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April 23, 2007

Hon. Mark. W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Temporary and Proposed Section 482 Regulations on Services and Other Issues

Dear Commissioner Everson:

Enclosed are comments on temporary and proposed section 482 regulations on services and other issues. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota  
Chair, Section of Taxation

Enclosure

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## **COMMENTS REGARDING PROPOSED SECTION 482 REGULATIONS ON SERVICES AND OTHER ISSUES**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility was exercised by Sean F. Foley. Substantive contributions were made by Brian Cody, Edward Futterer, Thomas Herr, Georg Hirsch, Robert Kirschenbaum, Darrin Litsky, Barbara Mantegani, Lisa Maranto, Mark Martin, Victor Miesel, Clisson Rexford, Ednaldo Silva, and Thomas Zollo. These Comments were reviewed by David J. Canale, Chair of the Committee on Transfer Pricing, Marc Levey for the Committee on Government Submissions, and Stephen E. Shay as Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such 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.

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Date: April 23, 2007

## EXECUTIVE SUMMARY

The following Comments relate to the Temporary and Proposed Regulations under section 482<sup>1</sup> for intercompany services ("Temporary Regulations"). Our Comments and suggestions focus on the following parts of the Temporary Regulations:

- Services Cost Method (Temp. Reg. § 1.482-9T(b)(1))
- Shared Services Agreements (Temp. Reg. § 1.482-9T(b)(5))
- "Significant Contribution Services" (Temp. Reg. § 1.482-9T(b)(2))
- Definition of Low-Margin Covered Services (Temp. Reg. § 1.482-9T(b)(4)(ii))
- Comparable Uncontrolled Services Price (Temp. Reg. § 1.482-9(c))
- Cost of Services Plus Method (Temp. Reg. § 1.482-9(e))
- Profit Split Method (Temp. Reg. §§ 1.482-6T and 1.482-9T(g))
- Other Transfer Pricing Methods for the Provision of Services (Temp. Reg. § 1.482-9T(d), (h))
- Income Attributable to Intangible Property (Temp. Reg. §§ 1.482-1T(d), 1.482-4T(f), 1.482-8T)
- Shareholder Activities (Temp. Reg. § 1.482-9T(l))
- Stock-Based Compensation (Temp. Reg. §§ 1.482-9T(b)(e)(f)(g))
- Contingent-Payment Contractual Terms for Services (Temp. Reg. § 1.482-9T(i))
- Economic Substance Principles (Temp. Reg. § 1.482-1T(d))
- Coordination with Transfer Pricing Rules for Other Transactions (Temp. Reg. § 1.482-9T(m))
- Delay of Effective Date ; Transition Rules (Temp. Reg. § 1.482-9T(n))

The following summarizes our recommendations and Comments with respect to each :

### Services Cost Method (Section I)

1. We recommend that the list of Specified Covered Services adopt broad functional descriptions, instead of using activity-based descriptions, to reduce the need to subdivide functions and improve the utility and efficiency of the list.

2. If the activity-based approach reflected in the Specified Covered Services provisions, and the exclusion of services representing significant contributions to the taxpayer's business, are ultimately retained, we recommend that the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") publish a more comprehensive list of services to be considered Specified Covered Services. We commend

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<sup>1</sup> All references to section are to sections of the Internal Revenue Code 1986, as amended.

the Service for publishing an expanded list of Specified Covered Services in Revenue Procedure 2007-13.<sup>2</sup>

3. The Service should consider, as a rule of administrative convenience, making certain transfer pricing results effective for a period of years (*e.g.*, three years).

4. We commend the Service for clarifying in Notice 2007-5<sup>3</sup> that the Services Cost Method (“SCM”) is elective and request that this clarification be made in the final regulations with a number of other clarifications, including the date by which the economic support for treating a service as a lower margin service must be in existence.

#### Shared Services Agreements (Section II)

5. To address circumstances in which not all controlled taxpayers that anticipate a benefit may participate in a Shared Services Agreement (an “SSA”), including for local law reasons, we recommend that Temp. Reg. § 1.482-9T(b)(5)(ii)(A)(2) be amended to allow taxpayers to make a reasonable segregation of costs for services based on whether the services are being provided to SSA participants or to one or more affiliates outside of the SSA. Such a minor change in focus -- from the total cost of the service to the portion of the services cost that benefit SSA participants -- would prevent the problematic disqualification of certain services from SSA treatment.

6. We commend the IRS for modifying the Temporary Regulations in Notice 2007-5<sup>4</sup> to extend availability of SSAs to all controlled services and not limiting SSAs to services for which the taxpayer has elected to apply the SCM.

7. We recommend that the standard for cost allocation be clarified to conform the SSA standard to the SCM standard requiring cost allocations under “any reasonable method.” If the allocation standards under the SCM and the SSA are intended to be different, the regulations should state the rationale for using a higher standard for SSAs.

#### “Significant Contribution Services” (Section III)

8. We would not treat a service that otherwise qualifies for the SCM differently based on whether or not it is a Significant Contribution Service (“SCS”) under Temp. Reg. §

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<sup>2</sup> 2007-3 I.R.B. 295.

<sup>3</sup> 2007-3 I.R.B. 269.

<sup>4</sup> *Id.*

1.482-9T(b)(2). The subjective content of the “significant contribution” rules creates substantial application uncertainty.

9. If the substantial contribution approach is retained, we recommend that the regulation provisions include explicit deference to taxpayers’ business judgments and that the examples be expanded to illustrate that deference.

10. The significant contribution test of Temp. Reg. §1.482-9T(b) should be applied on a controlled group basis rather than on an entity basis so that the test will not prevent use of the SCM in connection with headquarters service companies and other legal entities established solely to provide centralized services.

11. We recommend that the significant contribution test of Temp. Reg. § 1.482-9T(b)(2) be limited to applying the criterion in the OECD Transfer Pricing Guidelines that would exclude services that are a “principal” activity from qualifying for use of a cost-based method. By modifying the significant contribution test to establish a more objective standard for excluding services (in addition to the SCS list and the low-margin test), taxpayers will be better able to understand excluding those services from the SCM and to defend against adjustments by foreign tax authorities.

#### Definition of Low-Margin Covered Services (Section IV)

12. The definition of “low-margin covered services” under Temp. Reg. § 1.482-9T(b)(4)(ii) relies on the use of the median (*i.e.*, the midpoint of the interquartile range). Where the taxpayer establishes arm’s length results using a different statistical method than the interquartile range, the appropriate measure of the midpoint should be a measure of the midpoint that is appropriate for the statistical method being used.

13. The current formulation of “median comparable markup on total services” should also be revised. The following proposed language would simplify the definition of “low-margin covered services” in Temp. Reg. § 1.482-9T(b)(4)(ii), and incorporate the principle of using an appropriate midpoint from the arm’s length range:

Low-margin covered services are controlled transactions for which the comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the comparable markup on total services costs means the difference between the arm's length price of the controlled services transaction (determined under §1.482-1(b)-(e) without regard to this paragraph (b), and using the appropriate measure of the midpoint from the arm’s length range) and total services costs, expressed as a percentage of total services costs.

### Comparable Uncontrolled Services Price (Section V)

14. In our prior comments<sup>5</sup> on the Proposed Regulations, we expressed concern that the comparability standard set for the comparable uncontrolled services price (“CUSP”) method was higher than the standard used in the comparable uncontrolled price (“CUP”) method. Specifically, we noted that the proposed CUSP method ordinarily applied where the controlled services are “identical to, or have a high degree of similarity to” the uncontrolled services, which we believed was higher than the standard set forth in the corresponding CUP regulations. In contrast, we noted that the Proposed Regulations appeared to embrace a looser “no substantial differences” comparability standard in one of the proposed examples. We expressed the view that the “no substantial differences” standard enunciated in Proposed Example 1 of Prop. 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 related-party services compared to other related party transactions. The Treasury and the Service directly responded to these Comments in the preamble to the Temporary Regulations (the “Preamble”) noting that the comparability standards under the CUSP method for services are parallel to those under the CUP method for sales of tangible property. However, the Temporary Regulations continue to provide that, a controlled service is ordinarily evaluated under the CUSP method “where the controlled services either are identical to or have a high degree of similarity to the services in the uncontrolled transaction.” We reiterate our earlier comment and ask that the language of the regulations be changed.

