arrangement to exist. Commenters also argued that existing cost sharing arrangements should be grandfathered, or that there should be a longer transition period. Commenters suggested that financial accounting rules be used to calculate costs to be shared, and that the IRS address the impact of currency fluctuations on the cost-to-operating-income ratios. Finally, commenters asked that the regulations clarify that a cost sharing arrangement would not be deemed to create a partnership or a U.S. trade or business.

The Final Regulations

Without fundamentally altering the policies of the 1992 proposed regulations, the final regulations reflect numerous modifications in response to the comments described above. They also reflect the approach of the final section 482 regulations relating to transfers of tangible and intangible property.

Section 1.482–7(a)(1) defines a cost sharing arrangement as an agreement for sharing costs in proportion to reasonably anticipated benefits from the individual exploitation of interests in the intangibles that are developed. In order to claim the benefits of the safe harbor, a taxpayer must also satisfy certain formal requirements (enumerated in § 1.482–7(b)). The district director may apply the cost sharing rules to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding any failure to satisfy particular requirements of the safe harbor. It is further provided that a qualified cost sharing arrangement, or an arrangement treated in substance as such, will not be treated as a partnership. (A corresponding provision is added to § 301.7701–3 pertaining to the definition of a partnership.) Neither will a foreign participant be treated as engaged in a trade or business within the United States solely by virtue of its participation in such an arrangement.

Section 1.482–7(a)(2) restates the general rule of cost sharing in a manner intended to emphasize its limitation on allocations: no section 482 allocation will be made with respect to a qualified cost sharing arrangement, except to make each controlled participant's share of the intangible development costs equal to its share of reasonably anticipated benefits.

Section 1.482–7(b) contains the requirements for a qualified cost sharing arrangement. This provision substantially tracks the proposed regulations. A modification was made in the second requirement which now directs that the arrangement provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect anticipated benefits. The new standard is intended to ensure that cost sharing arrangements will not be disregarded by the IRS as long as the factors upon which an estimate of benefits was based were reasonable, even if the estimate proved to be inaccurate.

Section 1.482–7(b)(4) requires that a cost sharing arrangement be set forth in writing and contain a number of specified provisions, including the interest that each controlled participant will receive in any intangibles developed pursuant to the arrangement. The intangibles developed under a cost sharing arrangement are referred to as the ''covered intangibles.'' It is possible that the research activity undertaken may result in development of intangible property that was not foreseen at the inception of the cost sharing arrangement; any such property is also included within the definition of the term covered intangibles. The prescriptive rules in relation to the scope of the intangible development area under the proposed regulations are eliminated in favor of a flexible definition that encompasses any research and development actually undertaken under the cost sharing arrangement.

Section 1.482–7(c) provides rules for being a participant in a qualified cost sharing arrangement. Unlike the proposed regulations, the final regulations permit participation by unrelated persons, which are referred to as ''uncontrolled participants.'' Controlled taxpayers may be participants, referred to as ''controlled participants,'' if they satisfy the conditions set forth in these rules. These qualification rules replace the proposed regulations' concept of ''eligible participant.'' The tax treatment of controlled taxpayers that do not qualify as controlled participants provided in § 1.482–7(c)(4) essentially tracks the treatment provided for ineligible participants under the proposed regulations.

The requirements for being a controlled participant are basically the same as in the proposed regulations. In particular, a controlled participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. Thus, an entity that chiefly provides services (e.g., as a contract researcher) may not be a controlled participant. These provisions are necessary for the reason that they are necessary to the proposed regulations: to prevent foreign controlled entities from being established simply to participate in cost sharing arrangements. In accordance with § 1.482–7(c)(4) mentioned above, service entities (such as contract researchers) may furnish research and development services to the members of a qualified cost sharing arrangement, with the appropriate consideration for such assistance in the research and development undertaken in the intangible development area being governed by the rules in § 1.482-4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). In the case of a controlled research entity, the appropriate arm's length compensation would generally be determined under the principles of § 1.482–2(b) (Performance of services for another). Each controlled participant would be deemed to incur as part of its intangible development costs a share of such compensation equal to its share of reasonably anticipated benefits.

As under the proposed regulations, the activity of another person may be attributed to a controlled taxpayer for purposes of meeting the active conduct requirement. However, modified language is adopted to be more precise concerning the intended requirements for attribution. These requirements were phrased in the proposed regulations as bearing the risk and receiving the benefits of the attributed activity. Under the final regulations, the attribution will be made only in cases in which the controlled taxpayer exercises substantial managerial and operational control over the attributed activities.

As under the proposed regulations, a principal purpose to use cost sharing to accomplish a transfer or license of covered intangibles to uncontrolled or controlled taxpayers will defeat satisfaction of the active conduct requirement. However, a principal purpose will not be implied where there are legitimate business reasons for subsequently licensing covered intangibles.

The subgroup rules of the proposed regulations are eliminated. Their major purpose is accomplished by a simpler provision (see the discussion of § 1.482–7(h)). In addition, the final regulations treat all members of a consolidated group as a single participant.

Section 1.482–7(d) defines intangible development costs as operating expenses other than depreciation and amortization expense, plus an arm's length charge for tangible property made available to the cost sharing arrangement. Costs to be shared include all costs relating to the intangible development area, which, as noted, comprises any research actually undertaken under the cost sharing