State of California
Franchise Tax Board

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TECHNICAL ADVICE MEMORANDUM 2015-01

Requested by: National Business Audit, Audit Division
Requested Date: 12.22.14
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Subject: Cost Sharing Arrangements

QUESTION PRESENTED

Whether payments received pursuant to Cost Sharing Arrangements constitute gross receipts for purposes of the California sales factor.

CONCLUSIONS

For taxable beginning on or after January 1, 2011, Revenue and Taxation Code ("R&TC") section 25120(f)(2) defines "gross receipts" as "gross amounts realized . . . on the sale or exchange of property, the performance of services, or the use of property or capital . . . in a transaction that produces business income, in which the income, gain, or loss is recognized. . . . under the Internal Revenue Code . . ." Hence, for 2011 forward, California's definition of "gross receipts" is tied to what is considered income, gain, or loss under the Internal Revenue Code. While the definition of gross receipts is not tied to the Internal Revenue Code for years prior to 2011, for consistency purposes California should follow federal law for earlier years as well. The two different types of payments under Cost Sharing Arrangements should therefore be treated as follows:

1. Current Operating Cost Reimbursements via Cost Sharing Transactions ("CSTs"):

Payments received from controlled participants pursuant to a qualified cost sharing arrangement[1] for current operational research and development costs reduce expense deductions for the recipient and thus are not gross receipts for California sales factor purposes. These payments do not constitute payment for purchase of products or services under Revenue and Taxation Code ("R&TC") section 25134(a)(1)(A) or (C), but rather are reimbursements of costs incurred by the recipient and would therefore be reported as

[1] A qualified cost sharing arrangement is determined under 26 Code of Federal Regulations ("CFR") § 1.482-7 as follows: (1) 12/16/2011 to present, 26 CFR § 1.482-7(b)(1) through (4); (2) 01/05/2009 to 12/15/2011, 26 CFR § 1.482-7T(b)(1) through (4); (3) 01/01/1996 to 01/04/2009, 26 CFR § 1.482-7A(b).

contra-expense items. Payments in excess of the deductions available for the costs being reimbursed to the payee are payments in consideration for use of property or services made available to the Cost Sharing Arrangement ("CSA"), and thus are gross receipts for California sales factor purposes.[2]

2. Payments for Purchases of Resources External to the CSA or Platform Contribution Transactions ("PCTs"):

Payments from controlled participants for resources or capabilities developed, maintained, or acquired externally to the CSA (whether prior to or during the course of the CSA) that are reasonably anticipated to benefit the development of cost-shared intangibles within the CSA are not reimbursements of costs under the CSA, but rather are consideration for use of the intangible property or resource,[3] and thus, are gross receipts for California sales factor purposes under R&TC section 25134(a)(1)(A) or (C). These receipts are assigned using the California statutes and regulations applicable to the taxable year at issue. While Treasury Regulation 26 CFR § 1.482-7 allows PCT payments to be reduced by amounts owed to the payer, under authority of *General Mills v. Franchise Tax Board* (2012) 208 Cal.App.4th 1290,[4] these offset amounts owed to the payee, which constitute PCT Payments, are included at gross in the sales factor, subject to potential distortion analysis under section 25137.

ANALYSIS AND DISCUSSION

A. Federal Regulatory Time Periods

There are generally three versions of federal regulations applicable to this analysis; and, though there were a few amendments made at other times, those are not pertinent for California purposes. Thus, the applicable Treasury Regulations and time periods are:

1. 01/01/1996 through 01/04/2009: 26 CFR § 1.482-7A. (See 26 CFR § 1.482-7A(k) for effective dates.)

2. 01/05/2009 through 12/15/2011: 26 CFR § 1.482-7T. (See 26 CFR § 1.482-7T(l) for effective date.)

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[2] R&TC 25134(a)(1)(A) and (C); 12/16/2011 to present, 26 CFR 1.482-7(j)(3)(ii); 01/05/2009 through 12/15/2011, 26 CFR 1.482T(j)(3)(i); 01/01/1996 through 12/15/2011, 26 CFR 1.482-7A(h)(1).