### Cost of Services Plus Method (Section VI)

15. The requirement that the results of the cost of services method be tested with the comparable profits method (“CPM”) when external comparables are used should be eliminated.

### Profit Split Method (Section VII)

16. In our prior comments<sup>6</sup> regarding the Proposed Regulations, we expressed concern with the inherently subjective nature of the terms “high-value” and “highly integrated” services in determining whether to apply a profit split method (“Profit Split Method”). This sentence was deleted in the Temporary Regulations. The Temporary Regulations include the following new sentence: “The residual profit split method is ordinarily used in controlled services transactions involving a combination of nonroutine contributions by

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<sup>5</sup> Comm. On Transfer Pricing, ABA Tax Sec., *Comments on Regulations on Services, Intangibles, Economic Substance and Other Issues*, 26-27 (2004), commenting on Prop. Reg. § 1.482-9(b)(1), 68 Fed. Reg. 53464 (2003).

<sup>6</sup>*Id.* at 30-32, commenting on Prop. Reg. § 1.482-9(g)(1), 68 Fed. Reg. 53475 (2003).

multiple controlled taxpayers.” We believe this sentence should be deleted from the temporary regulations. We believe the sentence is unnecessary, as the description of the comparability criteria in Temp. Reg. § 1.482-6T(c)(2)(ii)(D) and Temp. Reg. § 1.482-6T(c)(3)(ii)(D) adequately addresses situations in which the Profit Split Methods would apply and describe the application of such methods.

17. The Temporary Regulations provide specific comparability guidance for application of the comparable profit split method. With one exception, we believe this guidance is consistent with existing guidance for determining comparability between controlled and uncontrolled transactions and, therefore, is appropriate and helpful. Our one concern is the statement in the Temporary Regulations that “the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.” Without further explanation, we think it is inappropriate to put this very specific comparability limitation into the Temporary Regulations. The current, final regulations contain a detailed statement of factors for determining comparability<sup>7</sup>, and it is unclear why a general reference to these factors, or a specific reference to a particular factor,<sup>8</sup> would not be sufficient in this context.

#### Other Transfer Pricing Methods for the Provision of Services (Section VIII)

18. The unspecified method is an important tool for establishing an arm’s length price. We recommend reworking the Temporary Regulation new example to provide a pair of examples. In one example, the facts would establish that it would be reasonable for the Commissioner to consider a sale structure as a realistic alternative when analyzing the controlled services transaction. In a second example, the facts would establish that it would be not reasonable for the Commissioner to look to a sale transaction. In both examples, the facts would establish that an unspecified method is the best method. We suggest a pair of examples, which will be discussed further below.

19. For including the “economically similar transactions” language in Reg. §§1.482-3(e)(1) and 1.482-4(d)(1),<sup>9</sup> we recommend similar pairs of examples be added to assure that the realistic alternative language is applied appropriately by examining agents.

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<sup>7</sup> See Reg. §§ 1.482-1(d) and 1.482-6(c).

<sup>8</sup> *E.g.*, Reg. § 1.482-1(d)(iv) (economic conditions).

<sup>9</sup> All references to “Regulations” or “Reg.” are to the existing Treasury Regulations, unless otherwise noted.

### Income Attributable to Intangible Property (Section IX)

20. Regarding ownership of an intangible, we support the approach taken in the Temporary Regulations to look to legal ownership of a particular intangible right as the fundamental touch point for Section 482 analysis.

21. It is unclear why the cross reference to Reg. §1.482-8 in Examples 10, 11, and 12 is not included in Temp. Reg. §1.482-4T(f)(4)(ii) Example 2. We recommend adding the cross reference.

### Shareholder Activities (Section X)

22. We understand the enumeration of categories of stewardship in the Temporary Regulations to be in the disjunctive; that is, an activity will constitute nonchargeable expense if it satisfies any one or more of the four enumerated subcategories of “stewardship.” Moreover, all of the categories must be read in context of the overarching principle that chargeable services are those for which the recipient would be willing to pay, at arm’s length, or would otherwise have performed for itself. For reasons discussed below, we recommend that the Temporary Regulations when issued in final form make the intended disjunctive evaluation clear. Additionally, the Regulations when finalized should reconsider the use of the word “sole” with reference to shareholder activities. The term “predominant” would seem to be a more appropriate term.

### Stock-Based Compensation (Section XI)

23. We observe that it is extremely unlikely that comparable transaction cost would include stock-based compensation. Accordingly, we recommend that total services costs exclude stock-based compensation.

24. Because stock-based compensation may or may not correlate well to a tested segment, we recommend that consideration be given to addressing the reliability of comparability adjustments related to stock-based compensation in Examples 3 through 6 of Temp. Reg. §1.482-9T(f)(3). More specifically, we recommend that Examples 3 through 6 be clarified to state that the taxpayer is engaged in only one business. Also, we recommend that an example be included to demonstrate that it is not appropriate in all instances to include stock-based compensation in the cost base in applying both the Cost Plus Method and CPM.

25. For purposes of the residual profit split, we reiterate our Comments for the CPM for purposes of assigning routine returns. The inclusion of stock-based compensation for

purposes of dividing residual returns is inconsistent with the arm's length standard for the same reasons as the court cited in *Xilinx v. Commissioner* ("*Xilinx*").<sup>10</sup>

26. We request that the Service provide clarification on two general issues: The various examples elucidating the requirement that stock options be included in the cost base all use the grant date valuation. The Service should state whether taxpayers may also use the section 83(h) value, looking to the exercise date. Second, a charge from a US. service provider including stock option costs may trigger transfer pricing penalties in the recipient jurisdiction if the local rules do not allow deduction for stock options. Because penalties are generally not amenable to competent authority relief, the Service should provide guidance as to how taxpayers can comply with the new U.S. rules. The Service should also state whether penalty relief will be provided by the Mutual Agreement process.

#### Contingent-Payment Contractual Terms for Services (Section XII)

27. We are pleased to note that the Service acted on a number of our comments on the Proposed Regulations, including removing the requirement to demonstrate that uncontrolled taxpayers engage in similar transactions, as well as removing redundant and confusing references to the economic substance requirements. We respectfully request that, absent a written agreement, a taxpayer be expressly permitted to present facts to demonstrate that a contingent- payment arrangement best reflects the economic substance of the underlying transaction.

28. Another comment to the Proposed Regulations related to the written basis for payment requirement, which was not changed in the Temporary Regulations. According to Temp. Reg. § 1.482-9(i)(2)(i)(C) the contract specifying the arrangements has to provide for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.

29. We suggest that the requirement to evaluate whether the specified contingency bears a direct relationship to the controlled services transaction based on all the facts and circumstances be combined with the specified contingency requirement for clarity purposes.

#### Economic Substance Principles (Section XIII)

30. As the Preamble to the Temporary Regulations makes clear, controlled taxpayers have substantial freedom to adopt contractual terms, and these contractual terms are to be given effect provided they are in accord with the economic substance of the controlled

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<sup>10</sup> *Xilinx v. Commissioner*, 125 T.C. 37 (2005). On August 30, 2006, the IRS appealed the decision in *Xilinx* to the Ninth Circuit Court of Appeals. *Xilinx Inc. v. Commissioner*, 9th Cir., No. 06-74246.

parties' dealings. Of particular moment is Temp. Reg. §1.482-1T(d)(3)(ii)(C), Example 5. The Example, after specifying the basis for an adjustment, continues to state:

In other facts and circumstances, had the compensation paid to USSub been *significantly* outside the arm's length range, that might lead the Commissioner to examine further whether, despite the contractual terms that require cost-plus reimbursement of USSub, the economic substance of the transaction was not consistent with FP's bearing the risk associated with promotional activities in the United States market. (emphasis added).

The Service and Treasury should clearly define the “facts and circumstances” under which the contractual undertakings will not be respected.

#### Coordination With Transfer Pricing Rules for Other Transactions (Section XIV)

31. We reiterate the request in our prior Comments that the “material” standard in paragraph (m)(2) be replaced with the time-tested “substantial” standard found in Reg. §1.482-4(b). This would be particularly important now that Treasury and the Service have manifested in the second sentence of paragraph (m)(2) an intention to maintain different treatment for service transactions with an element that effects a transfer of intellectual property. Appropriate cross-reference to the standard of Reg. §1.482-4(b) should be made.

