

COMMENTS ON PROPOSED REGULATIONS ON SERVICES, INTANGIBLES, ECONOMIC SUBSTANCE AND OTHER ISSUES

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by individual members of the Committee on Transfer Pricing of the Section of Taxation. Principal responsibility was exercised by Darrin Litsky. Substantive contributions were made by David Canale, Robert S. Kirschenbaum, Mark R. Martin, Clisson Rexford, John P. Warner, and Steven C. Wrappe. Three other individuals, who are employees of two separate companies that could be affected by the proposed regulations, made additional substantive contributions and these contributions were subject to review and scrutiny of the Chair and the remainder of the contributors.

The Comments were reviewed by Charles S. Triplett, Chair of the Committee on Transfer Pricing. The comments were also reviewed by Karen Kole as a member of the Section's Committee on Government Submissions and by Elinore J. Richardson, as Council Director for the Committee on Transfer Pricing.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which each member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Four members who contributed to these comments are employees of companies that could be affected by the proposed regulations. They have not, however, been personally involved in lobbying or otherwise specifically trying to influence the development or outcome of specific aspects of these proposals.

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EXECUTIVE SUMMARY

We are submitting the following comments and suggestions with the aim of assisting the Department of Treasury ("Treasury") and the Internal Revenue Service ("Service") with their announced intention to propose revised the section regulations relating to the intercompany provision of services, transfers of intangible property, and economic substance issues ("Proposed Regulations").¹ On January 3, 2002, comments were submitted to Treasury and the Service regarding proposed rules for transfer pricing of services transactions.

Our present comments and suggestions focus on the following areas:

- Re-issuance of the Proposed Regulations in proposed form;
- Ownership of intangible property;
- Contributions to develop or enhance intangible property;
- Economic substance rules;
- Contingent-payment contractual terms for services;
- Services transactions involving intangible property;
- Transfer pricing methods for the provision of services, including the present cost safe harbor and the proposed simplified cost-based method;
- The definition of "total services costs" and the allocation of costs to service recipients;
- Qualified cost sharing arrangements for headquarters services;
- Benefit rules, including stewardship/shareholder activities; and
- Effective date.

Proposed Regulations Should Be Reissued in Proposed Form (Section I)²

The Proposed Regulations would replace regulations that have been in place for over thirty years. In these comments, we have identified substantial issues that should be considered by Treasury and the Service in revised regulations issued in proposed form.

¹ Released on September 5, 2003, the Proposed Regulations were published in the Federal Register on September 10, 2003. 68 Fed. Reg. 53448.

² Section references in the subheadings to this Executive Summary refer to relevant section of the detailed comments.

Re-issuance of revised regulations with a related comment period would give taxpayers and their advisors an opportunity to consider at the same time the revised regulations and additional proposed changes to the cost-sharing regulations, which are expected to be issued by Treasury and the Service in the near future.

Ownership of Intangible Property (Section II.A)

We believe the Proposed Regulations clarify how tax ownership will be determined and they are a welcome improvement over existing rules. We believe that, in order to be more helpful, the Proposed Regulations should include an example, which recognizes that a taxpayer can structure its affairs so that a single party is respected as the legal and economic owner and risk-taker with respect to intangible property.

Contributions to Develop or Enhance Intangible Property (Section II.B)

The examples in the Proposed Regulations provide a “default” reliance on the residual profit split method to determine arm’s length allocations of income due to intangibles and contributions thereto. This default reliance on the residual profit split may be inconsistent with the way a multinational enterprise has allocated risk between related parties in an intercompany agreement. We suggest that a taxpayer’s allocation of risk should be respected if consistent with economic substance and should be taken into account for purposes of the best method rule.

Economic Substance Rules (Section II.C)

Proposed Examples 3 and 4 to Treas. Reg. §1.482-1(d)(3)(ii)(C) appear to be a reasonable application of the principles set forth in Regulation §1.482-1(d)(3)(ii)(B) regarding when an agreement should be imputed. However, the Proposed Examples present fact patterns that clearly do not have arm’s length terms. Therefore, we suggest that the Proposed Examples may not be materially helpful to taxpayers trying to structure their affairs to avoid having arrangements disregarded and/or arrangements imputed pursuant to Treas. Reg. §1.482-1(d)(3)(ii)(B). In this regard we recommend that consideration be given to adding some examples, which would address these concerns.

Proposed Example 5 is also troubling. It appears to apply the economic substance doctrine to what seems to be an unambiguous controlled party

arrangement. The doctrine permits the imputation of hypothetical controlled party arrangements, and thus raises the potential for unexpected and unpredictable adjustments. Is the intent to allow the Commissioner to impute some alternative transaction simply because of a failure to pay arm's length consideration when the nature of the controlled party transaction is undisputed? If this is so, we suggest that this unnecessarily introduces a significant element of uncertainty into controlled party relationships and transfer pricing results.

While Proposed Examples 3 and 4 provide flexibility as to the imputation of contractual terms based on facts and circumstances, we suggest that additional guidance is needed as to which factors are relevant in determining which imputed alternative arrangement best reflects the economic substance of a transaction. In this regard, Proposed Example 5 appears to validate an extension of section 482 beyond the statutory limit of its application to transactions or arrangements between commonly controlled parties, in that it appears to permit the imputation of a contingent-payment services contract, or another contractual relationship, between parties with respect to activities undertaken prior to their status as commonly controlled parties.

Contingent-Payment Contractual Terms (Section II.D)

We have made several recommendations that would clarify or eliminate certain requirements in agreements for contingent-payment contractual terms.

Service Transactions Involving Intangible Property (Section III)

Prop. Treas. Reg. §1.482-9(m)(2) describes three types of controlled services transactions that may affect a transfer of intangible property, including services transactions that may have "an effect similar to the transfer of intangible property." We suggest that the application of the "commensurate with income standard" in the absence of an identifiable transfer of an intangible asset is an overbroad application of such standard. In addition, we request clarification on the difference between the "material" standard set forth in Prop. Treas. Reg. §1.482-9(m)(2) and the well-established "substantial" standard of Treas. Reg. §1.482-4(b).

Transfer Pricing Methods Excluding Simplified Cost-Based Method (Section IV)

The comparability standard set for the comparable uncontrolled services method is arguably higher than that for use of the comparable uncontrolled price method,

its tangible property analog. We recommend an alternative standard “no substantial differences” used in one of the Proposed Examples.

The cost of services plus method appears to inappropriately include a comparable profits method check. We recommend elimination of such a check. We also suggest that consideration be given to clarifying the meaning of “comparable transaction costs.”

With regard to profit split methods, we are concerned with how easily the Proposed Regulations appear to impose a profit split analysis, particularly the residual profit split method. We are particularly troubled by the use of the residual profit split method in Example 2 of Prop. Treas. Reg. §1.482-9(g)(2).

Simplified Cost-Based Method (Section V)

We suggest that the simplified cost-based method is neither simple nor does it achieve any meaningful reduction of the compliance and administrative burden imposed on taxpayers when compared to other methods. If a taxpayer is able to navigate through the various screens that would exclude application of the simplified cost-based method, a taxpayer will still not know whether a particular service falls within the method until (1) determining the referenced uncontrolled mark up percentage, and (2) establishing that the cost base for its services is comparable to the cost base used by the Commissioner for the uncontrolled mark up. Because the method is focused only on services that are under-priced, it provides no benefit for inbound services transactions. For these and the other reasons outlined in the body of our comments, we believe the final regulations should retain the current safe harbor rule found in Treas. Reg. §1.482-2(b). If the simplified cost-based method is adopted in the final regulations, we recommend that the following modifications to that method be incorporated.

We recommend that certain requirements for use of the simplified cost-based method be further clarified. For example, the contract requirement set forth in Prop. Treas. Reg. §1.492-9(f)(3)(ii) could be clarified so that voluntary adjustments pursuant to Treas. Reg. §1.482-1(a)(3) may be made without being deemed ineligible for use of the simplified cost-based method. We also recommend either elimination or changes to the 50% recipient test in Prop. Treas. Reg. §1.482-9(f)(4)(ii). Prop. Treas. Reg. §1.482-9(f)(4)(iii) appears to inappropriately exclude back-office services merely because such services are associated with proprietary software and similarly may exclude transactions that result in mere economies of scale inherent in a controlled group (e.g., mass

purchasing activities). Also, we recommend that the type of transactions excluded from the simplified cost-based method be narrowed and clarified.

In order to provide a meaningful reduction of the administrative and compliance burdens placed on taxpayers, taxpayers meeting the requirements of the simplified cost-based method in a taxable year should be permitted to apply the method for the next two subsequent taxable years, assuming no significant change in facts and circumstances.

Lastly, any section 482 adjustment made under the simplified cost-based method should be to the lowest safe harbor price as finally determined.

Total Services Costs and Allocation of Costs (Section VI)

We recommend that a taxpayer should be able to rely on generally accepted accounting principles in determining total services costs.

Although there is no explicit reference in the Proposed Regulations to stock option costs, we are concerned that the Service will automatically include stock option costs in total services costs. In contrast to participants in QCSAs, related party service providers are often compensated on a cost-plus basis and bear little risk. More specifically, related party service providers are comparable to cost-plus government contractors and uncontrolled service providers. Thus, Treasury and the Service's position and arguments on stock options in the context of cost sharing arrangements do not apply in the context of intercompany services. With respect to total services costs, we believe that excluding stock option costs would be entirely consistent with the arm's length standard as evidenced by comparable cost-plus government contracts and other uncontrolled service transactions. In the alternative, we recommend that the issuance of stock options be analyzed solely for the purpose of determining and adjusting for comparability as presently required under Treas. Reg. §1.482-5(c)(2)(iv).

With respect to allocation of costs, we recommend retention of the current Treas. Reg. §1.482-2(b)(6)(i), which provides that any allocation and apportionment method that represents "sound accounting practice" will not be disturbed if used consistently and applied in a reasonable manner. We are concerned about the relative ease with which the Commissioner can make an adjustment on the basis of relatively minor difference in allocation methodology. See e.g., Examples 8 and 9 of Prop. Treas. Reg. §1.482-9(f)(5).

Qualified Cost Sharing Arrangements (Section VII)

As we recommended in our January 2002 comments, we again recommend that Treasury and the Service expressly sanction a headquarters services cost sharing model similar to the qualified cost sharing arrangement ("QCSA") for intangible property development under Treas. Reg. §1.482-7 and to the concept of the cost contribution arrangement ("CCA") under the OECD Guidelines. The Proposed Regulations are inconsistent with the OECD Guidelines in this regard.

Benefit and Stewardship/Shareholder Activities (Section VIII)

We commend the Treasury's and the Service's efforts to achieve harmonization with respect to the standard for chargeable intercompany services. This change should minimize competent authority disputes between the United States and OECD member countries as to the correct standard of review. Generally, the Proposed Examples provide welcome guidance and an acceptable synthesis of many of the Service's earlier pronouncements on the stewardship issue.

Effective Date (Section IX)

The Proposed Regulations represent both significant and unprecedented changes in and additions to regulations that have remained unchanged since 1968. As proposed, these regulations would be immediately effective. Such a proposal is not equitable to taxpayers because it does not provide any time for taxpayers to comply. Taxpayers will generally need time to adjust their activities and resources to acquire the additional information necessary to support and document the determinations required under the Proposed Regulations and revise their intercompany agreements. Therefore we recommend that the changes in the Proposed Regulations apply to taxpayers for tax years beginning no earlier than one year after the publication of the final regulations. This period should be adequate to allow both taxpayers and transfer pricing professionals the time necessary for proper training and education with respect to the new regulations, make the necessary determinations, revise or adopt appropriate intercompany agreements, make the corresponding significant changes to business operations and systems, and meet the documentation requirements under Treas. Reg. 1.6662-6 as applied to this significant change in the transfer pricing regulations for services and intangibles.

Alternatively, we suggest that the Proposed Regulations should generally apply no earlier than taxable years beginning 180 days after the date of publication of

the final regulations, with an exception for the application of the Proposed Regulations to non-integral services under Treas. Reg. §1.482-2(b)(7) which should apply to taxpayers with tax years beginning on or after one year from the date of publication of the final regulations.

I. Reissuance of the Proposed Regulations in Proposed Form

The changes reflected in the Proposed Regulations would replace regulations that have been in place for over thirty years. We have identified in these comments issues that we believe should be addressed by Treasury and the Internal Revenue Service in revised regulations issued in proposed form.

Because it is difficult to evaluate the impact of the proposed services and intangibles regulations without understanding the changes that will be proposed in pending cost-sharing regulations which are expected to be issued by Treasury and the Service in the near future, we recommend the re-issuance of revised proposed rules for services and intangibles with a related comment period for the Proposed Regulations to give taxpayers an opportunity to consider at the same time both the changes to the cost-sharing regulations, and the revised proposed rules for services and intangibles.

II. Income Attributable to Intangible Property

With respect to income attributable to intangible property, the primary changes in the Proposed Regulations include revision of the rules for determining the ownership and development of intangible property, the coordination and harmonization of the intangibles rules with the services regulations and the rest of the transfer pricing regime under section 482, and elimination of the infamous “cheese examples” in the current regulations. Proposed Treas. Reg. §1.482-4(f)(3) and (4) would replace the provisions of current Treas. Reg. §1.482-4(f)(3), relating to the ownership and allocation of income relating to intangible property.

A. Ownership

1. Current Regulations

a) Background

The 1968 section 482 regulations (“1968 Regulations”) adopted what is commonly referred to as the “developer-assister” rule for determining tax ownership. Under this rule there could be only one owner, the developer of the intangible, and all other controlled parties who contributed to the development of the intangible would be considered assisters who would be compensated for such assistance, but would not be owners. The developer was generally determined, based on all the facts and circumstances, to be the party that bore the most relative risk (*i.e.*, incurred the most expense) in developing the intangible. Legal ownership of the intangible was not necessarily a factor in determining tax ownership under this rule.

b) Emphasis on Legal Ownership

The developer-assister rule was criticized primarily because it ignored legal ownership of an intangible, which, in uncontrolled party transactions, plays a significant role in negotiations with respect to the transfer of the intangible. Addressing this deficiency in the 1968 Regulations, the current regulations identify the legal owner of a right to exploit an intangible that is legally protected as the tax owner.³ For intangibles that are not legally protected, the developer-assister rule is still maintained.⁴ In addition, the current rules adopted the multiple ownership concept where multiple taxpayers could be deemed owners of the same intangible.⁵

c) Cheese Examples

To illustrate these principles, the regulations provide what are commonly referred to as the “cheese examples,” where a foreign producer (“FP”) of cheese owns a valuable trademark and markets it outside the U.S.⁶ The trademark is not known in the U.S. and FP establishes a U.S. subsidiary distributor (“USSub”) to market the cheese and develop the intangible in the U.S. In Example 4, where USSub incurs marketing and promotional expenses significantly larger than what independent distributors would incur, and FP and USSub enter into a long term, exclusive distribution agreement, USSub is deemed the owner of the FP trademark.