[3] 12/16/2011 to present, 26 CFR 1.482-7(j)(3)(ii); 01/05/2009 through 12/15/2011, 26 CFR 1.482T(j)(3)(ii); 01/01/1996 through 12/15/2011, 26 CFR 1.482-7A(g)(2).

[4] *General Mills, supra*, addressed the receipts from sales on commodity futures markets. The Court decided that the full amount paid on the futures contracts was the gross receipt regardless of whether any gain was actually delivered or funds actually changed hands due to netting. (*Id.* at p. 1298.) The Court rejected the FTB argument that offsetting transactions were illusory with no real financial value. (*Id.* at p. 1299.)

3. 12/16/2011 to present: 26 CFR § 1.482-7. (See 26 CFR § 1.482-7(l) for effective dates.) This Treasury Regulation adopts the effective date rules and transition rules under 26 CFR § 1.482T for certain preexisting arrangements in existence before January 5, 2009. (See 26 CFR § 1.482-7(m) for transition rule.) Requirements for a CSA under the current rules were the same as those under 26 CFR § 1.482-7T, so additional transition rules were required for CSAs in existence under the prior treasury regulation on or after January 5, 2009.

B. Definitions

Reasonably Anticipated Benefit or "RAB": Until 2009, the following definitions applied to determine RABs: "Benefits are additional income generated or costs saved by the use of covered intangibles." (26 CFR § 1.482-7A(e)(1) (1996).) Reasonably anticipated benefits are the aggregate benefits that [a controlled participant] reasonably anticipates that it will derive from covered intangibles. (26 CFR § 1.482-7A(e)(2) (1996).) "A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits . . . divided by the sum of the reasonably anticipated benefits . . . of all the controlled participants." (26 CFR § 1.482-7A(f)(3)(i) (1996).)

Starting in 2009, the time period used to determine a participant's RAB share was the entire period when the intangible was expected to be exploited, and the regulation required adjustments to RAB shares based on updated information regarding benefits.[5] Starting in 2011, "RAB shares determined for a particular purpose shall not be further updated for that purpose based on information not available at the time that determination needed to be made."[6] However, the IRS was allowed to make retroactive adjustments to RAB shares.[7]

Cost Sharing Arrangement or "CSA": Currently, a CSA is defined as, ". . . an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (4) of this section are met." (26 CFR § 1.482-7(b)(2011).)[8]

Intangible Development Activity or "IDA": Currently, an IDA is defined as, ". . . the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles." (26 CFR § 1.482-7(d)(1)(i)(2011).)[9]

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[5] 26 CFR § 1.482-7T(e)(1)(i).

[6] 26 CFR § 1.482-7(e)(1)(i).

[7] 26 CFR § 1.482-7(e)(1)(i). The definition of RAB for 12/16/2011 to present is at 26 CFR § 1.482-7(e)(1)(i) and for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(e)(1)(i).

[8] A qualified CSA is determined for 12/16/2011 to present at 26 CFR § 1.482-7(b)(1) through (4), for 01/05/2009 to 12/15/2011 at 26 CFR § 1.482-7T(b)(1) through (4), and for 01/01/1996 through 01/04/2009 at 26 CFR § 1.482-7A(b).

[9] The definition of an IDA for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(d)(1)(i), and for 01/01/1996 through 01/04/2009 there is no definition for an IDA.