32. We also request clarification of the interplay between Temp. Reg. § 1.482-9T(m)(1) and Reg. § 1.482-1(f)(2)(i), which sets the rule for the aggregation of transactions. We request that Treasury and the Service clarify whether Temp. Reg. §1.482-9T(d)(1) sets a higher standard than Reg. § 1.482-1(f)(2)(i), and how the higher standard is justified when the line between one “integrated transaction” and two or more interrelated transactions is difficult to draw.

#### Effective Date and Transition Rules (Section XV)

33. The Temporary Regulations make significant changes to regulations that have been in place for over 38 years. The number of services for which transfer pricing studies will, for the first time, be required under the Temporary Regulations is considerable. We urgently request that the effective date of the regulations when finalized be delayed to allow taxpayers a sufficient period to comply with the new regulations.

34. If the Treasury decides not to delay the effective date, transition rules designed to alleviate the burdens outlined above should be adopted. Additionally, any adjustment made by the Commissioner pursuant to T.D. 9278 should be spread over a five-year period starting with the year of the adjustment (in a manner similar to IRC section 481). Because elimination of penalties and the spread of any adjustment would not address incremental costs (*e.g.*, potential lost foreign deductions) of a January 1, 2007 effective date, one of the following transition rules should be adopted.

1. For a taxpayer's initial tax year beginning after December 31, 2006, T.D. 9278 will not apply if a binding contract was in place prior to the issuance of the Temporary Regulations. Services provided pursuant to these binding contracts will not be subject to T.D. 9278 for that initial tax year.
2. We commend the Service for adopting in Notice 2007-5 (i) a one-year delay in implementation of the Temporary Regulations' SCM method, except application of the business judgment rule, and (ii) one-year transition relief from the application of penalties under Section 6662(e) and (h) if a taxpayer makes "reasonable efforts" to comply with the Temporary Regulations (as modified by the Notice).

## COMMENTS

### I. Services Cost Method

#### 1. Current Law

Under Reg. §1.482-2(b) taxpayers may charge out beneficial, non-integral services on a cost basis.

#### 2. Proposed Regulations

The Proposed Regulations included a new Simplified Cost Based Method (“SCBM”), which was intended to preserve the opportunity for taxpayers to charge out low-margin services at cost, while updating the regulations to be more in line with the methods applicable to other types of intercompany transfers. This method was overly complicated and seemed to require extensive economic analysis to establish the proper margins for low-margin services.

#### 3. Temporary Regulations

Temp. Reg. §1.482-9T(b)(1) identifies a new transfer pricing method, the Services Cost Method (“SCM”), which can be used to charge low-margin services on a cost basis. To qualify for the method, the services must either be included in an annual list of services published in a Revenue Procedure (“Specified Covered Services”), or be services for which the median markup on costs is less than or equal to seven percent, (“Low-Margin Covered Services”) and not be services specifically excluded from the SCM, (“Excluded Transactions” as defined by Temp. Reg. §1.482-9T(b)(3)(ii)). Specified or Low-Margin Covered Services will also be excluded from the SCM if they constitute, in the taxpayer’s business judgment, a significant contribution to the success or failure of the taxpayer’s business (see section III. below).

#### 4. Recommendations

The Treasury and the Service considered taxpayer comments in moving from the SCBM to the SCM. The SCM represents a marked improvement over the SCBM. We agree conceptually with most of the operational components of the SCM, that is, the list of Specified Covered Services, Low-Margin Covered Services, the list of Excluded Transactions, and the deference to taxpayers’ business judgments regarding the significance of a given service’s contribution to the taxpayer’s business. However, we believe the components are not balanced because, once a specific service is measured according to each component, the gains in administrative efficiency sought by both the government and taxpayers are lost. Thus, we recommend a re-balancing and reconsideration of these components.

First, the stated purpose of the list of Specified Covered Services is to identify services where no economic analysis (either to qualify as a Low-Margin Covered Service or to determine an appropriate transfer price under another method) is necessary. Although useful, the strict activity-based approach used in building the list of Specified Covered Services may require taxpayers to draw distinctions in the activities of its employees that currently are impractical, or do not have to be drawn. This can lead to significant complications, *e.g.*, where an employee provides a Specified Covered Service and a Low-Margin Covered Service for which the SCM is nonetheless unavailable because part of the service is on the list of Excluded Transactions. To illustrate, a provider of IT support covered under item 44 of Announcement 2006-50 may also give advice about selection of hardware or software. This part of the service could be viewed as excluded under Temp. Reg. §1.482-9T(b)(3)(ii)(E) requiring the employee's time to be segregated. These delineations would be burdensome to establish and track as well as difficult to defend to foreign tax authorities. Rather than establish processes and systems that would allow the functional delineation and related varied pricing of their non-core services, we believe most taxpayers will opt to forego use of the Specified Services List.

As the Preamble acknowledges for back office services that are common across many industries, "it is in the interest of good tax administration to minimize the compliance burdens applicable to such services, especially to the extent that the arm's length markups are low and the activities do not significantly contribute to business success or failure." As suggested above, a list specifying these services should align with how corporations customarily define their internal functions, and reflect a determination made at *that* level of organization, rather than on an activity-based level. The list of Excluded Transactions provided at Temp. Reg. § 1.482-9T(b)(3)(ii) adopts broad functional descriptions, an approach that, if applied to the list of Specified Covered Services, would improve its effectiveness measurably. For example, the Treasury could generalize the list of Specified Covered Services that it adopts to a departmental or cost center view in light of:

1. application of the rule concerning the taxpayer's business judgment regarding the significance of a given service's contribution to the taxpayer's business; and
2. the fact the vast majority of back office and administrative services are going to be low-margin if they are of the type provided by the departments reflected in the Services Regulations Coalition's or Tax Executive Institute's proposed White Lists.<sup>11</sup>

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<sup>11</sup> Letter dated June 2, 2004, from Charles S. Triplett, Counsel to Services Regulations Coalition, to Barbara M. Angus, International Tax Counsel, Department of the Treasury, and Harry J. ("Hal") Hicks, III, Associate Chief Counsel (International), Internal Revenue Service; Letter dated November 15, 2006, from David L. Bernard, International President, Tax Executives Institute, to Hal Hicks, International Tax Counsel, Department of the Treasury.

Second, the narrow, activity-based approach reflected in the Specified Covered Services provisions requires taxpayers to perform economic analyses for most of their non-core back-office services to establish that they are low-margin. If the provisions excluding services representing significant contributions to the taxpayer's business are ultimately retained (see section IV, below), it would be more practical (considering the fact that both the Treasury and taxpayers need an administrable framework) for Treasury and the Service to publish a more comprehensive list of services that are to be considered Specified Covered Services.

Third, and for the same reasons that warranted the replacement of the proposed regulations' SCBM, we ask that the Treasury and the Service consider, as a rule of administrative convenience, making certain transfer pricing results effective for a period of years. Because the current components of the SCM are biased towards the exclusion of the vast majority of inter-company services, taxpayers will be "required as a practical matter to devote significant compliance resources to enlist outside consultants or otherwise to develop support for [their quantitative] judgments." This was one of the reasons cited in the Preamble of the Temporary Regulations for the elimination of the SCBM. Providing an extended period for reliance would reduce taxpayer's compliance burdens, while not introducing significant risk of abuse. It would also add much-needed certainty to taxpayers' business planning.

Accordingly, we believe that, for Specified Covered Services and Low-Margin Covered Services, certain transfer pricing determinations should be effective for a period of three years. The reliance period could apply only to those taxpayers whose relevant facts and circumstances have not changed materially from the time the service was most recently established as a Covered Service. For a Specified Covered Service, the period could begin on the first day of each tax year for which that service was listed as a Specified Covered Service. For Low-Margin Covered Services, the period could begin on the first day of any year in which that service was the subject of a transfer pricing study establishing it as a Low-Margin service.

Fourth, for Low-Margin Covered Services, Treasury and the Service should provide the seven percent analysis (to determine the services that are low-margin) and publicize the results to avoid the need for each taxpayer to hire its own economist. This analysis might take the form of a Service developed set of comparables for various low-margin services, such as human resources, accounting & finance, information services and training. The Service's comparable set would be developed using publicly available information. Taxpayers could determine whether their services were comparable to the publicly available information on the Service's set, and if so, could rely on the Service's set and avoid creating their own.