These ownership rules and cheese examples have created much confusion with respect to the ownership of intangibles and the resulting allocation of income from such intangibles, and were often criticized for ignoring basic legal ownership principles. For example, if a tenant of real property entered into a long-term agreement with a landlord and incurred significant expenses improving the leased property, the tenant would not be deemed the owner of the property. Yet, application of the current regulations would conclude that the tenant became an owner of the property.

³ Treas. Reg. §1.482-4(f)(3)(ii)(A).

⁴ Treas. Reg. §1.482-4(f)(3)(ii)(B).

⁵ Treas. Reg. §1.482-4(f)(3)(i) and §1.482-4(f)(3)(iv), Example 4.

⁶ Treas. Reg. §1.482-4(f)(3)(iv), Examples 2, 3, and 4.

2. Proposed Regulations

The Proposed Regulations eliminate the infamous “cheese examples” and modify the analytical approach of Treas. Reg. §1.482-4(f)(3) to clarify that ownership of an intangible, generally, should be distinct from the rules for determining the allocation of income from an intangible. Generally, the Proposed Regulations provide that the intellectual property laws of the relevant jurisdiction, or contractual terms, or other legal provisions that entitle the taxpayer to rights in the intangible, govern the identification of the sole owners of discrete aspects of an intangible. The economic substance of the underlying transaction must always accord with the ownership of an intangible pursuant to Treas. Reg. §1.482-1(d)(3). In cases where an owner cannot be identified under intellectual property laws, contractual terms, or other legal provisions, the owner of the intangible property will be the controlled taxpayer who has control of the intangible, based on all the facts and circumstances.

3. Recommendations

In essence, the proposed rules adopt the “bundle of rights” approach to defining intangibles and recognize ownership of particular rights in the bundle under intellectual property law or contract law. They do not transfer ownership from the legal owner due to long-term agreements and excessive expenditures. We believe the proposed rules clarify how tax ownership will be determined and are a great improvement over the existing rules.

Although we support the approach set forth in the Proposed Regulations, we believe the Proposed Regulations should include an example that recognizes that a taxpayer can structure its affairs so that one party is respected as the legal and economic owner and risk-taker with respect to intangible property. This example could involve a limited-risk distribution arrangement. The example would, of course, need to include appropriate facts regarding the arrangements and conduct of the parties. We believe that such an example is important so that taxpayers, courts and Service personnel recognize that a single party may be the legal and economic owner and risk taker with respect to intangible property thereby permitting consequences to be predicted with certainty.

B. Contributions to Develop or Enhance an Intangible

1. Current Regulations

Under Treas. Reg. §1.482-4(f)(3)(iii), arm's length consideration must be provided to a party that provides assistance to an owner of intangible property in connection with the development or enhancement of the intangible.

2. Proposed Regulations

Like Treas. Reg. §1.482-4(f)(3)(iii), Prop. Treas. Reg. §1.482-4(f)(4)(i) provides that a contribution by one controlled taxpayer to develop or enhance an intangible owned by another controlled taxpayer must be compensated at arm's length. The section 482 regulations generally respect the contractual terms specified for controlled transactions, provided the economic substance of the transactions supports them. Depending on the contractual terms of the transaction, compensation may be in the form of a separate service fee or may be embedded in a royalty or the price paid for tangible property (e.g., a reduction in the royalty or price). Where controlled taxpayers "embed" compensation for a contribution in the contractual terms of a transaction (services or sale of goods transactions) involving an intangible, ordinarily no separate allocation would be made by the Service. The contribution, however, must be taken into account in evaluating the comparability of the controlled transaction to any uncontrolled comparables and in determining the arm's length consideration for the controlled transaction that includes the embedded contribution.

3. Recommendations

Unlike the existing regulations, the Proposed Regulations make explicit that contributions to develop or enhance an intangible may be compensated through reduced contract prices or other embedded compensation that often occurs in uncontrolled party transactions. In addition, the principles are generally consistent with the OECD Transfer Pricing Guidelines ("OECD Guidelines"),⁷ which should help achieve agreement on double tax cases caused by transfer pricing adjustments relating to intangibles and contributions thereto, between treaty partners.

⁷ See generally, OECD Guidelines paragraphs 6.36 to 6.39.
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Of concern, however, is the “default” reliance in the Examples on the residual profit split method to determine arm’s length allocations of income due to intangibles and contributions thereto. In many instances, the reliance on the residual profit split as a default method is not consistent with the way a multinational enterprise may have allocated risk between related parties in an intercompany agreement. For example, a service agreement might be used under which one party performs intangible development work on behalf of another in exchange for payment equal to all of its costs plus an arm’s length markup. Such an allocation of risk should be respected if consistent with economic substance⁸ and should be taken into account for purposes of the best method rule.⁹ See e.g., Example 1 of Prop. Treas. Reg. §1.482-(i)(5) in the context of contingent-payment contractual terms.

Although a best method analysis is appropriate in these cases, and in certain cases the residual profit split may be the best method, the emphasis on this method in the Examples may lead some revenue examiners to the conclusion that residual profit split is the best method in all cases. Unfortunately, the Proposed Regulations seem to recommend the residual profit split as a method of last resort in instances where uncontrolled transactions cannot be identified “that incorporate a similar range of interrelated elements.” This is a very high standard to meet. In comparison, the Preamble to the current regulations referred to the comparable profits method as the method of last resort.¹⁰ In removing a restriction upon use of the CPM in the 1993 temporary regulations in cases where the tested party was the owner of valuable non-routine intangibles, the Preamble of the current regulations noted that “it would be inappropriate to deny the use of the CPM if a comparable uncontrolled taxpayer could be located that owned...[similar] intangibles...”¹¹ By analogy, this should also hold for “non-routine contributions” under the Proposed Regulations.

We recommend that the final regulations de-emphasize the residual profit split in the Examples and emphasize (i) an analysis of functions performed and risks assumed and (ii) best method selection.

⁸ Treas. Reg. §1.482-1(d)(3)(iii)(B); Treas. Reg. §1.482-1(d)(3)(ii)(B).

⁹ Treas. Reg. §1.482-1(c).

¹⁰ 59 Fed. Reg. 34971, 34985 (July 8, 1994).

¹¹ Id.

C. Economic Substance

1. Current Regulations

If the parties to a transaction agree in writing to the contractual terms prior to consummating the transaction, the Service will give effect to such contractual terms for federal income tax purposes, provided they are consistent with the economic substance of the underlying transaction.¹² However, if the contractual terms are inconsistent with the economic substance of the underlying transaction, the Service may disregard them and impute terms that are consistent with the economic substance of the transaction.¹³ In the absence of a written agreement, the Service may impute a contractual agreement between taxpayers engaged in a controlled transaction.¹⁴ Such an imputed agreement must be consistent with the economic substance of the transaction.¹⁵ In evaluating the economic substance of the underlying transaction, the Service will place the greatest weight on the conduct and legal rights of the parties.¹⁶

Under current Treas. Reg. §1.482-1(d)(3)(ii)(B), the Service may impute contractual terms in cases where controlled taxpayers fail to specify the contractual terms or where the contractual terms specified do not accord with economic substance. Current Treas. Reg. §1.482-1(d)(3)(ii)(C), Example 3 (“current Example 3”) illustrates the application of Treas. Reg. §1.482-1(d)(3)(ii)(B). In current Example 3, a U.S. distributor (“USD”) is the exclusive distributor for its foreign parent (“FP”). For years 1 through 6, USD bears marketing expenses promoting FP’s tradename in the United States that are substantially above the level of such expenses incurred by comparable distributors in uncontrolled transactions. USD does not have an agreement with FP for the use of FP’s tradename and FP does not directly or indirectly reimburse USD for the marketing expenses to promote FP’s tradename. In year 7, the FP tradename has become very well known in the market and commands a price premium. Also in year 7, USD becomes a commission agent for FP.

Current Example 3 notes that an uncontrolled taxpayer operating at arm’s length would most likely not “incur these above-normal expenses without some assurance it could derive a benefit from these expenses.” Thus, current Example

¹² Treas. Reg. §1.482-1(d)(3)(ii)(B)(1).

¹³ *Id.*

¹⁴ Treas. Reg. §1.482-1(d)(3)(ii)(B)(2).

¹⁵ *Id.*

¹⁶ Treas. Reg. §1.482-1(d)(3)(ii)(B)(1) and (2).

3 concludes that these above-normal expenses “indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP tradename in the United States.” Accordingly, current Example 3 determines that the initial distribution arrangement and later commission agent contractual arrangements between USD and FP should be disregarded, and USD should retain “an appropriate portion of the price premium attributable to the FP tradename” under an imputed agreement.

2. Proposed Regulations

Although Treas. Reg. §1.482-1(d)(3)(ii)(B) allows the Service to disregard the form of a transaction and impute an arrangement consistent with the transaction’s economic substance, the Treasury Department and the Service continue to express concern that transactions structured as service transactions are in substance transfers of intangible property. More specifically, the Preamble to the Proposed Regulations provides:

Treasury and the IRS believe guidance is necessary to mitigate the extent to which the form or characterization of a transfer of intangibles as the rendering of services can lead to inappropriate results.

In the context of transactions structured as U.S. service provider arrangements, the fundamental concern of Treasury and the Service appears to be that such arrangements involve the uncompensated transfer or use of intangible property and, therefore, are inappropriately eroding the U.S. tax base.

We have bifurcated the discussion of the Proposed Examples under Treas. Reg. §1.482-1(d)(3)(ii)(C) into a discussion of the agreements and conduct which may trigger an imputed agreement under Regulation §1.482-1(d)(3)(ii)(B), and a discussion of such imputed agreements.

a) Agreements and/or Conduct Triggering an Imputed Agreement

In Proposed Regulation §1.482-1(d)(3)(ii)(C), the Service has proposed a replacement to current Example 3 and has proposed adding Example 4 and Example 5. These examples illustrate situations in which the Service may impute contractual terms pursuant to Regulation §1.482-1(d)(3)(ii)(B) in cases where members of a controlled group fail to specify the contractual terms of a

controlled transaction or where the contractual terms of such an arrangement do not accord with economic substance.

In our opinion, Proposed Examples 3 and 4 of Treas. Reg. §1.482-1(d)(3)(ii)(C) represent a reasonable application of the principles set forth in Regulation §1.482-1(d)(3)(ii)(B). Moreover, we believe these Proposed Examples appropriately advance the stated intent of the Treasury Department and the Service to tax controlled group arrangements according to their economic substance, and not according to their legal form or to the character attributed to them by the controlled parties. Thus, Proposed Example 3 suggests that where there is no legal arrangement regarding the incremental marketing activities, the conduct attributing a premium return in Year 7 to FP should be disregarded and an agreement compensating USSub should be imputed, as USSub would be compensated for such development activities in an arm's length transaction.

Similarly, in Proposed Example 4, after USSub funded six years of incremental marketing expenditures pursuant to a license arrangement for manufacturing and marketing intangibles with FP, the conduct is at odds with the implementation of the cost reimbursement compensation service provider arrangement to compensate USSub only for its incremental marketing expenditures during Years 1 through 6, the revision of the royalty agreement increasing the royalty to FP, and the attribution of all the premium return to FP in Year 7. An agreement compensating USSub for such incremental expenditures should be imputed.

Finally, in Proposed Example 5, the lack of a legal arrangement and conduct permitting Company Y to register compounds developed by Company X is deemed inconsistent with economic substance. As such, an agreement compensating Company X for the transfer of such rights should be imputed, as Company X would be compensated for such development activities in an arm's length transaction. For reasons discussed in section II.C.3.a.2 below, we think that the application of the economic substance doctrine is less clear in Proposed Example 5 than in Proposed Examples 3 and 4.

As noted, Proposed Examples 3 and 4 require compensation for incremental marketing activities and the transfer of intangible property and appropriately prevent U.S. tax base erosion.

b) Imputed Contractual Terms

Both Proposed Example 3 and Proposed Example 4 offer three alternative contractual agreements that the Service may impute to appropriately compensate USSub. First, the Proposed Examples note that the Service can impute a contingent-payment arrangement, where USSub is compensated for services rendered in years 1 through 6. As addressed more fully in the contingent payment discussion in section II.D below, we believe the income allocated to USSub in year 7 from the imputed contingent payment should take into account the benefits received by FP and the risks borne by USSub in connection with the imputed contingent payment arrangement. Second, the Proposed Examples note that the Service can impute a long-term distribution arrangement, in the case of Proposed Example 3, or a long-term license agreement, in the case of Proposed Example 4. A long-term license agreement is the only alternative described in current Example 3. Finally, Proposed Example 3 and Proposed Example 4 note that the Service can impute a contract termination payment, where the income allocated to USSub in year 7 would be deemed consideration for the termination of a long-term license agreement.

3. Recommendations

a) Agreements and/or Conduct Triggering an Imputed Agreement

(1) Supplement the Proposed Examples to provide useful guidance to taxpayers trying to structure their affairs

We recommend that the proposed Examples in Regulation §1.482-1(d)(3)(ii)(C) be supplemented to make them materially helpful to taxpayers trying to structure their affairs to avoid having arrangements disregarded and/or arrangements imputed pursuant to Treas. Reg. §1.482-1(d)(3)(ii)(B). In their present form, the Proposed Examples present fact patterns that clearly do not have arm's length economic terms (i.e., the use or transfer of intangible property for no consideration or for only a reimbursement of costs).

More difficult issues, and in our view the more likely scenarios, are not addressed in the Proposed Examples. To illustrate, assume that an intangible has been created (or enhanced) and there is a compensation arrangement in place (whether by conduct or agreement). The issue then, is whether such an

arrangement adequately compensates the service provider. Although it is apparent from Treas. Reg. §1.482-1(d)(3)(ii)(B) that the economics of such a compensation arrangement would be analyzed to determine whether the arrangement would be respected, we believe an example (“recommended Example 6”) illustrating the necessity of this analysis would be helpful to taxpayers as well as Service personnel. In this regard, current Example 3 may provide a useful starting place for recommended Example 6, as current Example 3 involves a situation where the parties enter into a “commission agent” arrangement to compensate USD for its development of marketing intangibles. As with current Example 3, this arrangement should be disregarded, as a routine return for distribution or sales activities would not properly compensate USD for the risk it incurred in Years 1 through 6. Recommended Example 6 is also discussed in section II.C.3.b (immediately below).

Finally, in the interest of presenting a spectrum of possible results under an application of Treas. Reg. §1.482-1(d)(3)(ii)(B), we believe Prop. Treas. Reg. §1.482-1(d)(3)(ii)(C) should contain an example of an arrangement that passes scrutiny under Regulation §1.482-1(d)(3)(ii)(B) (“recommended Example 7”). For example, recommended Example 7 could postulate a situation where USSub is reimbursed for its incremental costs annually in years 1 through 6. Then, in year 7 USSub enters into a limited-risk distribution arrangement with FP. Recommended Example 7 should be premised on the assumption that the risks, functions and payment terms of the distribution arrangement are consistent with comparable third-party arrangements. We suggest recommended Example 7 would provide more valuable guidance to taxpayers than the Proposed Examples, as it would demonstrate how taxpayers should structure their arrangements to avoid having such arrangements disregarded by the Service. Alternatively, since both Example 3 and Example 5 involve situations where USSub is not compensated at all for either incremental marketing activities or the transfer of intangible property, one of these examples could be replaced with recommended Example 7.

