

---

## FACEBOOK Vs IRS on CSA – RECALIBRATING ARM'S LENGTH STANDARDS

---

### A. Introduction

The United States tax court (“the court”) had issued a landmark ruling in the case of Facebook Inc., (“FB US” /



**Ms.NITHYA SRINIVASAN & CA. S. RANJANI**

“Petitioner”) which is significant in the transfer pricing arena on CSAs. The epicentre of the ruling deals with the manner of valuation of intangible property rights transferred to FB US’s Irish subsidiaries who are forming part of Cost Sharing Arrangement (“CSA”)

Among various other things, the court opined on the method of valuation by drawing reference to the 2009 US cost sharing regulations, where the court challenged only the manner of application of the income method while prima facie validating the selection of method.

The ruling throws light on certain crucial aspects such as selection / application of method of valuation, IRS’s regulatory power, arm’s length principles, etc., which might have an impact on the approach towards Cost sharing arrangement transactions globally.

---

## B. Background:

### *a. Overview*

In 2010, FB US entered into a CSA and two related license agreements with its Irish subsidiaries i.e., Facebook Ireland Holdings Unlimited (FIH) and Facebook Ireland Limited (FIL), collectively referred to as “FB Ireland.” The arrangement was executed for developing FB’s platform technology i.e. Facebook Online Platform (FOP) Technology, including hardware and software components wherein FB US retained the rights to exploit the cost-shared intangibles in the U.S. and Canada, while FB Ireland obtained the rights for Rest of the world (ROW) territories. In connection with CSA FB US and FB Ireland entered into multiple agreements including the FOP Technology License, the UBMI License, and the Data Hosting Services Agreement (DHSA).

As per the CSA, FB US was to be remunerated by FB Ireland in the form of:

- **Platform Contribution Transactions (PCTs):** Payments for the pre-existing intangibles contributed by FB US, including the FOP technology, user data, and marketing intangibles.

- **Cost Sharing Transactions (CSTs):** Ongoing payments for Intangible Development Costs (IDCs), based on FB Ireland's Reasonably Anticipated Benefit (RAB) share.

*b. Pre-CSA Structure and intercompany arrangements*

Prior to CSA in 2010, FB US as a part of its expansion of global operations, in 2008, established Facebook Ireland Limited (FIL) as its operating entity in Ireland, followed by the incorporation of Facebook Ireland Holdings Unlimited (FIH) in early 2009. FIH acted as a holding company and did not have employees, while FIL functioned as the entity performing routine sales and marketing support. From 2009 onwards, FB US entered into the following intercompany agreements with FB Ireland entities:

Arrangement	Description & Pricing policy
Sales and Marketing Services Agreements	<ul style="list-style-type: none"> <li>• Promoting FB's products and services in ROW territory</li> <li>• FB Ireland was compensated on a cost-plus basis</li> </ul>
Statement of Rights and Responsibilities	Formalized Facebook Ireland's operational responsibilities
Technology licenses	Gave Facebook Ireland limited rights to assist in regional marketing and business development

Despite these arrangements, FB Ireland did not own or develop any intellectual property prior to the CSA, and it has not employed any asset other than cash and intercompany receivables

---

Interestingly FIL became a disregarded entity for U.S. tax purposes effective September 1, 2010, just two weeks prior to the execution of the CSA which facilitated the centralization of rights in FIH and simplified the legal structure. Until the CSA became effective, FB Ireland performed only routine functions and bore limited risks. This historical profile underpinned the IRS's argument that Facebook Ireland did not contribute non-routine value to the CSA and should be treated as a routine participant.

*c. Issue under consideration*

As per the Transfer pricing documentation of FB Ireland, it has made contingent annual payments to FB US towards the PCT, based on a Net Present Value (NPV) of \$6.3 billion by adopting an unspecified method.

The IRS ("Respondent") challenged both the valuation method and key assumptions, thereby upholding a much higher PCT value of \$19.945 billion.

The prime contention of FB US was that the IRS improperly applied the income method by selecting the wrong values for three key inputs:

- 
- IRS overstated FB Ireland’s future income potential by including speculative “Other Revenue” streams.
  - IRS used an unrealistically low discount rate that failed to reflect market and firm-specific risk faced by FB Ireland
  - IRS erroneously characterized FB Ireland as a contract service provider and claimed its best alternative was a third-party reseller relationship that would justify a much higher residual return.