Finally, the regulations when finalized should make several clarifications. One relates to whether the SCM is an elective transfer pricing method. The Preamble states that where the conditions on application of the method are met, the SCM *will* be considered the best

method for purposes of Reg. § 1.482-1(c).<sup>12</sup> That statement is repeated in Temp. Reg. § 1.482-9T(b)(1). The use of the phrase "will be considered the best method" appears to contradict section A.1.b. of the Preamble, which provides that, if the SCM's conditions are satisfied, covered services in each category *may* be charged at cost with no markup. Moreover, a Service official has been quoted in the tax press as emphasizing that the SCM is an elective method.<sup>13</sup> If the Service regards this method as elective, it should state this clearly in the regulations when finalized and clarify by which time the "statement evidencing the taxpayer's intention to apply" the SCM has to be in existence (*i.e.*, by year end or by the date of tax return), and whether it can be prepared in anticipation of an audit. We welcome the Service's clarification in Notice 2007-5<sup>14</sup> that the SCM is elective.

Likewise, the Service should state by what date the study demonstrating that a service is low-margin, *i.e.*, less than seven percent, has to be in existence to elect the SCM. Again, possibilities include year end or the filing date of tax return, and the question arises whether the study can be prepared in anticipation of an audit. Furthermore, guidance should be provided as to whether a seven percent study can be prepared at the beginning of a year to allow the taxpayer to have certainty that it is properly electing a low-margin SCM, and how often a seven percent study has to be updated. The Service should also explain whether the taxpayer needs to prepare seven percent studies for each location where it provides similar low-margin services from the U.S. and from a foreign location.

For Core Capabilities, the Preamble states the Service will give deference to the taxpayer's business judgment that a service is not a "core capability" and therefore is eligible for the SCM. However, the language in the Temporary Regulations does not incorporate this position. Assurance should be provided by stating what will be done to ensure that this policy is followed by the Service in the field.

Finally, the Service should identify whose opinion or business judgment within a taxpayer's organization will be given deference. For example, assuming the head of the tax department is knowledgeable about the business; will his or her judgment suffice? Does it require the judgment of the head of the service line, or even the CEO?

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<sup>12</sup> See Section A.1.a, last sentence (emphasis added).

<sup>13</sup> See "Branch 6 Chief Clarifies Application of Cost Method, Other Aspects of New Temporary Services Regulations, 15 Tax Management Transfer Pricing Report 338 (September 13, 2006).

<sup>14</sup> 2007-3. I.R.B. 269.

## **II. Shared Services Agreements**

### **1. Current Law**

No provision.

### **2. Temporary Regulations**

The Temporary Regulations provide permissive rules under which taxpayers may establish an explicit agreement to share services costs within a corporate group, analogous to a cost sharing agreement under Reg. § 1.482-7 (a Shared Services Agreement or “SSA”). Only covered services that are eligible for the SCM may be included in an SSA, and taxpayers must maintain specific documentation concerning the SSA, in addition to the documentation maintained under Section 6662.

### **3. Recommendation**

Multinationals often seek the efficiencies and cost savings offered by centralization of shared services. Temp. Reg. § 1.482-9T(b)(5), which introduces the SSA, embodies Treasury’s response to the many recent requests urging guidance concerning the treatment of headquarters service arrangements. Like the SCM provisions, the SSA rules attempt to balance the administrative benefits of regulatory moderation against the risk of taxpayer abuse. Once the group of participants and the group of costs to be covered are properly identified, the SSA provisions offer a reasonable allocation method and common sense approach to aggregating transactions and costs. Without these simplified mechanisms, a taxpayer would spend hundreds of hours locating individual and grouped service transactions and their related costs, identifying specific beneficiaries for those transactions and quantifying levels of benefit on a per service (or grouped service) basis.

Despite these positive features, the restrictiveness of the Temporary Regulations concerning the conditions for establishing an SSA and the types of services that may be covered under it may limit the usefulness of SSA for the typical multinational company. Minor revisions can help the SSA provisions enhance the critical, if mundane, purpose of coordinated services arrangements: to facilitate the sharing of centralized services costs in a manner that, although at times imperfect, satisfies basic principles of economic fairness.

The first restriction is a more or less technical one, namely, to qualify as an SSA, an agreement must include as participants all controlled taxpayers that reasonably anticipate a benefit from one or more covered services. Temp. Reg. § 1.482-9T(b)(5)(ii)(A)(2). The intended goal of preventing a potentially small portion of a multinational group from paying for and deducting the total cost of the entire group’s centralized services seems straightforward and understandable. However, failing to recognize that certain companies are prevented by local law from paying for services via cost sharing, unnecessarily restricts the usefulness of SSAs.

For example, assume that one or more services are provided to 10 companies located throughout the world, including Mexico. The Mexican company may not join as a participant in an SSA because Mexican law restricts deductions for payments for services if the amount owed is determined by allocation key.<sup>15</sup> Thus under the Temporary Regulations, the Mexican company's receipt of a portion of the same services received by the other nine companies may prevent those nine companies from using an SSA at all. Taxpayers should have the opportunity to make a reasonable segregation of costs for services based on whether the services are being provided to SSA participants or to one or more affiliates outside of the SSA. A minor change in focus -- from the total cost of the service to the portion of the services cost that benefit SSA participants -- would prevent the problematic disqualification of certain services from SSA treatment.

Second, restricting coverage only to SCM services hinders the usefulness of the SSA provisions for many taxpayers. The Preamble does not explain this departure from the OECD's approach for cost contribution arrangements, or "CCAs."<sup>16</sup>

For purposes of discussion, we assume that the rationale of excluding services carrying markups from SSAs emanates from the more general goal of finding a workable middle ground between administrative flexibility and avoidance of manipulation and undue advantage. However, limiting the application of SSAs is too severe a step to arrive at an appropriate balance.

We agree with the reasonableness of requiring that more robust analyses be undertaken for higher-value services. However, this concern does not warrant limiting the availability of SSAs to only those services for which the taxpayer has elected to apply the SCM.<sup>17</sup> At minimum, the rules should be clarified to allow taxpayers to use the simplified aggregation

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<sup>15</sup> Sometimes, such companies have other means of making deductible payments for the same benefits, such as through royalties or as part of the price of purchased goods. However the technical restriction of the SSA rules would compel such companies to pay as participants and forego the deduction.

<sup>16</sup> See, for example, section 8.14 of the OECD Guidelines, Comm. on Fiscal Affairs, Organization for Economic Co-Operation and Development, *Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration* (July, 1, 1995) ("Under the arm's length principle, the value of each [CCA] participant's contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances. Therefore, in determining the value of contributions to a CCA the guidance in Chapters I through VII of these Guidelines [concerning, *inter alia*, traditional transfer pricing methodologies] should be followed.")

<sup>17</sup> Although Temp. Reg. § 1.482-9T(b)(5) refers only to "covered services", for which taxpayers may elect to use the SCM or not, the Preamble appears to definitively limit the use of SSAs to services for which the taxpayer has elected to apply the SCM ("Under an SSA, the arm's length charge to each participant is the portion of the total costs of the services otherwise determined under the SCM that is properly allocated to such participant . . .")

and allocation rules embodied in SSAs for shared services that qualify for the SCM *without* having to actually elect to apply the SCM. Moreover, there appears to be no reason why higher value services should not be eligible for inclusion in an SSA as well.<sup>18</sup> An SSA is simply a useful device to allocate arm's length charges, not a determinant of whether covered services are appropriately valued in the first place. When covered services are of the type that would typically carry a markup or other profit element, the amount to be charged into the pool of shared services over and above their cost could be separately determined under one of the more robust transfer pricing methods.

The SSA allocation rules are already designed to result in each participant paying its appropriate share for covered services. This would be the case regardless of whether the services are high margin or low-margin. If, however, the SSA rules in their temporary form are considered too permissive to handle the sharing of charges for higher value services correctly, provisions could be added requiring that the charges for such services be allocated only to a more appropriate select group of SSA participants.<sup>19</sup> We welcome the modification of the Temporary Regulations in Notice 2007-5<sup>20</sup> to extend availability of SSAs to all controlled services.