(2) Revise Proposed Example 5 to avoid an overextension of the economic substance doctrine

We believe that Prop. Treas. Reg. §1.482-1(d)(3)(II)(C) Example 5 represents an extension of the Commissioner’s authority to recast transactions beyond the authority of section 482. In Proposed Example 5, Corporation Y undertakes research and development in Years 1-4 to develop a valuable medicinal

compound. In Year 4, Corporation X, which apparently has no prior relationship with Corporation Y, acquires the group of which Corporation Y is a member and, following such acquisition, proceeds to register in its own name the patent rights to the compound developed by Corporation Y. The Proposed Example concludes that, because an uncontrolled party would not develop a valuable compound without either contemporaneous compensation or a reasonable expectation of receiving a future benefit from such development, the arrangement between Corporation Y and Corporation X is inconsistent with the economic substance of their relationship and may warrant imputation, among other things, of a contingent-payment arrangement.

Proposed Example 5 is troubling because it purports to apply the economic substance doctrine to what appears to be an unambiguous controlled party arrangement. The doctrine permits the imputation of hypothetical controlled party arrangements, and thus raises the potential for unexpected and unpredictable adjustments. Whatever the significance of Corporation X's registration of patent rights in its own name -- whether it represents mere nominal legal ownership of the patent rights or full beneficial ownership of those rights, a transfer of intangible property occurs between controlled parties in Year 4. The appropriate remedy for failure of Corporation X to pay arm's length consideration for that transfer is an adjustment under Treas. Reg. §1.482-4. Although Treas. Reg. §1.482-1(d) permits the Commissioner to impute arrangements consistent with economic substance when the controlled party arrangement is not evidenced by a contemporaneous written agreement, that authority should be limited to situations in which there is some ambiguity as to the true nature of the parties' relationship. To permit the Commissioner to impute some alternative transaction simply because of a failure to pay arm's length consideration when the nature of the controlled party transaction is undisputed unnecessarily introduces a significant element of uncertainty into controlled party relationships and transfer pricing results.

b) Imputed Contractual Terms

(1) Need for clarification as to factors relevant to establish an imputed agreement that would best reflect economic substance

The alternative imputed contractual arrangements described in Proposed Example 3 and Proposed Example 4 provide flexibility in determining the amount of income allocated to USSub in year 7, as the amount allocated for a contingent

payment, long-term license or a contract termination payment may differ significantly. This flexibility is confirmed by the final sentence of Proposed Example 4 which provides that the “taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties’ course of conduct in this particular case.”

The alternative imputed contractual arrangements described in Proposed Example 3 and Proposed Example 4 also appear to allow flexibility with respect to future arrangements between FP and USSub. Thus, if a contractual termination payment is, for example, imputed, it would appear that USSub could be compensated as a routine distributor in future years, provided the conduct of the parties was consistent with such an economic arrangement (e.g., USSub did not continue to incur incremental marketing expenses). We suggest that an example illustrating this point would be helpful. For example, recommended Example 6 (discussed in section II.C.3.a, above) would provide that a distribution agreement in year 7 coupled with a lack of reimbursement of costs in years 1 through 6 are operative facts that trigger an imputed termination payment in year 7. In this regard, the example would assume the necessary economic conditions to make such an adjustment in year 7. In addition, recommended Example 6 could also address the concern that the distribution agreement in subsequent years, again based on sufficient assumed facts regarding the risks and functions of the parties, would be respected.

The flexibility of imputed contractual terms in the Proposed Examples is further confirmed by the final sentence of Proposed Example 4 which provides that the “taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties’ course of conduct in this particular case.” In this regard, it appears the taxpayer could also establish that a lump sum contingent payment agreement or intangible property purchase agreement should be imputed in year 4, or a contingent-payment agreement or royalty agreement should be imputed over multiple years.

We believe the discussion of the potential imputed contractual agreements in the Proposed Examples is a substantial improvement over current Example 3. Current Example 3 does not clearly segregate the analysis of the operative economic conditions triggering an imputed agreement and the potential imputed agreement. Moreover, current Example 3 implies that the exclusive imputed agreement should be a long-term license agreement. The Proposed Examples

clearly address both the analysis of whether an arrangement should be disregarded as lacking economic significance and the imputation of an agreement. Also, the Proposed Examples clearly indicate that a range of imputed agreements consistent with the parties conduct may be imputed.

While Proposed Example 3 and Example 4 provide flexibility as to the imputation of contractual terms based on facts and circumstances, additional guidance would be useful as to the factors that are relevant in determining which imputed alternative arrangement best reflects the economic substance of a transaction. Although the Proposed Regulations appear to be quite helpful in affording taxpayers the opportunity to present facts that could indicate which of the possible imputed agreements "best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct . . .," the regulations provide little guidance as to what factors would be the most relevant in establishing that an imputed arrangement would best reflect economic substance.

In the Examples in Prop. Treas. Reg. §1.482-1(d)(3)(ii)(C) -- and, it seems probable, in most real world situations in which the parties' conduct is inconsistent with the economic substance of their arrangement -- the parties' conduct will be equally consistent (or inconsistent) with each of the potential alternative imputed contracts. For example, in proposed Example 3, the inconsistency of the parties' post-Year 6 allocation to FP of the premium value of watches attributable to the YY trademark (with USSub having built up the mark through uncompensated incremental Year 1-6 marketing activities in the U.S. market) would permit the Service to impute a contingent-payment arrangement, an imputed long-term distribution agreement or even a termination of either imputed agreement. So long as the consideration allocable to USSub fully takes into account USSub's functions and risks and the benefits to FP from USSub's incremental marketing activities, there is nothing in the Proposed Regulations, and nothing that can be gleaned from the Examples, that would even suggest what, if any, facts might be present that indicate which of those alternatives best reflect economic substance. Without guidance on this point, the apparent openness to consider the taxpayer's point of view will be illusory. We also believe that, subject to assurance that the amount allocated reflects arm's length consideration, taking into account the assets, functions, risks and the benefits to the parties, taxpayers should be able to choose any alternative imputed arrangement for which there are uncontrolled comparable counterparts or analogs in the marketplace.

(2) Revise Proposed Example 5 so that the imputation of contractual terms do not exceed the Commissioner’s Authority under section 482

Discussed in detail in section II.C.3.a.2 above, Proposed Example 5 is troubling in that it appears to validate an extension of section 482 beyond its statutory limit of transactions or arrangements between commonly controlled parties. Proposed Example 5 appears to evaluate – and therefore implicitly applies section 482 principles to – the relationship between Corporation Y and Corporation X for the four-year period prior to Corporation X’s acquisition of the group of which Corporation Y was a member, when the two corporations were completely independent parties. To impute a contingent-payment services contract, or any other contractual relationship, between the parties with respect to activities undertaken prior to their status as commonly controlled parties goes beyond the authority of section 482.

D. Contingent-Payment Contractual Terms for Services

1. Current Regulations

The current service regulations do not specifically address contingent-payment arrangements.

2. Proposed Regulations

Proposed Reg. §1.482-9(i) provides guidance on the treatment of contingent-payment arrangements. The Proposed Regulations provide that the Service may impute a contingent-payment arrangement under the principles set forth in Treas. Reg. §1.482-1(d)(3)(ii)(B) (discussed in section II.C.1, above).¹⁷ In addition, the Proposed Regulations provide that if certain conditions are satisfied, the Service will respect a taxpayer’s contingent-payment arrangement.

In order for a contingent-payment compensation arrangement to be respected by the Service, it must withstand the two-pronged analysis of Prop. Treas. Reg. §1.482-9(i). First, the arrangement is tested to determine whether the terms of the arrangement have economic substance (the “Economic Substance

¹⁷ Prop. Treas. Reg. §1.482-9(i)(3).
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Requirement”).¹⁸ If the arrangement has economic substance, the Service will then consider whether the amount charged under the arrangement is arm’s length (the “Arm’s Length Requirement”).¹⁹

a) Economic Substance Requirement

The Proposed Regulations create a two-pronged test to determine whether a contingent-payment arrangement meets the Economic Substance Requirement. The first prong of this analysis is whether the arrangement qualifies as a “contingent-payment arrangement” -- which requires that:

1. The arrangement must be set forth in a written contract entered into prior to the start of the activity or group of activities constituting the controlled services transaction (the “Written Agreement Requirement”).²⁰
2. The written contract must state that payment is contingent (in whole or in part) upon the happening of a future benefit for the recipient that is directly related to the controlled services transaction (the “Written Nexus Requirement”).²¹
3. The written contract must provide for payment on a basis that reflects the recipient’s benefit from the services rendered and the risks borne by the renderer (the “Written Basis for Payment Requirement”).²²
4. The conduct arising from the Written Nexus Requirement must be evaluated based on all the

¹⁸ See Prop. Treas. Reg. §1.482-9(i)(1) and (2).

¹⁹ See Prop. Treas. Reg. §1.482-9(i)(4).

²⁰ Prop. Treas. Reg. §1.482-9(i)(2)(i); *cf.* Treas. Reg. §1.482-1(d)(3)(iii)(B) (“An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance.”) (emphasis added).

²¹ Prop. Treas. Reg. §1.482-9(i)(2)(ii).

²² Prop. Treas. Reg. §1.482-9(i)(2)(iii).

facts and circumstances (the “Nexus Conduct Requirement”).²³

5. The conduct arising from the Written Basis for Payment Requirement must be evaluated based on all the facts and circumstances (the “Basis for Payment Conduct Requirement”).²⁴

Once an arrangement qualifies as a “contingent-payment arrangement,” it still must pass the following test: Whether uncontrolled parties operating under similar conditions would reasonably adopt a similar contingent consideration payment arrangement (the “Similar Arrangement Test”).²⁵

b) Arm’s Length Requirement

Once the economic substance of a contingent-payment arrangement is recognized, Prop. Treas. Reg. §1.482-9(i)(4) provides that the amount charged in the contingent-payment arrangement must then be evaluated to determine whether it satisfies the Arm’s Length Requirement.

3. Recommendations

a) Clarification as to the interaction between the Written Agreement Requirement set forth in Prop. Treas. Reg. §1.482-9(i)(2)(i) and the proposed economic substance rules set forth in Prop. Treas. Reg. §1.482-1(d)(3)(ii)(C).

The Written Agreement Requirement is consistent with Treas. Reg. §1.482-1(d)(3)(ii)(B)(2) which allows the Service, “[i]n the absence of a written agreement,” to impute a contractual agreement between controlled taxpayers consistent with the economic substance of their arrangement. Thus, we believe this is an appropriate requirement, at least where there is ambiguity as to the nature of the controlled party relationship. However, while the lack of a written agreement may allow the Service to initially disregard a contingent-payment arrangement, we believe that, under Prop. Treas. Reg. §1.482-1(d)(3)(ii)(C), the taxpayer may, in absence of a written agreement, present facts to demonstrate that a contingent-payment arrangement best reflects the economic substance of

²³ *Id.*

²⁴ *Id.*

²⁵ Prop. Treas. Reg. §1.482-9(i)(1).

the underlying transaction.²⁶ If this is not a proper interpretation of Prop. Treas. Reg. §§1.482-1(d)(3)(ii)(C) and 1.482-9(i)(2)(i), this point should be clarified and explained.

b) Reasonableness of the Written Nexus Requirement set forth in Prop. Treas. Reg. §1.482-9(i)(2)(ii) as a requirement towards establishing economic substance.

The Written Nexus Requirement mandates a written statement of the nexus between the specified contingency, the benefit for the recipient, and the services provided. In essence, these are the fundamental elements of a contingent payment compensation arrangement. If a purported contingent payment arrangement is reduced to writing, it should contain the elements required by the Written Nexus Requirement. Otherwise, it would appear the Service could question whether the purported contingent payment arrangement was reduced to writing at all. Thus, in our view, this requirement appears to be reasonable.

c) Reconsideration of the Written Basis for Payment Requirement set forth in Prop. Treas. Reg. §1.482-9(i)(2)(iii) as a requirement towards establishing economic substance

Under the Written Basis for Payment Requirement, the written contract must provide for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.²⁷ As demonstrated by Prop. Treas. Reg. §1.482-9(i)(5), Example 1 ("Proposed Example 1"), whether the Basis for Payment Conduct Requirement is satisfied is a factual question. Thus, determining whether a written contract sets forth sufficient facts to establish that this requirement has been satisfied becomes a highly subjective inquiry. We fear that whether this test is satisfied will be based on whether there are sufficient background recitals in the contract and whether the exhibits to the contract provide sufficient background economic information with respect to the controlled parties and their risks and functions. The Service has the right to examine whether the Basis for Payment Conduct Requirement has been satisfied under both existing Treas. Reg. §1.482-1(d)(3)(ii)(B) and Prop. Treas. Reg. §1.482-9(i)(2)(iii). Thus, we think that requiring that this test be reduced to

²⁶ Prop. Treas. Reg. §1.482-1(d)(3)(ii)(C), Examples 3, 4 and 5. These examples are discussed in section II.C.2, 3 above.

writing adds very little for the Service, but creates significant risk for uninformed or unsophisticated taxpayers. Thus, we believe that the Written Basis for Payment Requirement should be eliminated.

d) Clarification of the Conduct Requirements set forth in Prop. Treas. Reg. §1.482-9(i)(2)(iii).

In addition to the three items that must be included in the contract, Prop. Treas. Reg. §1.482-9(i)(2)(iii) sets forth the Nexus Conduct Requirement (i.e., whether the specified contingency bears a direct relationship to the controlled services transaction). Similarly, Prop. Treas. Reg. §1.482-9(i)(2)(iii) also sets forth the Basis for Payment Conduct Requirement (i.e., whether the basis for payment reflects the recipient's benefit and the renderer's risk). We believe that these requirements are appropriate, as the Service would have the right to evaluate the economic substance of the arrangement under Treas. Reg. §1.482-1(d)(3)(ii)(B).

Although we believe it is appropriate to have the Nexus Conduct Requirement and the Basis of Payment Conduct Requirement, we think that the presentation of these requirements in Prop. Treas. Reg. §1.482-9(i)(2)(iii) and Example 1 is confusing. In particular, the Written Nexus Requirement is set forth in Prop. Treas. Reg. §1.482-9(i)(2)(ii), yet the Nexus Conduct Requirement appears in Prop. Treas. Reg. §1.482-9(i)(2)(iii). Further complicating the situation is the fact that both the Written Basis for Payment Requirement and the Basis for Payment Conduct Requirement are also set forth in Prop. Treas. Reg. §1.482-9(i)(2)(iii). In the interest of clarity, we suggest that the Nexus Conduct Requirement in Prop. Treas. Reg. §1.482-9(i)(2)(iii) be moved to Prop. Treas. Reg. §1.482-9(i)(2)(ii).

