which is a specific point in time, while the latter calculates the adjustments necessary

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[53] Finley, "Periodic Adjustments, Part 1: Should the Arm's-Length Standard Matter?", *Tax Notes Federal*, August 15, 2022, p. 1064, at 1067, 1069, and 1070.
[54] See *supra* footnote 4, Avi-Yonah et al., at 1325 and 1329-1330.
[55] See Motion for Summary Judgment at paras. 33, 35, 59, 63, and 66, Facebook, No. 21959-16 (T.C. March 18, 2021). See also Redacted Second Amended Simultaneous Opening Brief at 273*ff*, Facebook, No. 21959-16 (T.C. January 27, 2023).

to apply the "commensurate with income" standard over the life of the CSA and all PCTs in any year from 2009 through the Adjustment Year.

With the above in mind, Reg. §1.482-7 should be amended to emphasize and make expressly clear the separateness of paragraphs (g) and (i)(6) clarifying that an ex ante PCT adjustment under paragraph (g) may be made regardless of whether the relevant participant's AERR under paragraph (i)(6) is within the PRRR for any post-PCT taxable year. Any explanation of the change should include that this is a clarification of the existing regulation and not the initiation of any new rule. Taxpayers should not be able to claim this amendment as justification for the meritless claim that Facebook is now making.

ECI Taxation and Partnership Status

It would be beneficial to both taxpayers and the APMA for any future Revenue Procedure 2015-41 update to include explicit language saying that any APA application must consider and include factual background on worldwide group or divisional operations including, for example, the nature of any group unitary businesses, the conduct of any joint business functions that benefit two or more group members, where and by whom critical business functions are conducted for transactions being recorded by any foreign group member, and the use of service agreements or similar contractual arrangements that cover core business functions (in contrast to internal staff functions such as HR, treasury, accounting, tax, etc.).

This information is not just needed; it is critical. First, of course, the APMA team should be aware if any requested APA appears to be merely a component of a profit-shifting or other tax avoidance structure. Secondly, both the taxpayer requesting an APA and the APMA team evaluating that request must be aware if transactions and business operations contemplated in connection with the requested APA cause:

- Joint business activities of two or more group members that create a separate entity for federal tax purposes under Reg. section 301.7701-1(a)(2) that will be treated as a partnership under the default rule of Reg. section 301.7701-3(b) if an active election is not made to treat the entity as an association taxable as a corporation; and/or

- Applicable foreign group members to become subject to direct U.S. taxation under the effectively connected income rules of section 864(c).

As a first example of why this additional information is needed, say that a U.S. MNC from its U.S. headquarters conducts for its worldwide product sales the bulk of all production functions (including those functions listed in Reg. section 1.954-3(a)(4)(iv)(*b*)) except for the physical manufacturing of the products. Physical manufacturing is performed by unrelated contract manufacturers. The centrally-managed group has a number of foreign group members in various countries around the world that conduct routine sales and marketing services, customer and logistics support, etc. The U.S. MNC has requested an APA due to its planned execution of a CSA between itself and a newly formed CFC (CFC), which is the holding company for the foreign group members, all of which are disregarded entity subsidiaries. Under the terms of the CSA, CFC will hold the rights to manufacture, or have manufactured, products for sale into its territory, which is the rest-of-world outside the United States. By contracting directly with

suppliers, vendors, and contract manufacturers, CFC (including its disregarded entity subsidiaries) will source its manufactured products using intangibles transferred in connection with the CSA (including as well cost-shared intangibles to be developed in the future under the CSA) and will then sell those manufactured products to unrelated customers within its rest-of-world territory.

The principal reasons for the requested APA are to establish the overall terms of the CSA as well as identify the platform contributions made by U.S. MNC and agree the amount of a PCT Payment that CFC must pay to U.S. MNC for these platform contributions (Reg. sections 1.482-7(b)(1)(ii) and (g)). Say that in reviewing the factual background of U.S. MNC's worldwide operations and how those operations would be conducted following the execution of the CSA, the APMA determines that U.S. MNC headquarters' personnel will continue to perform substantially all production functions and make all production decisions including, for example, decisions on production and inventory levels to be maintained worldwide. CFC will have few or no production personnel and will conduct little or no other product sourcing functions. As such, the relevant U.S. MNC headquarters' personnel will conduct joint production operations, i.e. for itself in connection with products to be sold into United States and for CFC for products that CFC will sell into its rest-of-world territory. Under a service agreement, CFC would pay U.S. MNC a service fee on a cost-plus basis for these production activities…and that service agreement would include a clause stating that U.S. MNC is an independent contractor and not an agent, joint venturer, or partner of CFC.

In contractual form, CFC is independently manufacturing the products that it will sell into its rest-of-world territory. Contracts with suppliers, component vendors, and contract manufacturers would be signed in CFC's name and CFC would invoice the sales to customers in its territory.