Finally, we request clarification for the standard for cost allocation. The SCM follows the general rules of Temp. Reg. § 1.482-9T(k)(2) requiring cost allocations under "any reasonable method." An SSA under Temp. Reg. § 1.482-9T(b)(5)(ii)(B) must use a cost allocation that is "the most reliable measure of the participants' respective shares of the reasonably anticipated benefits under the principles of the best method rule." The "most reliable measure" appears to be a higher standard than "any reasonable method." The allocation standards under the SCM and the SSA should not be different. If they are intended to be different, the new regulations should state the rationale for using a higher standard for shared service agreements.

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<sup>18</sup> Here we are referring to services for which market benchmarks are available. For other services, such as those that result in the transfer of intangible property, the current services regulations require application of the transfer pricing rules for intangible property and R&D cost sharing arrangements.

<sup>19</sup> Although the introduction of more rigorous benchmarking and specific allocations for separate subsets of covered services would add some complexity to SSAs, such added complexity would be far more palatable than the alternative: a complicated network of agreements covering multiple specific services. Further, provided appropriate protective measures are taken, there is no reason to exclude a broader category of service charges carrying arm's length profit elements from benefiting from the SSA rules.

<sup>20</sup> 2007-3 I.R.B. 269.

### III. “Significant Contribution Services”

#### 1. Current Law

No provision. An analogous provision exists in Reg. §1.482-2(b)(3) and (7), which allows services to be charged at cost without a mark-up where the services are not “an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services.” Services are deemed to be integral if: 1) either the renderer or the recipient is engaged in the trade or business of rendering similar services to unrelated parties; 2) the services are one of the principal activities of the renderer; 3) the renderer is peculiarly capable of rendering the services and such services are a principal element in the recipient’s operations; or 4) the recipient has received the benefit of a substantial amount of services from one or more related parties during the year.

#### 2. Temporary Regulations

Temp. Reg. §1.482-9T(b)(2) states that for services to be eligible for the services cost method (“SCM”) a taxpayer must “reasonably conclude in its business judgment” that the services “do not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both.” For ease of reference, the test set forth in Temp. Reg. §1.482-9T(b)(2) will be referred to as the “significant contribution test” and the services described there as “significant contribution services.”

#### 3. Recommendations

The Preamble to the Temporary Regulations states, for the exclusion of significant contribution services:

Exact precision is not needed and it is expected that the taxpayer’s judgment will be accepted *in most cases*. This condition is intended to focus transfer pricing compliance resources of both taxpayers and the IRS principally on significant valuation issues. Thus, it is anticipated that *in most cases* the examination of relevant services will focus only on verification of total services costs and their appropriate allocation.... There will be little need in all but *the most unusual cases* to challenge the taxpayer’s reasonable business judgment in concluding that such typical back office services do not contribute significantly to fundamental risks of success or failure. The condition effectively is reserved to allow the IRS to reject any attempt to claim that a core competency of the taxpayer’s business qualifies as a mere back-office service. (emphasis added).

First, we are not aware of any reason for treating a service that otherwise qualifies for the SCM differently based on whether or not it is a significant contribution service under

Temp. Reg. § 1.482-9T(b)(2). If a service is already considered to be low-margin by consensus (a Specified Covered Service) or by demonstration (a Low-Margin Covered Service), then from a cost-benefit perspective it should be chargeable at cost under the SCM. If it is nonetheless considered necessary that the Service in certain rare circumstances be able to foreclose use of the SCM for otherwise qualified services, we believe that Temp. Reg. § 1.482-9T(b)(2) as written is not the right approach to take. The subjective content of these provisions creates significant uncertainty regarding how they will be applied by the Service.

Second, the Preamble's statement that the taxpayer's judgment will be accepted in "most cases" and will be challenged only in "the most unusual cases" does not provide guidance to taxpayers seeking to rely on the SCM for their intercompany service charges. The Temporary Regulations and examples do not inform taxpayers and Service field agents of the extent of deference to taxpayer business judgment alluded to in the Preamble. Thus, we recommend that the Regulations, when finalized, include explicit guidance on the need for deference to taxpayers' business judgments and that the examples be expanded to illustrate that deference.

Third, Temp. Reg. § 1.482-9T(b)(2) provides that the determination of whether a service is a significant contribution service is made at the level of the legal entity (*i.e.*, "the renderer, the recipient, or both"). As written, the significant contribution test would prevent the use of the SCM in connection with headquarters service companies and other legal entities established solely for the purpose to provide centralized services. To make it clear that it is the service and not the taxpayer's structure that is being evaluated, language should be added to Temp. Reg. § 1.482-9T(b) stating that the significant contribution test is to be applied on a controlled group basis rather than on an entity basis.

Fourth, although Temp. Reg. § 1.482-9T(b)(6) provides several pairs of examples that purport to illuminate the differences between a service eligible for the SCM and a significant contribution service, many of the examples fail to achieve this goal. Overall, in fact, these examples demonstrate the difficulties inherent in attempting to apply subjective rules to address what should be very specific, "unusual" situations.

The first pair of examples provided under Temp. Reg. § 1.482-9T(b)(6) (Examples 1 and 2) purport to compare and contrast two situations involving data entry services. Data entry services are typically the kind of low-margin services that one would expect to be eligible for the SCM, and in fact these services are included in the list of covered services included in Announcement 2006-50. In Example 1, only one member of a three-member controlled group has the necessary hardware to scan and store medical records, so that member's personnel perform the scanning function for all three members. According to the example, the taxpayer could reasonably conclude that the services do not contribute significantly to key competitive advantages and therefore these services qualify for the SCM.

Example 2 involves a corporate group that includes both a casino operator and travel agencies. As part of their normal course of business the casino operator employs a device, a “Smart Card,” that gathers various data about its customers during the course of their stay. In turn, the travel agencies provide their customer lists to the casinos and request a copy of the data generated by the casinos about their customers, so that the agencies can then design customized vacation packages. The example notes that the company’s annual reports state that the data constitute an important element of the group’s overall strategic planning. The example then concludes that under the facts and circumstances the SCM is not available for “these services.”

Example 2 does not present a situation that can be contrasted to Example 1, however, for several reasons. First, the example does not identify any activities performed by the casino operator’s employees for which charges could be made. It is possible that someone would have to respond to the travel agencies’ request for information, but the example does not identify any personnel being involved and it is more likely that the “request” would be submitted electronically through a query to the database of information generated by the Smart Card. Further, the value rests with the data, which might be characterized as intangible property, and not any activity performed by an employee. Thus, the transaction in Example 2 might be more accurately described as a high value service (*i.e.* the supply of valuable customer information) or a charge for use of an intangible (*i.e.*, a license providing access to the database), rather than as data entry services.

The same problem exists with Examples 3 and 4, which both deal with recruiting services, but in different industries and involving different types of services. In Example 3, the services involve recruitment by in-house human resources personnel of middle-level managers for several related manufacturing companies, through activities such as attending job fairs and other recruitment events. Example 4, in turn, involves the use of a recruiting plan developed by one of the companies to recruit highly compensated agents representing celebrities in the entertainment industry on behalf of related companies in offshore subsidiaries.

As with Example 2, one could conclude after reading Example 4 that valuable intangibles, *i.e.*, the recruiting plan and possibly the know-how of the personnel implementing the plan, are the value drivers of the business. Thus, the inter-company transactions present in Example 4 involve the use of intangibles to provide specialized (and possibly non-routine) services, and not recruiting services fitting the list of Specified Covered Services. In the alternative, one could argue that these recruiting services are almost certain to attract a higher return than the median seven percent mark-up, given the expertise and personal relationships necessary to recruit such highly compensated agents. Thus, to allow these services to be charged at cost would create a significant loss of tax revenue to the country where the services are being performed.

Most of the examples identified as offering illustrations of how the significant contribution test properly excludes certain activities from the SCM actually involve high value services

and possibly other transactions that would not be eligible for the SCM in any case. By contrast, only one pair, Examples 8 and 9, is useful in illustrating how Temp. Reg. § 1.482-9T(b)(2) could be applied to exclude otherwise covered services (data verification services) from the SCM based on a determinable criterion (that of whether the services constitute the principal activity of a business).