Further confusing the presentation of the Nexus Conduct Requirement and the Basis for Payment Conduct Requirement, Prop. Treas. Reg. §1.482-9(i)(2)(iii) also provides that, “[p]ursuant to §1.482-1(d)(3)(ii)(B), one factor that is especially important is whether the contingency and the basis for payment are consistent with the economic substance of the controlled transaction and the conduct of the controlled parties (emphasis added).” It is not clear to us whether this last sentence in Prop. Treas. Reg. §1.482-9(i)(2)(iii) is intended to clarify that the Nexus Conduct Requirement and the Basis for Payment Conduct Requirement should be evaluated under Treas. Reg. §1.482-1(d)(3)(ii)(B), as the prior sentence merely refers to a consideration of “all the facts and circumstances” or whether this is intended to impose an overall analysis of the

transaction under the economic substance requirement of Treas. Reg. §1.482-1(d)(3)(ii)(B).

As noted, we believe that the Service has the authority under existing Treas. Reg. §1.482-1(d)(3)(ii)(B) to examine the economic substance of a purported contingent-payment arrangement. However, we believe this should be stated in a separate subparagraph, whether included in a new subdivision or in the flush language of that subparagraph.

If, as we have suggested, the Written Basis for Payment Requirement is eliminated, we believe it would be appropriate, although in our view not necessary, to state that the Basis for Payment Conduct Requirement will be considered as part of the overall analysis of the economic substance of the arrangement.

e) Elimination of the requirement of demonstrating uncontrolled taxpayers engaging in similar transactions under similar circumstances (Similar Arrangement Test) set forth in Prop. Treas. Reg. §1.482-9(i)(1).

To meet the Economic Substance Requirement, an arrangement must pass the Similar Arrangement Test. As discussed above, the Similar Arrangement Test addresses whether uncontrolled parties operating under similar conditions would reasonably adopt a similar contingent-payment arrangement.²⁸ We believe this test, which is set forth in both sentences of Prop. Treas. Reg. §1.482-9(i)(1), is in essence a blend of the “contingent-payment arrangement” determination and the Arm’s Length Requirement. Thus, we do not believe it adds to the analysis in Prop. Treas. Reg. §1.482-9(i). Moreover, since it is set forth in a separate subparagraph, we believe it could be interpreted by taxpayers, the Service and the courts as having some independent significance. For example, the Service may assert that comparable taxpayers would not enter into a particular type of contingent contract research arrangement, as the Service could not identify similar comparable uncontrolled transactions. However, the fact that no comparable uncontrolled transactions can be identified goes to the method used to establish an arm’s length charge, not to whether the arrangement can be disregarded altogether. If our recommendation is accepted, any inference that there is an independent Similar Arrangement Test in Proposed Example 1 and Proposed Example 2 would no longer be necessary.

²⁸ Prop. Treas. Reg. §1.482-9(i)(1).
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f) Modification of the Arm's Length Requirement set forth in Prop. Treas. Reg. §1.482-9(i)(4).

Once the economic substance of a contingent-payment arrangement is recognized, Prop. Treas. Reg. §1.482-9(i)(4) provides that the amount charged in the contingent-payment arrangement must then be evaluated to determine whether it is arm's length.²⁹ We believe the statement of the Arm's Length Requirement in Prop. Treas. Reg. §1.482-9(i)(4) and the application of that test in Proposed Example 1 and Proposed Example 2 are reasonable. However, we believe the second sentence of Prop. Treas. Reg. §1.482-9(i)(4) should be eliminated. This sentence provides as follows:

Payment under a contingent-payment contract must be reasonable and consistent with the economic substance of the controlled services transaction, based on all facts and circumstances, and must reflect the recipient's benefit from the services rendered and the risks borne by the renderer.

We are concerned that this sentence blends the Economic Substance Requirement and the Arm's Length Requirement. While the economic risks and functions of the parties clearly impact the analysis of whether the amount charged in a contingent-payment arrangement is arm's length, the general reference to Prop. Treas. Reg. §1.482-9(i) and "applicable rules under [s]ection 482" is sufficient to incorporate those concepts into the Arm's Length Requirement. Thus, we don't believe the sentence materially adds to the analysis under Prop. Treas. Reg. §1.482-9(i)(4). Moreover, we believe that taxpayers, the Service and the courts may interpret this sentence as having some independent significance.

III. Services Transactions Involving Intangible Property

A. Current Regulations

Under the current section 482 regulations, an intangible asset must have "substantial value independent of the services of any individual . . ." ³⁰ This language presumes a close relationship between services rendered and any intangibles transferred, although it must be recognized that services create

²⁹ Prop. Treas. Reg. §1.482-9(i)(4).

³⁰ Treas. Reg. §1.482-4(b).

intangible property. Where transferred intangible property has substantial value independent of the services provided, the transaction will be characterized under the intangible property regulations of Treas. Reg. 1.482-4, and services provided outside the transfer of intangible property may be subject to a separate services charge. If there is no substantial independent value, then the transaction will be characterized as a service.

Where services are rendered in connection with a transfer of intangible property, no separate allocation for services is required if the services are ancillary and subsidiary to the intangible property transfer.³¹ Examples of ancillary and subsidiary services include the demonstration and use of the property transferred, assistance in the start-up use of the property transferred, and performance under a guarantee relating to the start-up use of property.³² The continuing provision of services after the intangible property has been integrated into a licensee's operations, however, would require a separate allocation for services.³³

The current section 482 regulations fail to provide any guidance as to the considerations for determining whether a service transfers an intangible that has a separate and distinct value apart from the services performed. In addition, the 1988 White Paper (citing the experience of international examiners) criticized the current services regulations for failing to provide adequate guidance as to whether services provided in connection with an intangible property transfer require a separate services charge.³⁴

B. Proposed Regulations

The Treasury and the Service's stated goal is to evaluate economically similar transactions, in particular, transactions that affect a transfer of intangible property, in a consistent manner under the transfer pricing regulations. Prop. Treas. Reg. §1.482-9(m)(2) sets out three types of controlled services transactions that may affect a transfer of intangible property:

- 1) services transactions that result in a transfer, in whole or in part, of intangible property;

³¹ Treas. Reg. §1.482-2(b)(8).

³² Id.

³³ Id.

³⁴ Notice 88-123, 1988-2 C.B., 458, 463 n. 58, at 466.

- 2) services transactions that may have an effect similar to the transfer of intangible property; and
- 3) services transactions that may include an element that constitutes the transfer of intangible property.

Under this section of the Proposed Regulations, “[i]f such element relating to intangible property is material to the evaluation, the arm’s length result for the element of the transaction that involves the intangible property **generally must be** corroborated or determined by an analysis under Reg. Section 1.482-4.”³⁵ Although this section of the Proposed Regulations does not set an absolute requirement, as a practical matter, an intangible property analysis will be required.

C. Recommendations

1. Application of the “commensurate with income standard” in the absence of an identifiable transfer of an intangible asset is an overbroad application of such standard.

Treasury and the Service cannot require the application of the commensurate with income standard in the absence of an identifiable transfer of an intangible asset under an arrangement that exceeds one year.³⁶ Section 482 requires that “in the case of any transfer (or license) of intangible property ...the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.” Requiring the application of Treas. Reg. §1.482-4 to a transaction that is characterized appropriately as a service by the taxpayer and by comparable companies, we believe, goes beyond the dictates of the statute.

Under the Proposed Regulations, the Service can find an intangible element in many services transactions and may argue that such an element is material to the evaluation. It will be difficult for a taxpayer to argue the element is not material to the evaluation without performing the intangible property analysis under Treas. Reg. §1.482-4. Artificially bifurcating integrated transactions through the identification of “intangible elements” will increase taxpayer uncertainty regarding the treatment of controlled services transactions,

³⁵ Prop. Treas. Reg. §1.482-9(m)(2) (emphasis added).

³⁶ See Treas. Reg. §1.482-4(f)(2)(i).

controversies with the Service, and probability of double taxation of income because treaty partners are not likely to analyze such transactions in a similar fashion.

2. Clarification of the distinction between the “material” standard set forth in Prop. Treas. Reg. §1.482-9(m)(2) and the well-established “substantial” standard of Treas. Reg. §1.482-4(b).

Under the current section 482 regulations, an intangible asset must have "substantial value independent of the services of any individual . . ."³⁷ The Preamble to the 1994 regulations noted that the intangible asset definition was similar to that provided in the 1968 regulations.³⁸

Although it is less than clear, the “material” standard in Prop. Treas. Reg. §1.482-9(m)(2) could be interpreted as overlaying a lower standard onto the higher substantial standard of Treas. Reg. §1.482-4(b). Intangible property that does not have substantial value independent of the services of any individual is not intangible property for purposes of section 482.³⁹ Therefore, such property should never be “considered material to the evaluation” under the language of Prop. Treas. Reg. §1.482-9(m)(2) such that it is treated as if it were intangible property subject to the commensurate with income rule. We recommend that the Proposed Regulations be modified to make clear that the substantial standard of Treas. Reg. §1.482-4(b) must be met before the material standard in Prop. Treas. Reg. §1.482-9(m)(2) even comes into play.

3. Review of the “material” standard under the Proposed Regulations.

In our opinion, the “material” standard included in the Proposed Regulations is vague. Instead, a more objective standard in which we suggest the Proposed Regulations are modified to provide that the characterization and corresponding treatment of controlled services transactions be evaluated based on comparable uncontrolled transactions. If uncontrolled transactions are identified that are

³⁷ Treas. Reg. §1.482-4(b).

³⁸ 59 Fed. Reg. 34971, 34983 (July 8, 1994).

³⁹ Treas. Reg. §1.482-4(b) (“For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual...”).

comparable to the controlled transactions, then the controlled transactions would be characterized and treated in the same manner.

This analysis would require a facts and circumstances-based comparison of similar transactions by uncontrolled parties. Specifically, if a taxpayer can demonstrate that third parties use similar intangibles in providing similar services to unrelated parties without accounting for the intangibles component separately, the taxpayer would be able to treat the transaction wholly as a service. Further, if a taxpayer can show that third parties routinely engage in similar integrated transactions without separately licensing or otherwise formally transferring any involved intangibles, the taxpayer would not have to bifurcate its integrated transactions with controlled affiliates.

For this limited purpose of characterization and treatment, the comparable uncontrolled transactions identified need not meet either the standards of the comparable uncontrolled services price (CUSP) method or the comparable uncontrolled transaction (CUT) method. The purpose of this analysis is not necessarily to determine pricing based on the transactions identified, but instead to determine general comparability for characterization purposes. This is important given the high standards the Service has set in order to apply the CUSP and CUT methods.⁴⁰

For purposes of the best method rule under Treas. Reg. §1.482-1(c) and transfer pricing penalty purposes under Treas. Reg. §1.6662-6, we recommend that identification of generally comparable uncontrolled transactions and characterization of its controlled transactions similarly by a taxpayer should result in compliance. . For example, if a taxpayer has identified comparable uncontrolled services transactions, the taxpayer should be presumed correct with respect to characterization. In such case a taxpayer would not need to consider applying methods and concepts applicable to the transfer of intangible property (e.g., periodic adjustment rules), and also would not need to consider intangible property methods as potentially applicable methods in applying the best method rule and for purposes of the specified method requirement of Treas. Reg. §1.6662-6(d)(2)(ii). After characterization is established, the taxpayer would apply the best method rule consistent with the presumed characterization to determine the arm's length price.

⁴⁰ See section IV.C.1 with our concerns that the CUSP standard is set too high and our recommendation to remedy the proposed language.

4. Clarification of Proposed Treas. Reg. §1.482-9(m)(2) to dispel any inference that all material intangible elements in a controlled services transaction must be separately evaluated.

In our opinion, the regulations should clarify the relationship between the general rule in Prop. Treas. Reg. §1.482-9(m)(1) as to the evaluation of controlled services transactions that include non-service elements and the directive in Prop. Treas. Reg. §1.482-9(m)(2) that the arm's length result for a controlled services transaction that contains, as a material element, a transfer of intangible property or an economically equivalent element "generally must be corroborated or determined by an analysis under §1.482-4." To the extent that this directive would require a separate evaluation of the intangible element whenever such element is material to the overall transaction, it seems inconsistent with Prop. Treas. Reg. §1.482-9(m)(1), which states that "the separate elements [of an integrated transaction] need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables" We believe that the standard set forth in Prop. Treas. Reg. §1.482-9(m)(1), by giving effect to actual comparable uncontrolled arrangements, is more consistent with the arm's length principle and that any inference that a different standard applies when a material intangible element is present in a controlled services transaction should be dispelled.

IV. Transfer Pricing Methods for the Provision of Services

A. Current Regulations

The current services regulations are not integrated with the balance of the section 482 Regulations, such as the "best method rule" and comparability standards delineated in the section 482 Regulations (understandably so, since they predated the balance of the section 482 Regulations by 26 years). Moreover, the current services regulations do not set forth specific methods for determining the arm's length charge for intercompany services.

See Simplified Cost-Based Method in section V below for a discussion of the cost safe harbor in the current regulations.

B. Proposed Regulations

The Proposed Regulations improve on existing guidance by explicitly incorporating the arm's length standard, the "best method rule," the comparability factors of Treas. Reg. §1.482-1(d), as well as the arm's length range principle of Treas. Reg. §1.482-1(e).⁴¹ In this context, the Proposed Regulations seek to present a consistent set of overarching principles applicable to all related party transactions, including services transactions. We commend this improvement.

The Proposed Regulations reference six specified methods that may be used to price intercompany services.⁴² Those methods are: (1) the comparable uncontrolled services price method, (2) the gross services margin method, (3) the cost of services plus method, (4) the simplified cost-based method, (5) the CPM, and (6) the profit split method. The first three of these methods are generally analogous to the current specified methods for transfers of tangible property (*i.e.*, the CUP Method,⁴³ the resale price method,⁴⁴ and the cost plus method⁴⁵).

The Simplified Cost-Based Method is the intended replacement for the "cost safe harbor" of the existing services regulations. That important change in approach is discussed separately in section V, below. The six defined methods provide needed guidance to taxpayers currently using methods applicable to property transactions to evaluate their intercompany services transactions.

C. Recommendations

1. CUSP Method

We have some concerns with respect to the stated limitation on the use of the comparable uncontrolled services price ("CUSP") method. The CUSP method is ordinarily used where the controlled services are "identical to, or have a high degree of similarity to" the uncontrolled services.⁴⁶ This standard is arguably higher than the corresponding CUP comparability standards of the current

⁴¹ Prop. Treas. Reg. §1.482-9(a)(1).

⁴² Prop. Treas. Reg. §1.482-9(a).

⁴³ Treas. Reg. §1.482-3(b).

⁴⁴ Treas. Reg. §1.482-3(c).

⁴⁵ Treas. Reg. §1.482-3(d).