*b. Key disputes*

At this outset the key disputes emanated from the ruling are:

1. Whether the IRS’s income method under the 2009 cost sharing regulations was the best method?
2. Whether the three inputs adopted by IRS were reliable and whether the IRS’s adjustments and interpretations were legally permissible
3. Whether the contribution made by FB Ireland is justified and aligned with its characterization i.e., if it is a true contributor for the development of the platform?

4. Whether FB used the correct discount rate for valuing the PCT under the CSA, especially the Beta input in the CAPM model, since Facebook was not publicly traded and its Beta could not be directly determined?

A quick glance of the key disputes and corresponding position / contention of the court is provided on the table below:

Key dispute	Court's position / contention
Income method adopted by IRS under 2009 cost sharing arrangements	<ul style="list-style-type: none"> <li>The Court affirmed that FB US was the only party to make a non-routine contribution to the platform and hence the income method under § 1.482-7T(g)(4) was validly applied with modification to the inputs.</li> <li>Opined that since platform contribution comprised of FOP, user rights, marketing intangibles which are interlinked, a bundled approach under the Income method would be best suited</li> </ul>
Reliability of the inputs adopted by IRS and whether the IRS's adjustments and interpretations were legally permissible	<ul style="list-style-type: none"> <li>Method selection was appropriate whereas the manner of application of the same by IRS was flawed.</li> <li>Valuation inputs used by IRS i.e., revenue projections, discount rates, and growth assumptions, were economically unreasonable thereby inflating the value</li> </ul>
Justification of payment made by FB Ireland's to FB US in alignment with its value contribution	<ul style="list-style-type: none"> <li>Opined in IRS's favour by stating that FB US is the only contributor to the platform whereas FB Ireland did not perform any development activities in alignment to its characterization. Hence IRS's manner of reallocation of returns among FB US and FB Ireland was justified.</li> <li>Accordingly, the court upheld IRS's contention of increasing FB US's RAB share, subject to corrected inputs</li> </ul>

---

A deep dive into these aspects is discussed in the ensuing paragraphs.

### **C. Analysis and Court's standpoint**

The Court conducted a rigorous evaluation of the financial, operational, and functional characteristics of FB US and FB Ireland in relation to the CSA.

#### **a. 2009 Cost sharing regulations (2009 Regs")**

##### **Definition of arm's length result**

Arm's length result in connection with a CSA is defined in the 2009<sup>1</sup> Regs states that

*"A CSA produces results that are consistent with an arm's length result within the meaning of § 1.482-1(b)(1) if, and only if, each controlled participant's IDC share . . . equals its RAB share, each controlled participant compensates its RAB share of the value of all platform contributions by other controlled participants, and all other requirements of this section are satisfied"*

From the above it can be inferred that PCT allocations are intended to ensure that the participant of the CSA compensates RAB share value of platform contributions. Further the 2009 Regs authorizes the commissioner to make necessary allocations to adjust the result of a PCT / CST to ensure consistency with arm's length result.

---

<sup>1</sup> Temp. Treas. Reg. § 1.482-7T(a)(4)

---

### *Classification of contributions*

Court analysed the IRS's Cost Share Transactions ('CST') allocation and the veracity of the method adopted by drawing reference to classification of types of assets that CSA participants contribute to a CSA (i.e., Platform contributions, user rights, FOP technology and RAB share of IDC as per the 2009 Regs.

Platform contributions and operating contributions are external to the CSA while cost contributions and operating cost contributions are made as part of the CSA. They contribute to Development / Exploitation of the intangibles as below:

Development - Platform contributions and Cost contributions

Exploitation - Operating cost contributions and Operating contributions

### *Aggregation of Contributions:*

Considering the interlink between the FOP technology, user rights base, and marketing intangibles, the Court opined that valuation should occur on an integrated basis i.e., bundled approach like Income method and not as separate streams of intangibles

### *Regulatory Validity*

The Court carefully reviewed the framework of the 2009 Regs in alignment with the US Treasury regulations and found them to be



---

a reasonable interpretation of IRS S 482 and thereby rejected arguments of the Petitioner that the regulations contravenes the arm's-length principle.