It is instructive to consider the OECD's observations regarding the appropriate level of precision for determining arm's length intercompany service charges:

[A] cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations *where the provision of a service is a principal activity of the associated enterprise*, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price.

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VII Para 7.37 (1995) (emphasis added).

Temp. Reg. § 1.482-9T(b)(4) already excludes services "where the profit element is relatively significant" by excluding services that typically carry a profit markup in excess of seven percent. The other category of services referenced in the above-quoted portion of the OECD Guidelines, "principal activities," provides the basis for an *objective*, quantifiable measure that taxpayers and the Service could apply when identifying and excluding otherwise eligible services from coverage under the SCM. We therefore recommend that the significant contribution test of Temp. Reg. § 1.482-9T(b)(2) be limited to applying this criterion.

Further, by modifying the significant contribution test to establish a more objective standard, taxpayers will be better able to understand and defend excluding those services from the SCM against adjustments by foreign tax authorities. This will reduce the risk that taxpayers will be subject to double tax due to the disallowance of deductions for the marked-up portion of such services.

## IV. Definition of Low-Margin Covered Services

### 1. Current Law

No Provision

### 2. Temporary Regulations

Temp. Reg. § 1.482-9T(b)(4)(ii) defines “low-margin covered services” as those in which the median comparable markup on total services costs is less than or equal to seven percent.

### 3. Recommendations

The definition of “low-margin covered services” under Temp. Reg. § 1.482-9T(b)(4)(ii) relies on the use of the median (*i.e.*, the midpoint of the interquartile range), which is inconsistent with the principle of the arm’s length range. Reg. § 1.482-1(e)(2)(iii)(B) provides that “[t]he interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.” Where the taxpayer establishes arm’s length results using a different statistical method than the interquartile range, the median may not be an appropriate measure of the midpoint of the arm’s length range. For example, the appropriate measure of the midpoint for a 50% confidence interval would be the average, not the median. Where arm’s length results are established using a statistical method other than the interquartile range, the evaluation of such results against the seven percent cutoff should be performed using a measure of the midpoint that is appropriate for the statistical method being used.

The current formulation of “median comparable markup on total services” should also be revised because it is difficult to understand. In principle, this term means the difference between the price for the controlled services transaction and service costs, divided by service costs, where the price for the controlled services transaction is determined pursuant to the transfer pricing principles set forth in Reg. § 1.482-1(b)-(e). The following proposed language would simplify the definition of Temp. Reg. § 1.482-9T(b)(4)(ii), and also would incorporate the principle of using an appropriate midpoint from the arm’s length range:

*Low-margin covered services are controlled transactions for which the comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the comparable markup on total services costs means the difference between the arm's length price of the controlled services transaction (determined under Reg. §1.482-1(b)-(e) without regard to this paragraph (b), and using the appropriate measure of the midpoint from the arm's length range) and total services costs, expressed as a percentage of total services costs.*

In contrast to the proposed revision above, Temp. Reg. § 1.482-9T(b)(4)(ii) contains references to the interquartile range and adjustments to the median, which unnecessarily elevates the median to a unique position that is not contemplated under Reg. § 1.482-1(e)(2)(iii)(B). The restriction of the midpoint of the arm's length range to the median destroys the flexibility permitting that other statistical methods can provide a more reliable measure of the arm's length range and is at odds with the base concept of an arm's length range. Consistent with Reg. § 1.482-1(e)(2)(iii)(B), the italicized revision is both practical and comprehensible.

## **V. Comparable Uncontrolled Services Price**

### **1. Proposed Regulations**

The Proposed Regulations set forth the comparable uncontrolled services price (“CUSP”) method. This method evaluated whether the consideration in a controlled services transaction is arm's length by comparison to the price charged in a comparable uncontrolled services transaction. This method was closely analogous to the comparable uncontrolled price (“CUP”) method in existing Reg. §1.482-3(b).

### **2. Temporary Regulations**

The CUSP provisions in the Temporary Regulations are substantially similar to the corresponding provisions in the Proposed Regulations. The standards under the CUSP method emphasize the relative similarity of the controlled services to the uncontrolled transaction and the presence or absence of nonroutine intangibles. Section 1.482-9T(c)(2)(ii) of the Temporary Regulations provides, consistent with the best method rule, that the CUSP method generally provides the most direct and reliable measure of an arm's length result if the uncontrolled transaction either has no differences from the controlled services transaction or has only minor differences that have a definite and reasonably ascertainable effect on price, and appropriate adjustments may be made for these differences. However, if these adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the Temporary Regulations provide that the CUSP method may still be used, but the reliability of the results as a measure of the arm's length price will be reduced.

### **3. Recommendations**

In our comments to the Proposed Regulations, we repeatedly expressed concern that the comparability standard set for the CUSP method was higher than the standard used in the CUP method.<sup>21</sup> Specifically, we noted that the proposed CUSP method ordinarily applied

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<sup>21</sup> See, e.g., Comm. on Transfer Pricing, ABA Tax Sec., *Comments on Regulations on Services, Intangibles, Economic Substance and Other Issues*, 26-27 (2004).

where the controlled services are “identical to, or have a high degree of similarity to” the uncontrolled services, which we believed was higher than the standard set forth in the corresponding CUP regulations.<sup>22</sup> In contrast, we noted that the Proposed Regulations appeared to embrace a looser “no substantial differences” comparability standard in one of the proposed examples.<sup>23</sup> We expressed the view that the “no substantial differences” standard enunciated in Example 1 of Prop. 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 related party services compared to other related party transactions.

The Treasury and the Service directly responded to these Comments in the Preamble to the Temporary Regulations noting that the comparability standards under the CUSP method for services are parallel to those under the CUP method for sales of tangible property. The Temporary Regulations accordingly continue to provide that, to be evaluated under the CUSP method, a controlled service ordinarily should be “identical to or have a high degree of similarity to the services in the uncontrolled transaction.”<sup>24</sup>

## **VI. Cost of Services Plus Method**

### **1. Proposed Regulations**

The Proposed Regulations introduced the Cost of Services Plus Method, which is intended to ordinarily apply when the renderer of the service provides the same or similar service to both related and unrelated parties. The method is analogous to the cost plus method (“Cost Plus Method”) set forth for transfer of tangible property under existing Reg. § 1.482-3(d).

### **2. Temporary Regulations**

The Temporary Regulations clarify several aspects regarding the use of Costs of Services Plus Method, particularly the determination of which costs receive the gross margin markup and the need to test the results of the method using the markup on total costs. The Temporary Regulations have appropriately clarified that the facts and circumstances of the comparable transaction determine which transactional costs are subject to the gross service profit markup. A careful analysis of the transactional costs incurred in both the comparable uncontrolled and intercompany transactions is required.

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<sup>22</sup> Compare Prop. Reg. § 1.482-9(b)(1) (“identical to or have a high degree of similarity...”) with Reg. § 1.482-1(d)(2) (general standard of comparability is “sufficiently similar”), and Reg. § 1.482-3(b) (CUP method comparability standard requires “similarity of products”).

<sup>23</sup> Prop. Reg. § 1.482-9(b)(4) Example 1; see, also, Prop. Reg. § 1.482-9(b)(2)(i) (referring to the looser comparability standards of Reg. § 1.482-1(d)).

<sup>24</sup> Temp. Reg. § 1.482-9T(c)(1).

For the second issue – the need to test the results of the method using the markup on total costs – the clarification provided in the Temporary Regulations is more troublesome. In particular, the Temporary Regulations effectively limit the application of the Cost of Services Plus Method to only those rare instances when applicable internal comparables are available. “...If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, ...the taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer.” Temp. Reg. § 1.482-9T(e)(2)(ii)(A). Essentially, unless the related party service provider is in the business of providing the relevant service to third parties, the taxpayer will be subject to this limitation. The examples for the application of this method serve to reinforce this conclusion.

Experience suggests that there would be few instances when the Cost of Services Plus Method could be reasonably applied using external comparables. Functional differences and limited financial data regarding the costs incurred by external comparables obscure the analysis, reducing the reliability of the gross services markup percentage derived externally. These considerations are recognized by the Temporary Regulations and the accompanying examples. Nevertheless, the requirement that the results of this method be separately measured against total service costs when external comparables are used means that taxpayers must default to a CPM whenever external comparables are used. No similar provision exists for the application of this method’s counterpart under the tangible property regulations. Because the standards for comparability are different for the Cost of Services Plus Method and the CPM, this outcome means that taxpayers will have the burden of researching two sets of external comparables. Without a full blown CPM analysis, taxpayers cannot confirm whether the results expressed as a markup on total services costs are reasonable.