⁴⁶ Prop. Treas. Reg. §1.482-9(b)(1).

regulations.⁴⁷ On the other hand, the Proposed Regulations also appear to embrace a looser “no substantial differences” comparability standard in one of the Proposed Examples provided for guidance.⁴⁸ We believe the “no substantial differences” standard enunciated in Proposed Example 1 of Prop. Treas. Reg. §1.482-9(b)(4) strikes the correct balance, in that there is no clear policy justification to introduce a heightened standard of comparability for intercompany services than would apply to other intercompany transactions.

2. Cost of Services Plus Method

a) CPM Check

The Proposed Regulations provide that, because functional differences between uncontrolled and controlled service providers may not be reflected in comparable transactional costs, but may become apparent only after a comparison of total services costs, “it may be necessary” for taxpayers using the cost of services plus method to check functional comparability by expressing the results obtained under that method as a markup on total services costs.⁴⁹

Unfortunately, this admonition may have the unintended effect of reading the cost of services plus method out of the Proposed Regulations, or at least of making it a relatively burdensome method to apply. Although, as a general rule, the convergence of results under two or more transfer pricing methods is an indication of the reliability of the results under each method,⁵⁰ for no other method specified under the section 482 Regulations is there a directive to test results under a second method. Thus, taxpayers considering employing the cost of services plus method may well eschew use of such method for fear that they will always have their results second-guessed under a CPM analysis, regardless of whether such analysis is in fact more likely to yield a reliable indicator of an arm's length result. In fact, the markup on total services costs is not a particularly reliable indicator of an arm's length result where the differences in the levels of total services costs other than comparable transactional costs is due to differences in indirect costs -- such as different levels of overhead or non-

⁴⁷ Compare Prop. Treas. Reg. §1.482-9(b)(1) (“identical to or have a high degree of similarity...”) with Treas. Reg. §1.482-1(d)(2) (general standard of comparability is “sufficiently similar”), and Treas. Reg. §1.482-3(b) (CUP method comparability standard requires “similarity of products”).

⁴⁸ Prop. Treas. Reg. §1.482-9(b)(4) Example 1; see, also, Prop. Treas. Reg. §1.482-9(b)(2)(i) (referring to the looser comparability standards of Treas. Reg. §1.482-1(d)).

⁴⁹ Prop. Treas. Reg. §1.482-9(d)(3)(ii)(A).

⁵⁰ See Treas. Reg. §1.482-1(c)(2)(iii).

operational efficiency -- that have no bearing on the specific resources brought to bear in providing the relevant services.⁵¹

We note that this type of CPM verification is reminiscent of the mandatory confidence profit interval check included in the 1992 proposed transfer pricing regulations,⁵² which was widely criticized by commentators at that time and not included either in the 1993 temporary regulations or the 1994 regulations.⁵³

b) Comparable Transactional Costs

The cost of services plus method depends on the identification of "comparable transactional costs" and the markup of those costs by the appropriate gross services profit markup, which is derived from the results of comparable uncontrolled transactions. For this purpose, the Proposed Regulations describe "comparable transactional costs" as the cost of providing the controlled services being evaluated. No comprehensive definition of comparable transactional costs is provided; instead, such costs must be determined in a manner that permits comparison with costs incurred in comparable uncontrolled transactions, based on the available data for such transactions. The Proposed Regulations suggest that, ordinarily, comparable transactional costs include all compensation paid to employees directly involved in the performance of the services, the cost of supplies and materials consumed or made available in connection with such performance, "and other costs of rendering the services."⁵⁴

It appears that the definition of comparable transactional costs, which makes no mention of indirect costs, is designed to capture only the direct costs of providing services. However, the Proposed Regulations make clear that the overriding principle governing the determination of comparable transactional costs is that they be calculated so as to "facilitate comparison with the comparable uncontrolled transactions." Thus, the Proposed Regulations note that, although

⁵¹ See Treas. Reg. §1.482-5(c)(2)(iii).

⁵² 1992 Prop. Treas. Reg. §1.482-2(d)(5), 57 Fed. Reg. 3571, 3583 (Jan. 30, 1992). Under the 1992 Proposed Regulations most methods were required to be verified by the confidence profit interval ("CPI").

⁵³ See Preamble to the 1993 Temporary section 482 regulations, 58 Fed. Reg. 5263, 5265 (Jan. 21, 1993) and Preamble to the 1994 section 482 regulations, 59 Fed. Reg. 34971, 34972 (July 8, 1994).

⁵⁴ Prop. Treas. Reg. §1.482-9(d)(2)(iii).

GAAP and federal income tax accounting principles "may provide useful guidance," they do not conclusively establish the relevant cost base.

The guidance for determining controlled transactional costs appears to be unnecessarily cryptic. By not articulating any firm principle governing the calculation of such costs -- other than the need to facilitate comparison with comparable uncontrolled transactions -- the Proposed Regulations may leave taxpayers and the Service with no basis for agreement as to what is the most appropriate cost base in applying the cost of services plus method. A literal reading of the Proposed Regulations would seem to permit taxpayers or the Service to select as the appropriate cost base under this method any group of cost categories, irrespective of how narrow or broad, as long as the categories chosen were common to the taxpayer and the comparable uncontrolled service renderers. Thus, we believe the Proposed Regulations would not give taxpayers any degree of certainty as to whether their calculation of controlled transactional costs will be sustained, would give the Service undue discretion in challenging taxpayers' calculation of such costs, and could imply that taxpayers must generate a completely separate set of cost records solely to satisfy the requirements of the cost of services plus method.

Because the cost of services plus method appears to be intended to evaluate controlled services transactions based on a comparison with the returns from the resources directly employed in comparable uncontrolled transactions (adjusted to take into account differences in risks), the regulations should set forth the principle that controlled transactional costs encompass all direct costs incurred in rendering those services. The regulations should further provide that, for this purpose, the starting point for determining such costs is direct costs as determined for GAAP (or, if such information is available for comparable uncontrolled transactions, federal income tax accounting). Governing principles as to when modifications to GAAP or federal tax accounting principles would then be required or appropriate to more reliably reflect the cost base on which the arm's length return is to be determined.

3. Profit Split Method and Residual Profit Split Method

The Proposed Regulations provide guidance regarding the application of the comparable profit split and the residual profit split methods to controlled services transactions. The Proposed Regulations generally retain the guidance in the existing regulations at §1.482-6; however, Proposed Regulation §1.482-9(g) provides specific guidance on the application of §1.482-6 in the context of

controlled services transactions. For example, the Proposed Regulations amend the residual profit split method to divide residual profits based on the relative value of each taxpayer's "nonroutine contributions" rather than the "contributions of intangible property" under the current regulations.⁵⁵ "Non-routine contributions" are defined as contributions by controlled taxpayers that cannot be accounted for by reference to market returns, or that are so interrelated with other transactions that the contributions cannot be reliably evaluated on a separate basis.⁵⁶

The Proposed Regulations regarding the application of the profit split method are not particularly controversial. However, in our opinion, what is controversial is how easily the Proposed Regulations appear to dictate a profit split analysis, particularly the residual profit split method. The Proposed Regulations provide at least four ways to determine that the profit split method (particular the residual profit split method) is appropriate when controlled services transactions involve:

- Contributions to the value of an intangible owned by another.⁵⁷
- High-value services.⁵⁸
- Transactions that are highly integrated and cannot be reliably evaluated on a separate basis.⁵⁹
- Contingent-payment contractual terms for services.⁶⁰

We believe the proposed broad application of the residual profit split method is likely to significantly increase compliance costs for taxpayers, as the application of the profit split method is considerably more complex and expensive for taxpayers, when compared with the other methods. Application of the residual profit split method requires an allocation of the combined operating profit or loss from the relevant business activity between controlled taxpayers according to a two-step process. Operating income is first allocated to each controlled taxpayer

⁵⁵ The current regulations provide for a division of residual profit based upon relative value of each taxpayer's contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. See §1.482-6(c)(3)(i)(B).

⁵⁶ See Prop. Treas. Reg. §1.482-6(c)(3)(i)(B).

⁵⁷ See Prop. Treas. Reg. §1.482-4(f)(4), examples 2, 3, and 5.

⁵⁸ See Prop. Treas. Reg. §1.482-9(g)(1).

⁵⁹ Id.

⁶⁰ See Prop. Treas. Reg. §1.482-9(i)(1) and (i)(4).

to provide a market return for its routine contributions to the relevant business activity. The residual profit then is dividend among the controlled taxpayers based on the relative value of each taxpayer's "non-routine contributions".⁶¹ Essentially, the residual profit split method requires a CPM analysis applied to one tested party, another CPM analysis applied to the other tested party, and then a very complex economic analysis to value the "non-routine contributions" of each of the parties. Compared to the other methods, the economic analysis required under the residual profit split method is extensive. Further, the strong preference for the residual profit split method for controlled services transactions evidenced in the Proposed Regulations can be expected to greatly increase compliance costs and complexity for taxpayers. This preference appears unnecessary and should be eliminated from the final services regulations.

A further practical by-product of the proposed application of the residual profit split method to services transactions is the inherently subjective nature of a determination regarding the existence and relative value of asserted "nonroutine contributions." Prop. Treas. Reg. §1.482-9(g)(2), Proposed Example 2 demonstrates the potential for such subjective determinations. In that Example, Company A is a U.S. multinational engaged in mineral exploration, development and extraction/mining. Company B is a controlled U.S. subsidiary that provides general construction contracting services. Company C, a controlled Country C subsidiary of Company A, enters into an agreement with the government of Country C pursuant to which it obtains underground oil drilling rights on land Company C already owns. Company C then contracts with Company A for management services, and with Company B for equipment leasing and contract oilfield services. The Example concludes that Companies A, B, and C each make nonroutine contributions and proceeds to employ the residual profit split method.

From the text of the Example, one may not fairly infer that either the parent (Company A) or Company B, its U.S. contract construction services subsidiary, is transferring intangible property to Company C. While one cannot be certain from the statement of facts, it appears that Company C has assumed all of the contractual risks associated with its acquisition of drilling rights from the government of Country C. That is, C appears to be the "designated risk-taker." In such case, it is appropriate that Company A and Company B are entitled to a services return that fairly rewards each for its expertise and efforts. That said,

⁶¹ See Prop. Treas. Reg. §1.482-6(c)(3)(i)(B) and Treas. Reg. §1.482-6(c)(3).
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absent further facts suggesting the parties intended a joint venture, we would suggest that the use of a residual profit split method to analyze the intercompany transactions in Proposed Example 2 is unwarranted.⁶²

V. Simplified Cost Based Method

A. Current Regulations

The current regulations allow service renderers to charge the cost of services rendered for the benefit of related parties with no markup, provided such services are not “integral” to the business operations of either the service renderer or the recipient under the following four scenarios:

- The renderer or the recipient of the service is engaged in the trade or business of rendering or providing similar services to unrelated parties;⁶³
- The renderer provides services to one or more related parties as one of its principal activities;⁶⁴
- The renderer is “peculiarly capable” of rendering the services, the value of such services is substantially in excess of the cost of rendering them, and such services are a principal element in the operations of the recipient,⁶⁵ and

⁶² Compare the following language from the Preamble to the current §482 Regulations, which, we would submit, reflects the appropriate deference to be accorded related party contractual risk allocation:

“[T]o the extent that taxpayers allocate risks by contract and their conduct is consistent with such contract, their allocation of risk will be respected, unless the contract is executed after the impact of the risk is known or knowable.”

59 Fed. Reg. 34971, 34978 (July 8, 1994).

⁶³ Treas. Reg. §1.482-2(b)(7)(i).

⁶⁴ It is presumed that the renderer does not provide services to related parties as one of its principal activities if the cost of services provided to related parties during the taxable year does not exceed 25 percent of the total costs of the renderer for the taxable year. If the renderer fails the 25 percent test, the determination is based on the facts and circumstances.

⁶⁵ For example, when the renderer makes use of a particularly advantageous situation or circumstance, such as an influential relationship with customers or use of its intangible property. The renderer is not considered peculiarly capable, however, unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to the services. Treas. Reg. §1.482-2(b)(7)(iii).

- The recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year.⁶⁶

If the services provided conform to any of these four scenarios, those services are considered integral and must include a profit markup. For services other than those considered to be integral, an arm's length charge is deemed to be equal to the costs or deductions incurred for such services, unless the taxpayer establishes a more appropriate charge.⁶⁷

B. Proposed Regulations

We believe the proposed replacement of the cost only safe harbor with the simplified cost-based method would have a sweeping impact on taxpayers. The current regulations reduce administrative and compliance burdens by allowing taxpayers to charge or be charged costs without markup on controlled services that are not "integral" to the service renderer's or the recipient's business. The Proposed Regulations replace the cost only safe harbor with the new simplified cost-based method to provide "appropriately reduced administrative and compliance burdens," compared to other methods while "safeguarding against the inappropriate application of the simplified method to services that should be subject to a more robust arm's length analysis."⁶⁸ Unfortunately, the simplified method does not reduce these administrative or compliance burdens compared to other methods; instead, the simplified method requires taxpayers to expend considerably more effort while producing less benefit with more exposure than the current cost-only safe harbor.

The new simplified method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the markup on total services costs by uncontrolled taxpayers that engage in similar business activities. The simplified method attempts to reduce administrative and compliance burdens by limiting the Service's ability to make an adjustment. The thresholds for adjustment are determined on a sliding scale based on the level of the actual markup the taxpayer charged in the controlled services transaction. If the arm's length markup is less than the minimum arm's length markup (which is defined

⁶⁶ Generally, if the costs or deductions of the renderer that are directly or indirectly related to the services exceed an amount equal to 25 percent of the total costs or deductions of the recipient for the taxable year, a substantial amount of services are considered to have been received. Treas. Reg. §1.482-2(b)(7)(iv).

⁶⁷ Treas. Reg. §1.482-2(b)(3).

⁶⁸ Preamble to Proposed Regulations, 68 Fed. Reg. 53448, 53453 (Sept. 10, 2003).

as the sum of the markup actually charged by the taxpayer and the applicable number of percentage points), the Service cannot make an adjustment. If the taxpayer satisfies the simplified method test, the simplified method would be considered the best method.⁶⁹

Under the simplified cost-based method, the minimum arm's length markup is measured by the sum of the markup charged by the taxpayer and an applicable number of percentage points determined by Prop. Treas. Reg. §1.482-9(f)(2)(ii). The applicable number of percentage points is six if the taxpayer charges cost only, and declines by one percentage point for every two percentage points of taxpayer markup. The safe harbor created by this simplified method, expressed in the following table, may not be used if the arm's length markup exceeds 10 percent or is less than zero .

Markup Under Simplified Method⁷⁰

Markup charged by taxpayer	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%
Applicable number of percentage points	6	5.5	5	4.5	4	3.5	3	2.5	2	N/A
Arm's length markup necessary for allocation by IRS	6%	6.5%	7%	7.5%	8%	8.5%	9%	9.5%	10%	10%

A substantial number of conditions and requirements must be met if a taxpayer is to qualify for the simplified method. In effect, these conditions are a “substitute for a best method analysis.”⁷¹

The simplified method would not apply to situations whereby the amount charged by the taxpayer is less than related total service costs, or the markup used in the taxpayer's controlled services transaction exceeds the arm's length markup.⁷²

As a condition to using the simplified method, a taxpayer is required to maintain records regarding the determination and allocation of total costs and, subject to a

⁶⁹ Prop. Treas. Reg. §1.482-9(f)(1)(ii).