Intangible Development Costs or "IDCs": Currently, an IDC is defined as, ". . . all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. Thus, IDCs include costs incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles." (26 CFR § 1.482-7(d)(2011).)[10]

Cost Sharing Transactions or "CSTs": Under earlier versions of the Treasury Regulations, payments made pursuant to a CSA were referred to as cost sharing payments, but later versions used the term CST Payments. Currently, 26 CFR § 1.482-7(b)(1)(i) (2011) discusses CSTs as follows, ". . . In CSTs, the controlled participants make payments to each other (CST Payments) as appropriate, so that in each taxable year each controlled participant's IDC share is in proportion to its respective RAB share."[11]

Platform Contributions: Currently, 26 CFR § 1.482-7(c)(1) (2011) defines platform contributions as follows:

> (c)Platform contributions—
> (1) In general. A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. The determination whether a resource, capability, or right is reasonably anticipated to contribute to developing cost shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right reasonably determined not to be a platform contribution as of an earlier point in time, may be reasonably determined to be a platform contribution at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles. Notwithstanding the other provisions of this paragraph (c), platform contributions do not include rights in land or depreciable tangible property, and do not include rights in other resources acquired by IDCs. See paragraph (d)(1) of this section.

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[10] The definition of an IDC for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(d)(1) and for 01/01/1996 through 01/04/2009 is at 26 CFR § 1.482-7A(d)(1). Starting on 08/26/2003, stock-based compensation was expressly included as an IDC.

[11] The definition of CST for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(b)(1)(i). For 01/01/1996 through 01/04/2009 the term CST was not used; however, 26 CFR § 1.482-7A(f)(2) addresses "Share of intangible development costs" and 26 CFR § 1.482-7A(f)(2) addresses "Share of reasonably anticipated benefits."

Pre-2009 versions of this Treasury Regulation required buy-in payments only for preexisting intangibles that were contributed to the CSA for use in developing cost-shared intangibles. (26 CFR § 1.482-7A(g)(1) and (2) (1996).) The definition was later broadened to include other capabilities and resources, both preexisting and concurrent, which were developed outside of the CSA.[12]

Platform Contribution Transactions or "PCTs": Currently, 26 CFR § 1.482-7(b)(1)(ii) (2011) defines platform contribution transactions as follows:

> (ii)PCTs. All controlled participants must commit to, and in fact, engage in platform contributions transactions to the extent that there are platform contributions pursuant to paragraph (c) of this section. In a PCT, each other controlled participant (PCT Payor) is obligated to, and must in fact, make arm's length payments (PCT Payments) to each controlled participant (PCT Payee) that provides a platform contribution. For guidance on determining such arm's length obligation, see paragraph (g) of this section.

Pre-2009 versions of this Treasury Regulation referred to these required payments as "buy-in payments."[13]

C. Analysis

The issue presented is whether CST or PCT payments are considered gross receipts for California sales factor purposes.

CSAs are federally regulated under 26 CFR § 1.482-7, which has been repeatedly amended through the years. In the current treasury regulation, a CSA is defined as ". . . an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (4) of this section are met." (26 CFR § 1.482-7(b) (2011).)

Treasury regulations have been explicit for some time that CST payments are considered reimbursements of costs for the recipient (contra-expense) and PCT payments are considered compensation (income) for use of intangibles, services, or other resources outside of the CSA.

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[12] The definition of Platform Contribution for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(c). For 01/01/1996 through 01/04/2009 the term Platform Contribution was not used; however, transfers of intangibles are addressed at 26 CFR § 1.482-7A(g).

[13] The definition of PCTs for 01/05/2009 through 12/15/2011 is at 26 CFR § 1.482-7T(b)(1)(ii). For 01/01/1996 through 01/04/2009 the term PCT was not used; however, buy-in payments are addressed at 26 CFR § 1.482-7A(g)(2).

1. Cost Sharing Payments (01/01/1996–01/04/2009) or CST Payments (01/05/2009 to present):

The treatment of cost sharing payments (later known as CST Payments) was first set forth at 26 CFR § 1.482-7A(h)(1) (1996), which provides as follows (emphasis added):

> (h) *Character of payments made pursuant to a qualified cost sharing arrangement—*
>
> (1) *In general.*
> **Payments made pursuant to a qualified cost sharing arrangement** (other than payments described in paragraph (g) [buy-in payments] of this section) **generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee**. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. **Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee.** For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in § 1.41-6(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g) of this section, will be subject to the provisions of §§ 1.482-1 and 1.482-4 through 1.482-6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

This Treasury Regulation was operative for 01/01/1996 through 01/04/2009 and clearly stated that cost sharing payments were to be considered reimbursements unless the payments exceeded the amount of deductions available for the payee. While the language is less explicit in later versions of the regulation, the treatment should remain the same.