### **3. Recommendation**

The requirement that the results of the Cost of Services Plus Method be tested with the CPM when external comparables are used should be eliminated. This requirement places an undue burden on taxpayers, as well as unnecessary costs. It also causes this cost-based method to carry a heavier burden than the tangible property regulations’ cost-plus method for tangible property.

## **VII. Profit Split Method**

### **1. Proposed Regulations**

The Proposed Regulations provided guidance concerning application of the comparable profit split and the residual Profit Split Methods to controlled services transactions. Specifically, the Proposed Regulations provided that these methods evaluate whether an allocation of the combined operating profit or loss attributable to one or more controlled

transactions is arm's length by reference to the relative value of each controlled taxpayer's contributions to the combined operating profit or loss.

The Proposed Regulations provided that the guidance regarding the Profit Split Methods in Reg. § 1.482-6, as amended by the Proposed Regulations, applied to controlled services transactions. Section 1.482-9(g) of the Proposed Regulations also provided specific, additional guidance concerning application of Reg. § 1.482-6, as amended, to controlled services transactions.

## **2. Temporary Regulations**

The Treasury Department and the Service made substantial changes to the profit split provisions of the Proposed Regulations in promulgating the corresponding provisions in the 2006 Temporary Regulations.

### **a) Comparable Profit Split Guidance**

The Temporary Regulations provide additional comparability guidance for the application of the CPM. In particular, the Temporary Regulations note the importance of evaluating the contractual terms of controlled and uncontrolled transactions in the comparability analysis and conclude that “comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers.”<sup>25</sup> The Temporary Regulations also provide that “the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.”<sup>26</sup> Further, the Temporary Regulations note that “the comparable profit split relies exclusively on external market benchmarks.”<sup>27</sup> Accordingly, the Temporary Regulations explain that, “as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase.”<sup>28</sup> Finally, the Temporary Regulations note that the reliability of the comparability analysis “may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split.”<sup>29</sup>

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<sup>25</sup> Temp. Reg. § 1.482-6T(c)(2)(ii)(B)(1).

<sup>26</sup> *Id.*

<sup>27</sup> Temp. Reg. § 1.482-6T(c)(2)(ii)(D).

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

## b) Residual Profit Split Guidance

The Temporary Regulations provide that the residual Profit Split Method is "ordinarily used in controlled services transactions involving a combination of nonroutine contributions by multiple controlled taxpayers."<sup>30</sup> The Temporary Regulations define a "nonroutine contribution" as "a contribution that is not accounted for as a routine contribution."<sup>31</sup> The Temporary Regulations define a "routine contribution" as a contribution one "of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns."<sup>32</sup> Thus, under the Temporary Regulations, a nonroutine contribution is one for which the return cannot be determined by reference to market benchmarks.

The Temporary Regulations also provide additional guidance for allocations to the routine return in the initial step of the residual profit split analysis. Specifically, the Temporary Regulations provide that routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns.<sup>33</sup> Here, the Temporary Regulations provide that routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities.<sup>34</sup> The Temporary Regulations also provide that a functional analysis is required to identify routine contributions.<sup>35</sup>

The Temporary Regulations also provide additional comparability guidance regarding application of the residual Profit Split Method. In analyzing the routine contributions in the first step of the residual profit split analysis, the temporary regulations note that external market benchmarks should be utilized and, as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded to such benchmarks will increase.<sup>36</sup> The Temporary Regulations also provide that, to the extent the allocation of profits in the second step is not based on external market benchmarks, the

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<sup>30</sup> Temp. Reg. § 1.482-9T(g)(1).

<sup>31</sup> Temp. Reg. § 1.482-6T(c)(3)(i)(B)(1).

<sup>32</sup> Temp. Reg. § 1.482-6T(c)(3)(i)(A).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> Temp. Reg. § 1.482-6T(c)(3)(ii)(D).

reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks.<sup>37</sup> Finally, the Temporary Regulations note that the reliability of the analysis under the residual Profit Split Method may be enhanced because all parties to the controlled transaction are evaluated under the residual profit split.<sup>38</sup>

The Temporary Regulations remove §1.482-9(g)(2) Example 2 of the 2003 Proposed Regulations and replace it with a new example.

The Temporary Regulations eliminate statements in Example 2, Example 3, Example 5, and Example 6 in §1.482-4(f)(4)(ii) of the 2003 Proposed Regulations which may have been interpreted to imply that the Profit Split Methods were preferred methods in any case that involved a contribution to the value of an intangible. In addition, the examples in the Temporary Regulations specifically refer to the best method rule and cross-reference new Example 10, Example 11, and Example 12 in Temp. Reg. §1.482-8T, which illustrate application of the best method rule to intangible development activities.

### **3. Recommendations**

#### **a) Application of Profit Split Methods**

The Proposed Regulations included guidance on when it would be appropriate to apply the comparable and residual Profit Split Methods. Specifically, the Proposed Regulations provided that “[t]he profit split method is ordinarily used in controlled services transactions involving high-value services or transactions that are highly integrated and that cannot be reliably evaluated on a separate basis.”<sup>39</sup>

We expressed concern with the inherently subjective reference to the nature of the terms “high-value” and “highly integrated” services used in determining whether to apply a Profit Split Method.<sup>40</sup> This sentence was deleted in the Temporary Regulations.<sup>41</sup> In its place, the temporary regulations include the following new sentence:

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> Prop. Reg. § 1.482-9(g)(1).

<sup>40</sup> We also noted that Prop. Reg. §1.482-9(g)(2), Proposed Example 2, did not effectively provide guidance on how to apply this subjective determination. As discussed more fully below, this example was deleted and replaced by a new example in the temporary regulations.

<sup>41</sup> In addition, the temporary regulations deleted the reference to “interrelated” transactions in Prop. Reg. § 1.482-6(c)(3)(i)(B)(1).

The residual profit split method is ordinarily used in controlled services transactions involving a combination of nonroutine contributions by multiple controlled taxpayers. Temp. Reg. § 1.482-9T(g)(1).

We believe this sentence should also be deleted from the Temporary Regulations. We understand that this sentence is intended to create a more objective standard regarding the applicability of the residual Profit Split Method, because the Temporary Regulations define a “nonroutine contribution” as one for which the return cannot be determined by reference to market benchmarks.<sup>42</sup> This intent is confirmed in the Preamble to the Temporary Regulations, where the Treasury and the Service indicate that “the profit split method applies if a controlled services transaction has one or more material elements for which it is not possible to determine a market-based return.” Because the comparable profit split relies exclusively on external market benchmarks,<sup>43</sup> it appears that this comment in the Preamble was referring to the application of the residual Profit Split Method. This is confirmed by the specific reference to the “residual profit split method” in the above quoted language from Temp. Reg. § 1.482-9(g)(1).

Even as applied solely to the residual Profit Split Method, this new sentence in Temp. Reg. § 1.482-9(g)(1) does not add to the analysis of whether that method should be applied. For comparability purposes, the Temporary Regulations provide that, “to the extent the allocation of profits in the second step [*i.e.*, the residual allocation in the application of the residual profit split method] is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks.”<sup>44</sup> Thus, the Temporary Regulations, as well as the current, final regulations,<sup>45</sup> acknowledge that market benchmarks may be used as an element of the residual allocation in applying the residual Profit Split Method. However, this new sentence suggests that the residual Profit Split Method would apply where there are no market benchmarks. We believe this circularity can be avoided by simply eliminating the new sentence in Temp. Reg. § 1.482-9(g)(1). We believe the sentence is unnecessary in any event, as the description of the comparability criteria in Temp. Reg. § 1.482-6T(c)(2)(ii)(D) and Temp. Reg. § 1.482-6T(c)(3)(ii)(D) adequately address situations in which the Profit Split Methods would apply and the application of such methods. This is particularly true with the helpful elimination of the subjective terms “high-value,” “highly integrated” and “interrelated” services that were utilized in the proposed regulations.