⁷⁰ Prop. Treas. Reg. §1.482-9(f)(2)(iv).

⁷¹ Preamble to the Proposed Regulations, 68 Fed. Reg. 53448, 53452 (Sept. 10, 2003).

⁷² Prop. Treas. Reg. §1.482-9(f)(2)(v).

de minimis exception, have a written contract in place that dictates the charges for the provision of services.⁷³

The Proposed Regulations also provide that certain services transactions are ineligible for the simplified method, including:

- Services similar to services rendered by either the provider or the recipient to uncontrolled parties;
- Services rendered to a recipient that receives services from controlled taxpayers in significant amounts;
- Services involving the use of valuable or unique intangibles;
- Non-services transactions that are included in integrated transactions; and
- Specifically identified categories of transactions, including manufacturing, production, extraction, construction, reselling, distribution, acting as a sales agent, or acting under a commission or other similar arrangement, research, development or experimentation, engineering or scientific, financial transactions including guarantees, and insurance or reinsurance.⁷⁴

C. Recommendations

1. Shared services qualifying as nonintegral services under the current regulations are not profit generating activities.

The Proposed Regulations seem to view all services, even shared services qualifying as nonintegral services under the current regulations, as profit generating activities; however, in reality this is often not the case. Shared services are most often provided by a related party for legitimate business reasons.

For example, the consolidation of services within a particular affiliate is frequently done to save costs (e.g., via location savings, economies of scale, etc.). Such affiliates are properly viewed by multinational enterprises as cost centers, not

⁷³ Prop. Treas. Reg. §1.482-9(f)(3), including the de minimis discussion.

⁷⁴ Prop. Treas. Reg. §1.482-9(f)(4).

profit centers. The service provider's benefit from participation in such an arrangement is merely a pro rata reduction in the costs allocable to its own operation. From the standpoint of a services recipient, we believe it is inappropriate for the Proposed Regulations to assign all the value of such cost savings to one single affiliate (i.e., the service provider). Most of the "profit element" in such services results from efficiencies of the group as a whole and is not due to the special capabilities of the service provider.

Additionally, many shared services are provided by related parties instead of outside vendors merely to ensure confidentiality and data security.

Such services are intended to be cost saving to all affiliates, not income producing for one services provider. Therefore, we suggest that it is not appropriate to include a profit margin associated with the performance of these intercompany services. Evidence of unrelated taxpayers forming tax-exempt cooperatives that charge members for services at cost also support this view. Such tax-exempt cooperatives are directly analogous to shared services organizations. Thus, shared service organizations, like tax-exempt cooperatives, should also be permitted to charge cost for the provision of such services.

Moreover, controlled shared service recipients have the ability to reduce costs by internalizing service functions. Although outside firms provide similar services for profit, they may charge a higher markup and incur higher overall costs in providing non-integral services than what a related recipient of shared services would be willing to pay. Cost savings is a key reason that services are often provided by related parties instead of by third parties. As discussed in section VIII below, this view is consistent with the benefit rules of the Proposed Regulations, which focus on the benefit to the recipient.

2. A substantial increase in the administrative burden and uncertainty associated with compliance is harmful to U.S. businesses.

In comparison to the existing cost safe harbor, we believe that the requirements imposed by the Proposed Regulations would require taxpayers to undertake a substantial amount of additional work merely to comply with the new complex rules. We think it is doubtful that the additional revenue that would be collected by determining an appropriate arm's length price under the new rules justifies the resulting costs and administrative burdens imposed on taxpayers. Several specific points support this conclusion.

a) Need for clarity and certainty by business planners

Tax regulations should provide sufficiently clear guidance to enable taxpayers to comply with provisions of the Internal Revenue Code. The existing cost safe harbor has provided a certain level of clarity and certainty. However, as drafted, the Proposed Regulations do not provide the same level of clarity and certainty.

Specifically, a taxpayer will not know whether a particular service falls within the simplified cost-based method until (1) determining the referenced uncontrolled mark up percentage, and (2) establishing that the cost base for its services is comparable to the cost base used by the Commissioner for the uncontrolled mark up.

To illustrate, in determining the arm's length markup – which would be required to determine both the eligibility of the transaction for the method and the minimum permissible markup to avoid adjustment -- for each service under the Proposed Regulations, a taxpayer must undertake an analysis of the general transfer pricing rules (i.e., the best method rule). One of the main benefits of the current at cost safe harbor is the elimination of such a time consuming analysis. However, under the simplified cost-based method taxpayers would have to undertake this analysis to ensure they could even use the proposed simplified cost -based method. Further, if the best method is not a net cost-plus CPM, then the best method result would also have to be translated into an arm's length markup on cost. We recommend that revised services regulations provide a true cost safe harbor method for routine services.

b) The Proposed Regulations will likely cause an increase in competent authority cases

In defining tax deductible costs, many countries allow little or no markup on routine services. Thus, the Proposed Regulations' requirement to use various methods to charge services costs will likely cause an increase in competent authority cases under our tax treaties. This increase will add incremental burdens to a competent authority group with an already large number of pending cases.

c) Minor allocation disputes could result in adjustments

Like the current regulations, Prop. Treas. Reg. §1.482-9(f)(2)(v)(B) would provide a reasonableness test for evaluating the allocation of costs. However, troubling examples in the Proposed Regulations indicate relatively minor audit disputes

over allocation methodology may result in adjustments. See Prop. Treas. Reg. §1.482-9(f)(5), Examples 8 and 9. Allocation of costs is discussed in further detail below in section VI.B.

d) We recommend clarification as to the contract requirement in Prop. Treas. Reg. §1.482-9(f)(3)(ii) and the ability to make a voluntary adjustment pursuant to Treas. Reg. §1.482-1(a)(3)

Because the simplified cost-based method requires determining the arm's length markup on total services costs, eligibility for the simplified cost-based method cannot be known until after the close of the taxable year. The contract requirement set forth in Prop. Treas. Reg. §1.482-9(f)(3)(ii) that must be met in order to use the simplified cost-based method requires that the controlled recipient become "unconditionally obligated at the time the renderer incurs costs to pay the renderer an amount equal to total costs plus, to the extent provided in such contract, any markup on total services costs." It is not clear to us whether this requirement would permit a taxpayer to voluntarily adjust its transfer price for services pursuant to Treas. Reg. §1.482-1(a)(3) in order to be within the range of the applicable number of percentage points described in Prop. Treas. Reg. §1.482-9(f)(2)(ii). We recommend that such adjustment be permitted and that Prop. Treas. Reg. §1.482-9(f)(3)(ii) be clarified in this regard.

3. Access to the simplified cost-based method for both inbound and outbound service transactions.

The simplified cost-based method appears to operate only to limit the Service's ability to increase the markup used in a controlled services transaction. Thus, the Service could impose a downward adjustment on the price paid by a taxpayer on an inbound controlled services transaction regardless of the relative size of the adjustment or whether the subject service is considered "low margin". Due to this imbalance of application, a taxpayer that receives and pays for inbound services faces the full administrative and compliance burden of the remainder of the Proposed Regulations, including the best method rule. We believe this result is both unfair and unwarranted. If the simplified cost-based method is retained, we recommend that it be revised to apply in an even-handed fashion. If an alternative to the simplified cost-based method is developed, it should provide equivalent benefits to both inbound and outbound service transactions.

4. Limitation of transactions with uncontrolled taxpayers that render ineligible the use of the simplified cost-based method.

Proposed Treas. Reg. §1.482-9(f)(4)(i) states that the simplified cost based method may not be used when the renderer, the recipient, or another controlled taxpayer in the same controlled group renders, *or has rendered*, similar services to one or more uncontrolled taxpayers (unless such services are rendered on a *de minimis* basis). In applying this limitation on the use of the simplified cost-based method, we recommend that only services provided to uncontrolled taxpayers in the taxable year under review be considered.

5. Reconsideration of the 50% recipient test.

Proposed Treas. Reg. §1.482-9(f)(4)(ii) precludes the use of the simplified cost-based method for services rendered to a recipient receiving services from controlled taxpayers in significant amounts. A recipient is presumed to fall into this exception unless the renderer proves that the aggregate amount paid or accrued by the recipient for all controlled services transactions with respect to such services during a taxable year is less than an amount equal to 50% of the total costs of the recipient.

The regulations appear to apply on a per recipient basis. For example, a taxpayer could provide identical services to two affiliates, one large, the other small. If the smaller affiliate receives services from controlled parties in excess of the 50% threshold, the taxpayer would not be eligible to use the simplified cost-based method with respect to its charges to that small affiliate. Thus, the taxpayer is put in the position of having to charge out identical costs for identical services on two different bases. Moreover, the more successful service recipients are in reducing their operating expenses and/or centralizing services, the more likely they are to run afoul of the 50% limitation. We predict this limitation alone will mean that most, if not all, U.S. multinationals will have no relief from completing annual transfer pricing documentation studies to address the transfer pricing of services provided to subsidiaries that meet or exceed the 50% threshold. In order for U.S. multinational companies to have a meaningfully reduced compliance and administrative burden, we recommend that this limitation be eliminated.

If the 50% test is retained, we recommend the test should be limited to the taxable year under review with special rules to take into account services

recipients with abnormally low costs due to commencement or cessation of operations. See e.g., Treas. Reg. §1.482-2(b)(7)(iv).

6. Improper exclusion of services made more valuable by the use of intangible property

a) Prop. Treas. Reg. §1.482-9(f)(4)(iii), in our opinion, would inappropriately exclude back-office services merely because they are associated with proprietary software

Prop. Treas. Reg. §1.482-9(f)(4)(iii) would apparently preclude application of the Simplified Cost Based Method to any controlled services transaction in which the renderer's valuable or unique intangible property contributed significantly to the value of the services if the renderer did not, in rendering the services, incur significant costs with respect to such intangible property. In our opinion, this exclusion would inappropriately exclude from the simplified method most, if not virtually all, back office administrative and managerial services and would lead to so much uncertainty regarding the eligibility of any such services for the simplified method as to negate the very purpose for having the method.

To put the issue in perspective, the proposed exclusion for services enhanced by the use of intangibles would not operate to screen high-margin services; controlled services with an arm's length markup of 10 percent or greater would be independently excluded from the simplified method.⁷⁵ As the exclusion is drafted, the simplified method would be unavailable whenever the following three conditions were present, irrespective of the arm's length markup for such services: (i) the renderer's intangibles associated with the services were "valuable or unique," (ii) those intangibles contributed "significantly" to the value of the services, and (iii) the renderer's cost of using the intangibles in connection with the particular transaction were insignificant.

All three conditions may be present in cases in which proprietary computer software or programs are used in connection with administrative or managerial services. Proprietary software or programs are by definition "unique." Under certain circumstances, such software or programs embedded in intercompany services can make the services provided more valuable. Unless the software or programs are developed specifically for the transaction under review, the

⁷⁵ Prop. Treas. Reg. §1.482-9(f)(2)(iii).
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renderer's cost for use of such intangibles in connection with the services is not likely to be significant.

Even if the exclusion for services significantly enhanced by intangibles ultimately did not operate to exclude certain back office administrative and managerial services from the simplified method, the fact that the apparent reach of the exclusion is so broad would, in our view, be enough to discourage taxpayers from even trying to take advantage of the method. As a result, the method would lead to little of the intended reduction in taxpayers' administrative and compliance burdens in connection with low-margin services. We recommend that the exclusion of services enhanced by intangibles be removed from the regulations or, at a minimum, be clarified to provide that the exclusion does not apply to administrative or similar intercompany services.

b) The presence of mass purchasing and similar economies of scale associated with the controlled group structure should not preclude application of the simplified method

Mass purchasing and similar efficiencies result from economies of scale inherent in the controlled group organizational structure. However, Prop. Treas. Reg. §1.482-9(f)(4)(iii), which would exclude from the simplified method controlled service transactions in which "the renderer's particular resources or capabilities (such as the knowledge of an ability to take advantage of particularly advantageous situations or circumstances) contributed significantly to the value of the services ...," could be interpreted as applying to such functions. If the exclusion for services enhanced by intangibles is retained, we recommend that exclusion should provide clarification that efficiencies resulting from the group structure, including the ability to obtain volume and similar discounts, that may be associated with the provision of intercompany services would not preclude application of the simplified cost-based method to such services.

7. Certain transactions excluded from the Simplified Cost Based Method: Prop. Treas. Reg. §1.482-9(f)(4)(v)(E).

The exclusions from the simplified cost-based method in Prop. Treas. Reg. §1.482-9(f)(4)(v)(E) appear overly broad; and in our opinion they should be narrowed and made clearer. For example, the Service appears concerned that controlled taxpayers performing extensive services such as toll processing need to charge appropriate markups. However, these activities often include shared

services that should qualify for a cost-based exception (e.g., global manufacturing managers).

While it is presumed in Proposed Example 10 of Prop. Treas. Reg. §1.482-9(f)(4)(v)(E) that mere mechanical supply-chain services do not fall within the type of transactions excluded from the simplified cost-based method, this should be made explicit.

8. Application of the simplified cost-based method should extend for three years, assuming no significant changes in facts and circumstances.

If the simplified cost-based method is properly applied in a taxable year, then a taxpayer should be able to rely on the method as applied in the subsequent two taxable years assuming no significant change in facts and circumstances. This three-year approach would provide taxpayers with significant relief from compliance and administrative burdens and is consistent with the general three-year period used in CPM analyses.⁷⁶

9. Section 482 adjustments under the SCBM should be to the lowest safe harbor markup corresponding to the arm's length price as finally determined.

Under Prop. Treas. Reg. §1.482-9(f), a taxpayer that seeks to take advantage of the SCBM but erroneously determines the arm's length markup, such that the difference between the markup actually charged and the correct arm's length markup exceeds "the applicable number of percentage points" under section 1.482-9(f)(3)(ii), would be subject to a full transfer pricing adjustment, and not merely to an adjustment to the lowest markup that would have precluded an adjustment had the taxpayer correctly determined the arm's length markup. To illustrate, assume that the taxpayer, X, determined that the arm's length markup for back office services rendered for its affiliates was less than 6 percent (e.g., 5.99%) and, accordingly, charged those services out at cost with no markup. Assume further that the Service established that the arm's length markup (presumably the median result from comparable uncontrolled data) was actually 7 percent, rather than less than 6 percent (e.g., 5.99%) and that the interquartile range was from 4-9 percent. In those circumstances, the Service under the Proposed Regulations would be able to adjust the transfer price

⁷⁶ See Treas. Reg. §1.482-5(b)(4).
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charged by X from cost to cost plus 7 percent -- and not merely to cost plus 2.01 percent, a result which, if actually reported, would have been immune from adjustment.

