arrangement. As under the proposed regulations, the district director may adjust the pool of costs shared in order to properly reflect costs that relate to the intangible development area.

Section 1.482–7(e) defines anticipated benefits as additional income generated or costs saved by the use of covered intangibles. The pool of benefits may also be adjusted in order to properly reflect benefits that relate to the intangible development area.

Section 1.482–7(f) governs cost allocations by the district director in order to make a controlled participant's share of costs equal to its share of reasonably anticipated benefits. Anticipated benefits of uncontrolled participants will be excluded from anticipated benefits in calculating the benefits shares of controlled participants. A share of reasonably anticipated benefits will be determined using the most reliable estimate of benefits. This rule echoes the best method rule for determining the most reliable measure of an arm's length result under § 1.482–1(c).

The reliability of an estimate of benefits principally depends on two factors: the reliability of the basis for measuring benefits used and the reliability of the projections used. The cost-to-operating-income ratio used in the proposed regulations to check the reasonableness of an effort to share costs in proportion to anticipated benefits has not been included in the final regulations. Rather, the final regulations provide that an allocation of costs or income may be made if the taxpayer did not use the most reliable estimate of benefits, which depends on the facts and circumstances of each case.

Section 1.482–7(f)(3)(ii) provides that in estimating a controlled participant's share of benefits, the most reliable basis for measuring anticipated benefits must be used, taking into account the factors set forth in § 1.482–1(c)(2)(ii). The measurement basis used must be consistent for all controlled participants. The regulations provide that benefits may be measured directly or indirectly. In addition, regardless of whether a direct or indirect basis of measurement is employed, it may be necessary to make adjustments to account for material differences in the activities that controlled participants perform in connection with exploitation of covered intangibles, such as between wholesale and retail distribution.

Section 1.482–7(f)(3)(iii) describes the scope of various indirect bases for measuring benefits, such as units, sales, and operating profit. Indirect bases other than those enumerated may be employed as long as they bear a relationship to benefits.

Section 1.482–7(f)(3)(iv) discusses projections used to estimate benefits. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. However, the regulations note that in certain circumstances, current annual benefit shares may be used in lieu of projections.

Section 1.482–7(f)(3)(iv)(B) states that a significant divergence between projected and actual benefit shares may indicate that the projections were not reliable. A significant divergence is defined as divergence in excess of 20% between projected and actual benefit shares. If there is a significant divergence, which is not due to an unforeseeable event, then the district director may use actual benefits as the most reliable basis for measuring benefits. Conversely, no allocation will be made based on a divergence that is not considered significant as long as the estimate is made using the most reliable basis for measuring benefits.

For purposes of the 20% test, all non-U.S. controlled participants are treated as a single controlled participant in order that a divergence by a foreign controlled participant with a very small share of the total costs will not necessarily trigger an allocation (section 1.482–7(f)(3)(iv)(D), *Example 8*, illustrates this rule). Section 1.482–7(f)(3)(iv)(B) and (C) notes that adjustments among foreign controlled participants will only be made if the adjustment will have a substantial U.S. tax impact, for example, under subpart F.

Section 1.482–7(f)(4) states that cost allocations must be reflected for tax purposes in the year in which costs were incurred. This reflects a change from the rule in the 1992 proposed regulations, which stated that cost allocations would be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year. The purpose of the change was to match up cost adjustments with the year to which they relate in accordance with the clear reflection of income principle of section 482.

Section 1.482–7(g) provides buy-in and buy-out rules that are similar to the rules in the proposed regulations. However, some of the clarifications suggested by commenters have been incorporated in these rules. A ''substantially disproportionate'' cost-to-operating-income ratio will no longer trigger an adjustment to income under these rules. However, if, after any cost allocations authorized by § 1.482–7(a)(2), the economic substance of the arrangement is inconsistent with the terms of the arrangement over a period of years (for example, through a consistent pattern of one controlled participant bearing an inappropriately high or low share of the cost of intangible development), then the district director may impute an agreement consistent with the course of conduct. In that case, one or more of the participants would be deemed to own a greater interest in covered intangibles than provided under the arrangement, and must receive buy-in payments from the other participants.

The rules do not provide safe harbor methods for valuing intangibles, but rely on the intangible valuation rules of §§ 1.482–1 and 1.482–4 through 1.482–6. To the extent some participants furnish a disproportionately greater amount of existing intangibles to the arrangement, they must be compensated by royalties by the participants who furnish a disproportionately lesser amount of existing intangibles to the arrangement. Buy-in payments owed are netted against payments owing, and only the net payment is treated as a royalty. No implication is intended that netting of cross royalties is permissible outside of the qualified cost sharing safe harbor rules.

Section 1.482–7(h) provides rules regarding the character of payments made pursuant to a qualified cost sharing arrangement. Cost sharing payments received are generally treated as reductions of research and development expense. A net approach is applied to foster simplicity and generally preserve the character of items actually incurred by a participant to the extent not reimbursed. In addition, 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 § 1.41–8(e). Finally, any payment that in substance constitutes a cost sharing payment will be treated as such, regardless of its characterization under foreign law. This rule is intended to enable foreign entities to participate in cost sharing arrangements with U.S. controlled participants even if foreign law does not recognize cost sharing. This rule obviated the main reason for the subgroup rules which, as noted, have accordingly been eliminated.