Despite this contractual form, U.S. MNC and CFC's operations are integrally related along both management and operational lines. CFC would not have the personnel or practical ability to manufacture or otherwise source the products it sells. It could not operate as an independent unit. Following the execution of the CSA, the functions that it performs through its disregarded entity subsidiaries will still be routine functions concerning sales and marketing and customer and logistics support.

The application of U.S. tax law and regulations involves first understanding a taxpayer's factual situation, which includes its organizational form, the legal relations it has created through contracts, and the physical activities that each entity's employees and agents perform. When there is a serious divergence between legal form and the conduct of the parties, the IRS may use judicially based doctrines (e.g. substance vs form, assignment of income, etc.) to recharacterize a taxpayer's chosen form into something else. In this discussion of U.S. MNC and CFC, it is assumed that the APMA in its analysis would accept the entity and contractual form that the taxpayer created.

Without going into detail, in applying U.S. tax rules to the taxpayer's chosen structure, the APMA could notice the joint production activities. Just these joint production activities are enough to cause an entity to exist for federal tax purposes under the entity classification rules

(section 761(a) and Reg. section 301.7701-1(a)(2)). Additional factors that likely exist such as centralized management and U.S. MNC's participation in the negotiation and conclusion of CFC's more major sales contracts only cements this "entity for federal tax purposes" finding. In the absence of an active election for association status, the default rule in Reg. section 301.7701-3(b) treats such an entity as a partnership that is conducting the joint business of the partners.[56]

Partnership status can, of course, have a number of possible implications. The most significant for purposes of Revenue Procedure 2015-41 from an overall perspective is that if the joint business activities, which include the CSA Activity, are all within the partnership, *then there can be no CSA*. This is because there is only one taxpayer: the partnership. The putative CSA participants (the U.S. parent and one or more of its CFCs) are now partners in a partnership that is conducting the joint business. With no CSA, there is no ability to even request an APA, and of course no ability for the APMA to issue one.

A particularly important result of partnership status is that the application of the effectively connected income rules to CFC are much easier and more straight-forward to apply.[57] The various rules to calculate effectively connected income are applied at the partnership level. The foreign partner's share of that income is then subject to taxation under section 882.

Even in the absence of the finding of a partnership, the APMA would see that U.S. MNC through its management and conduct of the entire production process is making day-to-day business decisions on behalf of CFC and is, in fact, conducting a major portion of CFC's business as its *de facto* agent. This causes CFC to be engaged in a trade or business within the United States. A further factual finding that U.S. MNC participates in the negotiation and conclusion of not only CFC's contracts with suppliers, vendors, and contract manufacturers, but also with CFC's more major sales contracts would only further cement this *de facto* agent status.

With a finding that CFC is engaged in a U.S. trade or business and the TCJA's focus on location of production (amended section 863(b)), there would be some amount of U.S. source income that would be treated as ECI under section 864(c)(3).[58]

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[56] See *supra* note 37. The cited article examines how many profit-shifting structures create unexpected partnerships with relevant group members being partners and the joint business being conducted by the partnership. See also LTR 201305006.

[57] There is no need to discuss any detailed consequences of an active election (Reg. section 301.7701-3(c)) to threat the "entity" as an association taxable as a corporation. It is extremely unlikely that a taxpayer would ever make such an election. The "entity" includes the joint business activities conducted by U.S. MNC and CFC. If the "entity" were treated as a domestic corporation, then the portion that relates to CFC's proportionate share would be fully subject to current U.S. taxation. If the "entity" were treated as a foreign corporation, then even U.S. MNC's proportion of the joint business would be subject to ECI taxation, which is generally worse than being taxed in the normal manner. While there can be additional disadvantages, the most important would be the section 884 branch profits tax, which can significantly increase the effective tax rate above the normal section 11 U.S. corporate rate.

[58] See also section 865(e)(2) and Reg. section 1.865-3.

This sort of analysis will help the APMA decision-making process on whether to issue an APA, and if they decide to issue one, what its terms and restrictions might be. This analysis will also help taxpayers decide if they wish to continue with a planned structure, and if they do, how they might scale back or eliminate any tax-motivated aspects so that they focus on only the business and commercial benefits (if any) to be derived.

Where the execution of a planned CSA would result in shifted profits and/or that execution raises concerns about the existence of a partnership and/or ECI taxation, a narrowly focused APA that considers only the terms of the CSA and the amount of PCT Payment would not further either taxpayer certainty or good tax administration. Rather, if the APA application process can identify partnership and ECI taxation issues that will accompany a taxpayer group's planned CSA structure (often indications of the planned structure being primarily for inappropriate profit shifting), then the taxpayer group may choose to reconsider its plans and perhaps avoid executing a risky structure.

In brief, a second example is a U.S. MNC engaged in an internet-based business that earns primarily advertising revenues. Substantially all personnel and equipment that maintain and operate the worldwide internet platform through which users access the platform and advertisers reach users are located within the United States. U.S. MNC plans to establish a CFC, which through a CSA or license agreement will hold the rights to contract with foreign advertisers. Following the establishment of CFC, there will be no change in operations so that the same U.S. personnel and equipment will continue to provide the advertising services to users and advertisers worldwide. CFC and U.S. MNC enter into a service or similar agreement under which U.S. MNC will directly provide the advertising services to CFC's advertisers on CFC's behalf.