In light of the extensive qualitative filtering process for determining whether a transaction is eligible for the SCBM and the almost inherent imprecision in determining the "arm's length price," there is no compelling policy reason to disqualify entirely from the method a controlled services transaction that is otherwise eligible for the method if the taxpayer has made a good faith effort to determine its intercompany service price in compliance with the requirements of the Proposed Regulations. By removing the possibility of an adjustment for certain intercompany service prices notwithstanding that they fall outside the arm's length range, we understand the Proposed Regulations to in effect reflect a judgment that strict adherence to the arm's length standard is not worth the cost of absolute compliance with that standard with respect to low-margin services. In the above example, the tradeoff between easing compliance burdens and protection of the tax base is reflected in the SCBM sanctioning an approximate 2 percent markup with respect to a 7 percent arm's length markup services transaction. Limiting adjustments to the nearest result that would be immune from challenge based on the arm's length price finally determined would ensure that SCBM is an administratively feasible safe harbor and not a transfer pricing method whose application is highly contingent on the taxpayer's exactitude in determining the ideal transfer price. Absent some compelling administrative reason that the modified arm's length standard should be unavailable whenever the taxpayer reports a result that does not reflect the "exact" arm's length price, a taxpayer that is otherwise eligible for the SCBM should be accorded the benefit of the SCBM tradeoff that is appropriate to the arm's length price that is actually determined.

We do not believe such compelling administrative reason exists. Although the Service has an interest in seeing to it that taxpayers apply the SCBM with some care, that interest should be satisfied so long as taxpayer has notified the Service in its return that it is seeking to take advantage of the method and, in fact, the transaction satisfies all the criteria for applying the method.

We realize that, under the rules governing adjustments to reported results that are outside the arm's length range, the appropriate adjustment "will ordinarily be to the median of all the results."⁷⁷ In a case where a taxpayer, with an obligation

⁷⁷ Treas. Reg. §1.482-1(e)(3).
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to apply a rigorous best method analysis, has failed to report results that are within the arm's length range, such an adjustment may be appropriate. However, the Proposed Regulations would condition the taxpayer's eligibility for any form of the SCBM on the taxpayer's determination of the "exact" arm's length price, which is subject to correction based on such factors as the addition or removal of a single comparable or an additional adjustment to the results of one or more of the appropriate comparables. Moreover, the possible effect of forcing a full transfer pricing adjustment is to raise the stakes in examination, one of the consequences that the Service and Treasury are seeking to avoid in making the SCBM safe harbor available. Thus, to require an adjustment to the precise arm's length price that is ultimately determined would undermine the stated rationale of the SCBM: to permit "reduced compliance and administrative burdens with respect to the pricing of low margin services,"⁷⁸ without materially furthering transfer pricing compliance.

10. Summary

The simplified cost-based method under the Proposed Regulations generally offers significantly less benefit for more effort with a higher degree of uncertainty than the cost safe harbor under current regulations. The new simplified cost-based method would only allow the use of cost without a markup when the arm's length markup (the median of the interquartile range of companies performing similar activities) is less than 6 percent. Even then, documentation would be required to avoid penalty exposure. Other eligible services for which the arm's length markup is more than 6 percent and less than 10 percent could charge a reduced markup, but again would need documentation and face exposure to adjustments and penalties.

The simplified method also would increase compliance complexity and expense for taxpayers, with less certainty than under the current safe harbor method. To apply the simplified method correctly and to achieve certainty in respect of pricing services transactions, taxpayers would need to determine the arm's length markup for each service. To determine the arm's length markup for each service, it appears that a taxpayer must undertake an analysis based on the application of the general transfer pricing rules, *including* the best method rule.

⁷⁸ 68 Fed. Reg. 53448, 53452 (Sept. 10, 2003).

Finally, the new simplified method would apply to a much more restricted class of eligible services than the current safe harbor method, and it is likely that determining whether a service transaction would qualify for the simplified method would give rise to additional controversy. As such, a substantial number of specific services would no longer be eligible for any reduced administrative burden.

For these reasons, and the more detailed reasons discussed above, we recommend retaining the present safe harbor rule set forth in Treas. Reg. §1.482-2(b).

VI. Total Services Costs and Allocation of Costs

A. Total Services Costs

The Proposed Regulations introduce the concept of "total services costs" in applying the CPM operating profit-to-total services costs PLI, in applying the simplified cost-based method, and in checking the functional comparability of uncontrolled service providers to controlled service providers under the cost of services plus method. Proposed Treas. Reg. §1.482-9(j) defines "total services costs" as "all costs of rendering those services for which total services costs are being determined, [including] all costs ... that can be directly identified with the act of rendering the services, and all other costs reasonably allocable to the services, under the principles of [Prop. Treas. Reg. §1.482-9(k)(2)]." The Proposed Regulations provide that such costs should reflect "full consideration for all resources expended, used or made available to achieve the specific objective for which the service is rendered."

1. Taxpayers should be able to rely on generally accepted accounting principles.

It appears that the concept of "total services costs" is intended to capture all costs related to the controlled services on a "fully loaded" basis. The Proposed Regulations, however, are insufficiently helpful in guiding taxpayers (and the Service) as to how to determine total costs. The Proposed Regulations state that, while generally accepted accounting principles ("GAAP") and federal income tax accounting principles "may prove a useful starting point, they will not be conclusive." In our view, the regulations should permit all taxpayers who use GAAP in reporting their financial results to stockholders, creditors, customers or prospective investors to calculate total services costs based on the amount of

total costs calculated under that method, provided that their application of GAAP principles is reasonable and consistent.

Alternatively, the regulations should elaborate on the principles that should be considered in determining when it is appropriate to deviate from GAAP or federal income tax accounting principles and in determining what types of modifications to such principles would be necessary or appropriate. In the absence of such guidance, taxpayers will lack sufficient assurance that their calculation of total services costs is appropriate and may be susceptible to second guessing by examiners that will have few constraints on their ability to do so.

2. Stock Options

a) Recent Regulatory Guidance on Stock Options

The Proposed Regulations do not directly address whether stock options are included in total services costs. In August 2003, Treasury and the Service released final regulations relevant to stock options with respect to qualified cost sharing arrangements (“QCSAs”), Treas. Reg. §1.482-7(d)(2), and the comparable profits method (“CPM”), Treas. Reg. §1.482-5(c)(2)(iv).⁷⁹ Treas. Reg. §1.482-7(d)(2) requires taxpayers with cost sharing agreements to include stock option costs as part of intangible development costs. In applying the CPM, Treas. Reg. §1.482-5(c)(2)(iv) states that a comparability adjustment between the tested party and comparable parties may be appropriate “to account for material differences in the utilization of or accounting for stock-based compensation.”

The new cost sharing regulations are clear as to how taxpayers in cost sharing arrangements are to include stock options in the pool of costs to be shared. In contrast, the new CPM regulations provide no guidance as to how a taxpayer should account for material differences with respect to stock options.

b) Arm’s Length Standard

In the Preamble to the recently issued cost sharing regulations addressing stock options, Treasury and the Service state their belief that even in the absence of evidence that unrelated parties would share such stock-based compensation costs, such costs should be included in the pool of costs to be shared. The

⁷⁹ T.D. 9088, 68 Fed. Reg. 51171 (Aug. 26, 2003).
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Preamble cites the legislative history of the Tax Reform Act of 1986 and states that Congress intended cost sharing agreements to be consistent with the commensurate with income standard and the arm's length standard "if and to the extent participants' shares of income 'reasonably reflect the actual economic activity undertaken by each.'"⁸⁰ From this legislative intent, Treasury and the Service conclude that in order to reasonably reflect economic activity, cost must be determined on a comprehensive basis, which includes the compensation of employees through stock-based compensation.⁸¹ According to Treasury and the Service, data concerning the sharing of stock option costs under cost sharing agreements between unrelated parties is not available because there is "little if any, public data regarding transactions involving high-profit intangibles."⁸²

Treasury and the Service dismissed commentators' assertions that third party evidence such as government contracting practices and agreements between unrelated parties establish that unrelated parties do not share stock option compensation. According to Treasury and the Service, such practices and agreements do not share enough characteristics of QCSAs to support the commentators' assertions.⁸³ With respect to government contracting practices, Treasury and the Service concluded that government contractors receiving cost-plus compensation under government procurement law assumed substantially less risk than participants to QCSAs. Other third party agreements identified by commentators were viewed as too dissimilar to QCSAs.⁸⁴

c) Recommendations

In contrast to participants in QCSAs, related party service providers are often compensated on a cost-plus basis and bear little risk. More specifically, related party service providers are comparable to cost-plus government contractors and uncontrolled service providers. Thus, we do not believe that Treasury's and the Service's position and arguments on stock options in the context of cost sharing arrangements should apply in the context of intercompany services.

We believe that a definition of total services costs that explicitly excludes stock option costs would be entirely consistent with the arm's length standard as evidenced by comparable cost-plus government contracts and other uncontrolled

⁸⁰ Id. at 51172 citing H.R. Conf. Rep. No. 99-481, at II-638 (1986).

⁸¹ Id.

⁸² Id. at 51173 citing H.R. Conf. Rep. No. 99-426, at 423-25 (1985).

⁸³ Id. at 51173.

⁸⁴ Id.

service transactions. In the alternative, we recommend that the issuance of stock options be analyzed solely for the purpose of determining and adjusting for comparability as presently required under Treas. Reg. §1.482-5(c)(2)(iv).

B. Allocation of Costs

The Proposed Regulations in many respects elaborate upon, and do not radically alter, the rules of Treas. Reg. §1.482-2(b)(5) and (6) of the existing regulations as to the allocation and apportionment of costs to controlled services transactions when a cost-based TPM is used. Under Prop. Treas. Reg. §1.482-9(k)(2)(i), “any reasonable method may be used to allocate and apportion costs” Allocations must, however, be based on full – and not incremental – costs. Under Prop. Treas. Reg. §1.482-9(k)(2)(ii), the taxpayer’s cost apportionment practices in its reports to shareholders, creditors, customers and potential investors “will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner.” This provision represents a change from the existing regulations, §1.482-2(b)(6)(i) which provides that any allocation and apportionment method that represents “sound accounting practice” will not be disturbed if used consistently and applied in a reasonable manner.

We believe that the standard in the Proposed Regulations as to when a taxpayer’s allocation and apportionment method may be challenged should be clarified. As the regulation is now worded, it does not set forth any principles as to the basis on which the Commissioner may question a taxpayer’s allocation and apportionment method, much less the standard that must be met to permit the Commissioner to substitute its allocation and apportionment method for that of the taxpayer. Our concern is evident in Proposed Examples 8 and 9 of Prop. Treas. Reg. §1.482-9(f)(5), which apply the simplified cost-based method. As discussed in section V.C.2.c above, the ease at which the Commissioner can make substantial allocations on the basis of relatively minor differences in allocation methodology is unsettling to us. In our view, the regulations should continue the rule in existing Treas. Reg. §1.482-2(b)(6)(i), that a taxpayer’s allocation of costs to a controlled services transaction under GAAP will not be disturbed, so long as the taxpayer consistently uses such allocation method and applies the method in a reasonable manner.

VII. Qualified Cost Sharing Arrangements

A. Headquarters Services

1. Current Regulations

Presently, qualified cost sharing arrangements are generally limited to sharing the costs of development of intangible property.⁸⁵ However, the OECD Guidelines explicitly sanction the use of cost sharing arrangements for headquarters services.⁸⁶

2. Proposed Regulations

The Proposed Regulations do not address the use of qualified cost sharing arrangements in the context of headquarters services.

3. Recommendations

We acknowledge that the Proposed Regulations represent an effort to achieve the goals of providing reduced administrative and compliance burdens for “low-margin” services and of bringing the definition of “service” for which arm’s length compensation is appropriate more in line with international standards. However, the Proposed Regulations stop short of achieving those goals, in our view, by failing to provide explicitly for the use of cost sharing arrangements with regard to charges for “headquarters” services (*i.e.*, centralized general and administrative services that benefit two or more members of the corporate group.)

We understand that multinational corporations increasingly seek to provide centralized support for certain activities, including but not limited to accounting, financial, legal, management, marketing, internal audit, and computer or information technology activities, in order to achieve consistency of practice and economies of scale across various members of the corporate group. The majority of such headquarters services typically fall within the class of “low-margin” services for which both at-cost pricing and reduced administrative and compliance burdens are appropriate. The regulations as currently proposed, however, call for the implementation of a potentially very burdensome direct-charge system under which innumerable headquarters service transactions between members of a corporate group would have to be specifically identified

⁸⁵ Treas. Reg. §1.482-7.

⁸⁶ OECD Guidelines, ¶18.7.

and priced using third party data. We predict that such a requirement would create severe administrative difficulties for all multinational corporations using centralized headquarters services to increase corporate efficiencies. Consistent with the OECD Guidelines, the revised services regulations should allow for the formation and administration of coordinated arrangements by which headquarters services may be provided to appropriate group members at cost.

We recommend that Treasury and the Service expressly sanction a headquarters services cost sharing model similar to the qualified cost sharing arrangement ("QCSA") for intangible property development under Treas. Reg. §1.482-7 and to the concept of the cost contribution arrangement ("CCA") under the OECD Guidelines. Importantly, this services model should not encompass stock option costs, which are addressed below.

Since the cost sharing arrangement we recommend would be applicable to low value headquarters services charges, we believe that the model should be less complex than the cost sharing model applicable to valuable intangibles. Such a simplified model for sharing headquarters services charges, like both the QCSA and CCA approaches, would reflect the economic realities of integrated global groups. Moreover, the rules governing a simplified headquarters services cost sharing arrangement could be crafted so as to be entirely consistent with the substantive framework of the Proposed Regulations. Specifically,

- The arrangement could be limited to those members that actually benefit from the pool of services covered by the arrangement;
- The pool of charges to be shared could be restricted to only those costs resulting in benefits to the participating members;
- Where necessary to achieve arm's length results, certain types of headquarters services that do not belong in the class of "low margin" services could be charged to the cost sharing pool with an appropriate markup;
- Through the use of reasonable methods of allocation similar to those upon which QCSAs and CCAs rely, each participant could be responsible for a share of the overall pool of headquarters services charges in proportion to the participant's anticipated share of the benefits received from the arrangement.

Strong support for using a QCSA approach to handling headquarters services charges is found in the following quoted excerpts from the OECD Guidelines:

- Paragraph 7.22: A direct-charge method for charging for intra-group services is so difficult to apply in practice in many cases for MNE groups [*i.e.*, “multinational enterprises”] that such groups have developed other methods for charging for services provided by parent companies or group service centers....
- Paragraph 7.23: In such cases, MNE groups may find they have few alternatives but to use cost allocation and apportionment methods which often necessitate some degree of estimation or approximation, as a basis for calculating an arm’s length charge....
- Paragraph 7.24: In some cases, an indirect charge method may be necessary due to the nature of the service being provided. One example is where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis....Another case is where a separate recording and analysis of the relevant service activities for each beneficiary would involve a burden of administrative work that would be disproportionately heavy in relation to the activities themselves.
- Paragraph 8.7: While CCAs for research and development of intangible property are perhaps most common, CCAs need not be limited to this activity. CCAs could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services. For example, business enterprises may decide to pool resources for acquiring centralized management services, or for the development of advertising campaigns common to the participants' markets.