#### **b. Reliability of inputs adopted by IRS**

- **Revenue Projections:** The Court found the IRS's inclusion of \$1.9 billion in Other Revenue unjustified, as it comprised aspirational figures added by Facebook's CEO and was not linked to any specific resource, capability, or right developed or maintained by FB US. This inclusion unrealistically inflated the anticipated benefits to Facebook Ireland.
- **Discount Rate:** The Court favoured the 17.7% discount rate proposed in Facebook's transfer pricing documentation, as it accurately reflected the systemic and company-specific risks. It rejected IRS's lower market-based rate, balancing the inputs to reflect realistic investment returns.
- **Best Realistic Alternative:** FB Ireland was neither merely a reseller (as FB contended) nor merely a contract service provider (as IRS argued). The Court arrived at a mid-point by selecting advertising agencies as a comparable and established a 13.9% cost-plus markup that better reflected entrepreneurial risk.

---

### c. FB Ireland's remuneration

#### Substance over form

Despite the terms of the arrangement between FB US and FB Ireland as per the CSA, the Court placed reliance on the FAR analysis of FB Ireland wherein it performed only routine functions and bore limited risks. Basis this strong footing, the Court held that FB Ireland did not make any platform contribution under the CSA as it did not own or develop any intangibles. The Court emphasized that contributions to a CSA must involve valuable, pre-existing intangibles and that mere participation or funding of future development does not qualify as a Platform Contribution. Accordingly, ownership rights and economic returns must be aligned with the actual functions, assets, and risks borne by the parties. *RAB Share Methodology*

The Court endorsed IRS's use of a perpetual NPV approach based on of projected gross profits over the entire period of exploitation to estimate Reasonably Anticipated Benefits but insisted on use of corrected inputs. It found that the IRS's approach yielded a reliable and regulation-consistent output.

---

#### **d. Court's conclusion**

While Facebook had valued the PCT Payment at \$6.3 billion, the Court concluded that the correct amount to be \$7.786 billion (higher than original figure purported by FB US, however much lower than the amount asserted by IRS) by applying the income method with refined inputs.

The CST Payment and RAB share of 53.5% (as against 44% of FB US) were similarly upheld, with adjustments as needed. The Court issued a Rule 155 order directing both parties to recompute tax liability using the Court-approved framework.

#### **e. Our observations and key takeaways**

The ruling is a reminder that the tax authorities can recharacterize intercompany payments and revise allocations years after the transaction, based on updated or actual financial outcomes. Multinationals (MNEs) entering into CSAs must be mindful of the fact that irrespective of the method adopted, the MNEs to be able to justify the numbers / inputs used in application of such method.

In this ruling the US tax court has opined the manner of relying on ex-post outcomes wherein it has stated that inference can be

---

made from post-transaction to validate the reasonableness of an assumption, however using it as an input into the valuation model is objectionable. This calls for meticulously documenting not only the basis for their original assumptions but also anticipate how those assumptions could be challenged in hindsight.

In the light of OECD's 2022 guidelines on Hard to Value Intangibles (HTVI), this ruling underscore the importance of using reliable assumptions about future outcomes when valuing intangibles. The Court's critical opinion on the unrealistic financial and growth assumptions of the Petitioner is in alignment with the OECD's Guidelines on HTVI wherein it states that where reliable ex-ante projections are unavailable or flawed, tax administrations may use ex-post outcomes (actual results) to evaluate the reasonableness of the pricing of intangibles.

#### *Points to ponder*

- MNEs must prepare thorough contemporaneous documentation that supports projections, discount rates, and comparables, so as to ensure that their contemporaneous documentation can endure the retrospective analysis.

- 
- All inputs used in transfer pricing analysis must be internally consistent and supported by documentary evidence because even if a methodology is accepted, flawed inputs can undermine the reliability of the result.
  - Taxpayers must ensure that intercompany agreements and payments reflect the underlying economic arrangements, rather than relying solely on labels or formal structures.
  - Courts may favor bundled valuation where intangibles are economically interdependent / interrelated.
  - The Court's willingness to select a middle-ground comparable (advertising agencies) signals that hybrid economic realities must be accommodated.

*(Inputs contributed by V. Bharathi – Transfer Pricing Associate at VSTN Consultancy Private Limited.*

*The authors are part of VSTN Consultancy Private Limited, Transfer Pricing boutique firm and can be reached at [snithya@vstnconsultancy.com](mailto:snithya@vstnconsultancy.com), [ranjani@vstnconsultancy.com](mailto:ranjani@vstnconsultancy.com) and [bharathiv@vstnconsultancy.com](mailto:bharathiv@vstnconsultancy.com))*