As with the first example, it is assumed that the APMA accepts the entity and contractual form that the taxpayers created. Without going into detail, the same partnership and ECI results arise from this structure. There is one centrally managed and operated worldwide business with U.S. MNC personnel and assets conducting CFC's business. This is joint business activities that will cause an "entity for federal tax purposes" that will be treated as a partnership under the entity classification rules. There will be a U.S. trade or business (section 875(1)), income will be U.S. source under Reg. section 1.861-4,[59] and there will be ECI under section 864(c). And of course, with the finding of a partnership, there will be only one taxpayer: the partnership. As such, with only one taxpayer, there can be neither a CSA nor a license.

Schedule UTP Disclosures

It is recommended that any Mandatory Pre-Filing Memorandum must include information on whether Schedule UTP (Form 1120) disclosure has been, is, or is expected to be required for any aspect of the transactions or businesses for which an APA is being sought. Doing so will alert APMA personnel to areas and issues requiring closer attention.

[59] See Reg. section 1.937-3(e), Example 5, which involves an application service provider and which relies on Reg. section 1.861-4 to determine the taxpayer's source of income.

Effect of OECD BEPS Pillars One and Two

It is recommended that consideration be given to including in any Mandatory Pre-Filing Memorandum information on how the taxpayer expects that Pillars One and Two of the OECD Inclusive Framework BEPS project might affect the transactions or businesses for which an APA is being sought. Doing so would allow anticipation and the development of approaches for the resolution of potential future issues.

Potential for Joint Audits

It is recommended that any updated Revenue Procedure 2015-41 include notice that the APMA may recommend through appropriate IRS channels that the IRS and relevant tax authorities from other countries should consider the conduct of a joint audit of applicable transactions and/or businesses of the taxpayer that are the subject of an APA. This of course makes obvious sense for any bilateral or multilateral APA. But such a notice within an updated Revenue Procedure 2015-41 should apply as well to unilateral requests. Such a notice would discourage taxpayer planning to present differing factual information and differing transaction characterizations to two or more tax administrations.

While we are not aware of the current state of jointly conducted audits of MNCs, we understand that such audits should become more common in the future. As a prime example of why such joint audits are needed, the referenced article noted in footnote 3 on Apple highlights the differing factual information that Apple has presented to the European Commission and the United States in regard to its structure and its CSA. See in particular pages 1073*ff* in part 1 of the article dated August 16, 2021.

It is understood that the APMA has certain restrictions to provide taxpayer comfort with the APA process (e.g. Section 6.05 of Revenue Procedure 2015-41). There are also limits on future examinations that cover the subject transactions of an APA (e.g. Section 7.03 of Revenue Procedure 2015-41). This recommended notice of potential future joint audits should not violate these aspects of the APA process.

Reflection of TCJA Update to Section 482

Any future update to Revenue Procedure 2015-41 should include guidance to implement the additional sentence that was added to section 482 by the TCJA. This sentence reads:

> For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

Guidance on this would be useful in Revenue Procedure 2015-41. Since this additional sentence is principally focused on valuations as of the time of each intangible transfer, this coordinates well with the periodic adjustment rules, which focus on actual achieved CSA results in the years subsequent to the one or more intangible transfers.

One additional matter should be raised in the context of the TCJA amendment to section 482, which applies to transfers in tax years beginning after December 31, 2017, in that Revenue Procedure 2015-41, Section 7.07 states:

> If controlling U.S. case law, statutes, regulations, or treaties change the federal income tax treatment of any matter covered by the APA, the new case law, statute, regulation, or treaty provision supersedes any inconsistent terms and conditions of the APA.

It is recommended that for any already issued APA that involved a transfer of intangible property where the year of the transfer is still open and the transfer occurred in a tax year beginning after December 31, 2017, the APMA may at its discretion enter into discussion with the taxpayer to revise the APA in accordance with section 7.05 so as to be in accordance with the TCJA amendment to §482. If an agreement to revise cannot be reached with the taxpayer, the APMA may revoke or cancel the APA in accordance with section 7.06.

Protection from Certain Penalties

The conclusion of an APA, especially one that includes one or more rollback years, may cause additional taxes to become payable. Section 7.01(1) refers to this and states, in part:

> … for such an APA year, the taxpayer will not be subject to the failure to pay penalties under sections 6651 and 6655 of the Code, or the failure to make timely deposit of taxes penalty under section 6656 of the Code, by reason of the APA primary adjustment and any related adjustments.

It is recommended that this protection from certain penalties should be conditioned on the taxpayer's having not already been under audit with respect to the transfer pricing used in any applicable year.

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We hope that this submission is useful to you. We would be pleased to respond by email or phone to any questions or comments concerning the above discussion and recommendations.

Very truly yours,

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