By adopting a simplified cost sharing approach, at least two important goals could be accomplished: (1) the adoption of a transfer pricing methodology that provides for a reasonable allocation of headquarters services charges to appropriate recipients, and (2) greater consistency between the U.S. transfer pricing laws and the OECD Guidelines followed by many of our treaty partners.

For the reasons cited in section VI.A.2 above regarding total services costs, QCSAs covering headquarters services should not be required to include stock option costs in the pool of costs to be shared as implied by the Preamble to the recently issued cost sharing rules.⁸⁷

⁸⁷ T.D. 9088, 68 Fed. Reg. 51171 (Aug. 26, 2003)
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B. Services Subject to a Qualified Cost Sharing Arrangement

In our view, controlled participants to a qualified cost sharing agreement should be able to pay fees for technical services at cost. Despite proposed regulation §1.482-9(m)(3), it is not clear that they could be charged out at cost under the Proposed Regulations. Nevertheless, they are a type of payment that we suggest should be charged out at cost.

Most technology cannot be absorbed or implemented through formulas or data alone. It must be transmitted to the recipient and the users must be educated in its use and be shown how the technology is to be applied. The implementation must go through a testing and trouble-shooting period and the process must be defined. Since the participating affiliates have jointly paid for the creation of the underlying body of technology, they should not have to pay a premium on the services required to access and fully utilize the technology. Therefore, inter-affiliate technology services performed through qualified research agreements pursuant §1.482-7 should be at cost. Similar to back room staff service providers, the controlled group's engineering staff may be centralized in one single location for efficiency purposes or geographic proximity considerations. This sole fact does not entitle the affiliate housing the personnel to a profit margin. Thus, QCSA participants should be allowed access to this "know-how" at cost under the assumption that the QCSA participants have already paid to develop the technology. Having to charge a markup on technology and services provided to QCSA participants would be charging the participants twice. Additionally, as pointed out earlier, transfers of know-how ancillary to the transfer of technology have been treated by the courts and the Commissioner as part of the underlying technology. To illustrate this point, we propose the following Example 5 under Prop. Treas. Reg. §1.482-9(m)(6):

Example 5. (i) Company X, a US company, and Company Y, a foreign company, are members of a controlled group. Company X and Company Y are also members of a qualified cost sharing arrangement contemplated by Treas. Reg. §1.482-7. Pursuant to the provisions of their cost sharing arrangement, Companies X and Y have jointly funded the development of U Technology. All of the controlled group's research and development and engineering personnel are located at Company X's United States laboratory facilities. Company Y desires to build a plant incorporating the U Technology. Company X personnel provide Company Y with all the necessary technical manuals, engineering design packages, advice during the construction process and plant start-up assistance.

(ii) The services rendered by Company X to Company Y make the U Technology available to Company Y. However such services are necessary in order for Company Y to obtain the economic benefit of its participation in the cost sharing agreement concerning U Technology. Accordingly, pursuant to section 1.482-9(m)(3) these services are covered by §1.482-7 rather than §1.482-9."

As a final point, in Prop. Treas. Reg. §1.482-9(m)(6), Example 4, we suggest a clarification be added that the research and development activities to which the transfer of know-how related were not pursuant to a QCSA. (The services described in the example, if related to a QCSA, should not be recharacterized as a transfer of know-how. Otherwise, the commensurate with income standard would be inappropriately applied to services, changing the long-accepted understanding of how such activities are to be characterized.)

VIII. Benefit and Stewardship/Shareholder Activities

The Proposed Regulations indicate that any "activity" that provides a "benefit" to a related party is a chargeable service.⁸⁸ "Activity" is defined broadly to include the performance of functions, assumptions of risks or the use by one party of "tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances."⁸⁹ An activity provides a "benefit" to the service recipient if it "*directly* results in a *reasonably identifiable* increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so."⁹⁰

The Proposed Regulations define benefit as "a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so."⁹¹ In testing whether a controlled service recipient realizes such an increment of economic or commercial value, the Proposed Regulations generally look to whether a comparable uncontrolled service taxpayer "would be willing to pay an uncontrolled party to perform the same or similar activity ... or if the recipient

⁸⁸ Prop. Treas. Reg. §1.482-9(l)(1).

⁸⁹ Prop. Treas. Reg. §1.482-9(l)(2).

⁹⁰ Prop. Treas. Reg. §1.482-9(l)(3)(i).

⁹¹ Prop. Treas. Reg. §1.482-9(l)(3)(i).

otherwise would have performed for itself the same activity or a similar activity."⁹² Although, in this respect, the Proposed Regulations follow the OECD Guidelines,⁹³ they seem to present an element of uncertainty as to whether the presence of a benefit is dependent on the existence in the marketplace of actual payment for, or undertaking for one's own benefit, comparable uncontrolled activities. On the one hand, the increment of economic or commercial value test, at least on its face, appears to set forth an absolute standard for whether an activity gives rise to a benefit to a controlled service recipient. However, the determination of whether in fact an apparently useful activity has economic or commercial value is not made in the abstract, but requires the presence of some economic benchmark of value. Moreover, the interpretation of that standard in terms of whether an uncontrolled service recipient would either pay for, or itself perform, the relevant activity in comparable circumstances seems to imply that actual marketplace comparables be present.⁹⁴

As noted, the Proposed Regulations articulate the relevant inquiry as: "whether an uncontrolled recipient would have been willing to pay for, or to perform for itself, the activity in question."⁹⁵ This standard reverses the governing principle under the current Regulations: *whether an uncontrolled services provider would have charged for the service in question.*⁹⁶ The proposed new standard is consistent with analogous OECD guidance, which provides that an activity is a chargeable service if it is one for which an independent enterprise would be willing to pay.⁹⁷ Seventeen proposed Examples apply the Proposed Regulations to a variety of fact patterns. Overall, the Examples suggest that the new rules

⁹² *Id.*

⁹³ OECD Guidelines ¶7.6.

⁹⁴ The decision of the Tax Court in *Seagate Technology, Inc. v. Commissioner*, T.C. Memo 2000-388, that the Commissioner need not present evidence of actual comparable uncontrolled cost sharing arrangements in which the cost of employee stock options was taken into account and shared in order to require the sharing of such costs under the 1968 section 482 cost sharing regulations may not be dispositive of the lack of any need for marketplace comparables. The regulations at issue in that case described the relevant arm's length standard as "terms and conditions . . . , which would have been adopted by unrelated parties similarly situated had they entered into [a cost sharing] arrangement." Expression of the standard in the 1968 regulations in the hypothetical likely reflected the fact that uncontrolled parties in fact did not enter into cost sharing arrangements for the development of valuable intangibles. In contrast, the vast majority of activities that conceivably give rise to benefits to be taken into account under the proposed services regulations have counterparts or analogs associated with dealings between uncontrolled parties.

⁹⁵ *Id.*

⁹⁶ Treas. Reg. §1.482-2(b)(2)(i).

⁹⁷ OECD Guidelines ¶ 7.6.

are indeed intended to harmonize with the OECD Guidelines, as is the professed intent, in determining which intercompany activities are chargeable services.

The interaction between one proposed Example and the Preamble to the Proposed Regulations might be clarified. In proposed Example 4, the non-duplicative activities of the parent's Treasury Department, including raising capital, arranging financing and cash management for all of its subsidiaries, are deemed to directly benefit the subsidiary. proposed Example 4 does not state whether the subsidiary in question participates directly in the borrowing, or whether its working capital needs are met through other sources.⁹⁸ If the proposed Example is read to mean that the Service subscribes to the "general benefit" theory set forth in TAM 8806002 (*i.e.*, "expenses incurred for the benefit of the group as a whole [must] be allocated to the members on some ratable basis even if there is no specific, identifiable benefit received by the affiliates currently"), it is inconsistent with the Preamble's express disavowal of the general benefit theory.⁹⁹

In proposed Example 14, representatives of a United States parent company and its foreign subsidiaries collaboratively prepare a strategy statement identifying potential growth initiatives and ways to improve the group's profitability. The subsidiary then determines whether to implement any or all of the initiatives contained in the strategy statement for its own business. The proposed Example concludes that the preparation of the strategy statement is not a shareholder expense, because it is not primarily related to the parent's role as an investor in the subsidiary. Having reached this threshold determination, it concludes that whether the subsidiary should pay an arm's length price for access to the strategy statement depends on whether the subsidiary would have been willing to pay for a similar analysis or to prepare a similar strategy statement if it was an uncontrolled taxpayer. This proposed Example may suggest an expanded scope of potentially chargeable services relative to the current §1.482-2 Regulations.

⁹⁸ It may be implied from proposed Example 5 that the subsidiary in proposed Example 4 does participate in the facility.

⁹⁹ The Preamble to the Proposed Regulations states:

The proposed regulations and the examples set forth under §1.482-9(l)(4) do not adopt a so-called "general benefit" approach, under which certain activities in a corporate group were presumed to generate a benefit to the controlled group as a whole. . . . The Treasury Department and the IRS believe that the general benefit concept is inconsistent with the arm's length standard."

Under the current Regulations, such a strategy statement might well be viewed as primarily related to the parent company's interest in increasing the value of its investment in the subsidiary. Further, the new Regulations focus on whether the benefit to the subsidiary was *direct* and *reasonably identifiable*, in order to justify an intercompany charge. The joint development of a strategy statement would not appear to satisfy the latter criterion.¹⁰⁰

Similarly, proposed Example 3 of the Proposed Regulations involves a corporate restructuring designed to increase management efficiency. The structural changes are in fact implemented by one of the corporate group's foreign subsidiaries. Still, it is not clear that the initial restructuring plan, a global initiative, can be divorced from the parent's interest in protecting its capital investment. The mere fact that a foreign subsidiary *may* benefit does not, in our view, answer the question of whether, at arm's length, the subsidiary would have been independently willing to pay for all or a part of the corporate restructuring analysis. It would perhaps be more appropriate to leave this question open.

In proposed Example 17, the facts seem insufficient to justify the conclusion reached. We believe that the activities of Company X should be evaluated for this purpose as of the time of their performance rather than with the benefit of hindsight. The proposed Example relates that Company X "began the process of negotiating the contract." Even if the "start" of a negotiation process is "successful", it typically results in a mere non-binding Memorandum of Understanding ("MOU") or Letter of Intent ("LOI"), with many of the variables critical to concluding the agreement left for future negotiations. Thus, the mere commencement of negotiations should not entitle Company X to compensation. We would propose that compensation should be paid to Company X only if it concludes a binding agreement with the financial institution that is then assigned to Company Y. Absent a binding agreement, a MOU/LOI represents a mere "opportunity", but not a reasonably measurable economic benefit that would merit the payment of consideration for services rendered. Importantly, we also believe that, under the facts of proposed Example 17, it is more appropriate to conclude that Company Y has received an intangible rather than a service. It is difficult to see how Company X could be viewed as rendering a service to an entity with whom Company X has absolutely no relationship, contractual or otherwise, at the time the activities at issue occur. (In essence, such "services" would purportedly be rendered to an unknown recipient.)

¹⁰⁰ We assume the subsidiary participated at its own expense in the initial effort, although that is not made clear in the Example.

With respect to benefit issues, we commend Treasury's and the Service's efforts to achieve harmonization with respect to the standard for chargeable intercompany services. This change should minimize competent authority disputes between the United States and OECD member countries as to the correct standard of review. Generally, the Proposed Examples provide welcome guidance and an acceptable synthesis of many of the Service's earlier pronouncements on the stewardship issue.

IX. Effective Date

The Proposed Regulations are currently expected to be effective for each taxpayer's first taxable year beginning after they are finalized.¹⁰¹ Typically, when regulations will cause a significant change in the effort required by taxpayers to comply, a prospective effective date that affords taxpayers a reasonable time to comply with the regulations is provided for in the final regulations. For example, in the transfer pricing regulations issued in July of 1994, a ninety-day deferral period was provided.¹⁰²

The Proposed Regulations represent both significant and unprecedented changes in and additions to regulations that have remained unchanged since 1968. For example, the previous regulations issued in 1968 with respect to intercompany transactions generally required the Taxpayer to determine the arm's length price for integral services, but provided for a safe harbor for non-integral services. Under the Proposed Regulations, a significant number of taxpayers that currently apply the cost safe harbor for non-integral services will be required to perform a transfer pricing study to determine and document the appropriate arm's length price for these transactions. The limited safe harbor provided by the Simplified Cost Based Method still requires a taxpayer to conduct a study in order to determine whether the method will apply.

As stated above, the Proposed Regulations would be immediately effective. We suggest that leaving no period to permit taxpayers to comply is not equitable. Taxpayers will need time to adjust their activities and resources to acquire the additional information necessary to support and document the determinations required under the Proposed Regulations and revise their intercompany agreements. For example, use of the simplified cost-based method for any

¹⁰¹ Prop. Treas. Reg. §1.482-9(n).

¹⁰² Treas. Reg. §1.482-1(j).

controlled services transaction would require a written contract that specified the markup in place at the time the costs associated with the services were incurred.¹⁰³ If this new requirement is retained in the final regulations, taxpayers will have to amend all such agreements in order to try to qualify for the simplified cost-based method. Therefore, we recommend that revised services regulations apply to taxpayers for tax years beginning no earlier than one year after the publication of the final regulations. This period should be adequate to allow both taxpayers and transfer pricing professionals the time necessary for proper training and education with respect to the new regulations, to make the necessary determinations, to revise or adopt appropriate intercompany agreements, to make the corresponding significant changes to business operations and systems, and to meet the documentation requirements under Treas. Reg. 1.6662-6 as applied to this significant change in the transfer pricing regulations for services and intangibles.

Alternatively, we recommend that revised services regulations apply no earlier than for taxable years beginning 180 days after the date of publication of the final regulations, with the exception of services that are non-integral services under Treas. Reg. §1.482-2(b)(7) for which the application of these regulations should apply to taxpayers with tax years beginning on or after one year from the date of publication of the final regulations. As mentioned above, the 1994 changes to the transfer pricing regulations went into effect for tax years beginning on or after ninety days from the date of publication of the final regulations. However, this limited period was understandable considering the prolonged proposal period from 1992 through 1994, which allowed taxpayers sufficient time to review and comment on the 1992 proposed regulations, comment on and implement changes necessary to comply with the 1993 temporary and proposed regulations, and ultimately comply with the final regulations issued in July 1994. Clearly, the limited time period taxpayers and advisers have been exposed to the Proposed Regulations warrants an extended effective date beyond the ninety days provided for in the 1994 regulations under Treas. Reg. §1.482-1(j).

Finally, we recommend the Proposed Regulations include a provision enabling taxpayers to elect retroactive application of the final regulations to all open years. This would provide a taxpayer with the necessary flexibility to conform its current transactional agreements to the final regulations if desirable.

¹⁰³ Prop. Treas. Reg. §1.482-9(f)(3)(ii).
January 23, 2004