In addition, there has been no sale of a product or service in such circumstances under California Code of Regulations § 25134(a)(1)(A) and (C) which provide as follows:

> (a) Sales Factor. In General
> (1) Section 25120(e) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under Sections 25124 to 25127 inclusive. Thus, for the purposes of the sales factor of the apportionment formula for each

> trade or business of the taxpayer, the term "sales" means all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business. The following are rules for determining "sales" in various situations:
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> (A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sales of such goods or products . . . held by the taxpayer primarily for sales to customers in the ordinary course of its trade or business. . . .
> (C) In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency, or the performance of equipment service contracts, research and development contracts, "sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items.

The payer of the CST payment is not providing payment in consideration for the payee selling a product or a service to the payer. That is, the party receiving the CST payment has not provided a product or a service to the payer for which the payer is providing payment. Accordingly, cost sharing payments or CST payments are not gross receipts for California sales factor purposes. Only those amounts that exceed the recipient's available deductions for the costs being reimbursed should be characterized as gross receipts and included in the sales factor.

2. PCT Payments (01/05/2009 to present) or Buy-In Payments (01/01/1996–01/04/2009):

The treatment for buy-in payments (later known as PCT Payments) was first set forth at 26 CFR § 1.482-7A(g)(2) (1996) which provides as follows (emphasis added):

> (g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)—*
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> (1) *In general*. **A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants**, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§ 1.482-1 and 1.482-4 through 1.482-6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants, is a **transfer of intangible property**, and the district director may make appropriate allocations, under the provisions of §§ 1.482-1 and 1.482-4 through 1.482-6, to reflect an arm's length

consideration for the transfer. See paragraphs (g) (3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangible*s. If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4*, of this section. **Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee.** Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5*, of this section.

This regulation was operative 01/01/1996 through 01/04/2009 and clearly stated that buy-in payments were to be characterized as consideration for the purchase of pre-existing intangibles. The next two versions of this Treasury Regulation at 26 CFR § 1.482-7T(j)(3)((ii)) (2009) and 26 CFR § 1.482-7(j)(3)((ii)) (2011) provide as follows:

(3) Character
. . .

((ii)) PCT Payments. A PCT Payor's payment required under paragraph (b)(1)(ii) of this section is deemed to be reduced to the extent of any payments owed to it under such paragraph from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors. PCT Payments will be characterized consistently with the designation of the type of transaction pursuant to paragraphs (c)(3) and (k)(2)(ii)(H) of this section. Depending on such designation, **such payments will be treated as either consideration for a transfer of an interest in intangible property or for services**.

Hence, from 2009 forward, PCT Payments were still treated as consideration, but in addition to being payment for an interest in intangible property, they could also be payment for a service. Consequently, consideration in the form of buy-in payments or PCT Payments constitute gross receipts for California sales factor purposes under California Code of Regulations § 25134(a)(1)(A) or (C) because there has been a sale of a product or service. The assignment of these gross receipts for sales factor purposes is according to the standard apportionment rules for the year at issue, subject to potential distortion analysis under R&TC section 25137.

While 26 CFR § 1.482-7 allows PCT payments to be reduced by amounts owed to the payer, under authority of *General Mills v. Franchise Tax Board* (2012) 208 Cal. App. 4th 1290 California may include the offset amounts owed but not paid to the payee at gross as PCT Payments. *General Mills, supra*, addressed the receipts from sales on commodity futures markets. The Court decided that the full amount paid on the futures contracts was the gross receipt regardless of whether any gain was actually delivered or funds actually changed hands due to netting. (*Id.* at p. 1298.)