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<sup>42</sup> See Temp. Reg. § 1.482-6T(c)(3)(i)(B)(1) and Temp. Reg. § 1.482-6T(c)(3)(i)(A).

<sup>43</sup> Temp. Reg. § 1.482-6T(c)(2)(ii)(D).

<sup>44</sup> Temp. Reg. § 1.482-6T(c)(3)(ii)(D).

<sup>45</sup> Reg. § 1.482-6(c)(3)(ii)(B).

## **b) Comparable Profit Split Guidance**

As described above in paragraph 2.a), the Temporary Regulations provide specific comparability guidance regarding application of the comparable Profit Split Method. With one exception, discussed immediately below, we believe this guidance is consistent with existing guidance for determining comparability between controlled and uncontrolled transactions<sup>46</sup> and, therefore, is appropriate and helpful.

Specifically, we are concerned that the statement in the Temporary Regulations that “the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.”<sup>47</sup> Without further explanation, it is inappropriate to put this very specific comparability limitation into the Temporary Regulations. The current, final regulations contain a detailed statement of factors for determining comparability,<sup>48</sup> and it is unclear why a general reference to these factors, or a specific reference to a particular factor,<sup>49</sup> would not be sufficient in this context.

## **c) Residual Profit Split Guidance**

### **(1) Comparability Guidance**

As described above in paragraph 2.b), the Temporary Regulations provide specific comparability guidance regarding application of the residual Profit Split Method. We believe this guidance is consistent with existing guidance for determining comparability between controlled and uncontrolled transactions<sup>50</sup> and, therefore, is appropriate and helpful.

### **(2) Elimination of Ex. 2 of Prop. Reg. §1.482-9(g)(2)**

**(3)** In our comments to the Proposed Regulations, we expressed particular concern about the use of the residual Profit Split Method in Example 2 of Prop. Reg. § 1.482-9(g)(2). Specifically, we questioned whether it was appropriate to apply the residual profit method to the facts set

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<sup>46</sup> Reg. §§ 1.482-1(d) and 1.482-6(c).

<sup>47</sup> *Id.*

<sup>48</sup> *See* Reg. §§ 1.482-1(d) and 1.482-6(c).

<sup>49</sup> *E.g.*, Reg. § 1.482-1(d)(iv) (economic conditions).

<sup>50</sup> Reg. §§ 1.482-1(d) and 1.482-6(c).

forth in that example. The Temporary Regulations remove Example 2 of Prop. Reg. § 1.482-9(g)(2) and replace it with a new example. The new example provides a more comprehensive description of the routine and, more importantly, nonroutine services provided by the related parties described in the example and, therefore, is an improvement over the example set forth in the Proposed Regulations.**Residual Profit Split Not Default Method**

In our comments on the Proposed Regulations, we expressed concern with how easily the Proposed Regulations imposed a profit split analysis, particularly the residual Profit Split Method. Specifically, we objected to certain aspects of Example 2, Example 3, Example 5, and Example 6 in § 1.482-4(f)(4)(ii) of the 2003 Proposed Regulations, which suggested that Profit Split Methods were preferred methods. In the Preamble to the Temporary Regulations, the Treasury and the Service provide helpful clarification by stating that: “[t]he clear intent is that no method, including the profit split, is a default method for purposes of the best method rule.” Accordingly, the Temporary Regulations eliminate statements in Example 2, Example 3, Example 5, and Example 6 in § 1.482-4(f)(4)(ii) of the 2003 Proposed Regulations which may have been interpreted to imply that the Profit Split Methods were preferred methods. In addition, the examples in the Temporary Regulations specifically refer to the best method rule and cross-reference new Example 10, Example 11, and Example 12 in Temp. Reg. § 1.482-8T, which show application of the best method rule to intangible development activities.

## **VIII. Other Transfer Pricing Methods for the Provision of Services**

### **1. Proposed Regulations**

The Proposed Regulations improved on existing guidance by explicitly incorporating the arm’s length standard, the “best method rule,” the comparability factors of Reg. § 1.482-1(d), as well as the arm’s length range principle of Reg. § 1.482-1(e).<sup>51</sup> Here, the Proposed Regulations seek to present a consistent set of overarching principles applicable to all related party transactions, including services transactions.

The Proposed Regulations reference six specified methods that may be used to price intercompany services.<sup>52</sup> 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

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<sup>51</sup> Prop. Reg. §1.482-9(a)(1).

<sup>52</sup> Prop. Reg. §1.482-9(a).

first three of these methods are generally analogous to the current specified methods for transfers of tangible property (*i.e.*, the CUP Method,<sup>53</sup> the resale price method,<sup>54</sup> and the Cost Plus Method).<sup>55</sup>

The Simplified Cost-Based Method is the intended replacement for the “cost safe harbor” of the existing services regulations. The six defined methods provide needed guidance to taxpayers currently using methods applicable to property transactions to evaluate their intercompany services transactions.

## **2. Temporary Regulations**

### **a) Gross Services Margin Method**

The Temporary Regulations adopt the proposed Gross Services Margin Method substantially without change. One clarification in the Temporary Regulations is the definition of the uncontrolled transaction that is associated with the controlled services from a “related” uncontrolled transaction to a “relevant” uncontrolled transaction. While we had not commented on the ambiguity potentially created by the use of the term related, we believe the clarification is useful to eliminate any confusion that the uncontrolled transaction is between related parties. This change generally is carried through the Gross Service Margin Method section, however, the first sentence under Temp. Reg. § 1.482-9T(d)(3)(B) (Other comparability factors) continues to use the word “related” and should be amended.

### **b) Unspecified Method**

The Temporary Regulations add the phrase “including economically similar transactions structured as other than services transactions” to further illuminate the general requirement of the unspecified method that taxpayers must consider “realistic alternatives” to the transaction tested under the unspecified method. In the Preamble to the Temporary Regulations, the Treasury and the Service note that they are considering adding similar language to Reg. §§1.482-3(e)(1) and 1.482-4(d)(1).

The Temporary Regulations also add a new example<sup>56</sup> to the unspecified method section of the Proposed Regulations. In the new example, for business reasons the company provides

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<sup>53</sup> Reg. §1.482-3(b).

<sup>54</sup> Reg. §1.482-3(c).

<sup>55</sup> Reg. §1.482-3(d).

<sup>56</sup> Temp. Reg. § 1.482-9T(h) Example.

access to its computer program, and does not sell the computer program, in controlled and uncontrolled services transactions. The example states that the Commissioner may consider the alternative structure of a sale of similar software when evaluating the arm's length charge for the controlled services transaction.

### 3. Recommendations

We agree that the additional language, (*i.e.*, “economically similar transactions structured as other than services transactions”) can be an important check on the use of an unspecified method. This language, and the realistic alternative “check”, however, must not default to a routine recharacterization of services transactions. The unspecified method is an important tool for establishing an arm's length price. Taxpayers using an unspecified method should not be disadvantaged by the characterization of their transactions. An “economically similar transaction” must consider the actual allocation of risks, functions, and ownership of intangible property between the controlled parties. The realistic alternative to the taxpayer's actual transaction must be a realistic alternative based on the taxpayer's actual facts and circumstances. This critical requirement, unfortunately, is not carried through in the new unspecified method example. The new example is also inconsistent with the sensible policy established by Temp. Reg. § 1.482-1T(b)(2)(ii) Example 5 (contract respected where parties conduct is consistent with allocation of risk) and Temp. Reg. § 1.482-1T(f)(2)(ii) (allocation based on taxpayer's actual transaction).

The new example specifically states that the services structure is established for “business reasons”. The new example also contains the critical fact that the same transaction structure, *i.e.*, a service and not a sale, is employed by the taxpayer for both controlled and uncontrolled transactions.<sup>57</sup> A service is an economically different transaction as compared to a sale. Importantly, the allocation of risk between a vendor and a vendee as compared to a service provider and a service recipient is fundamentally different. If the Commissioner can look to a sale transaction for guidance on the arm's length price based on the facts in this new example, there is no force in the admonitions in Temp. Reg. § 1.482-1T(b)(2)(ii) Example 5 and Temp. Reg. § 1.482-1T(f)(2)(ii) to respect a taxpayers contractual form where it comports with economic substance. A further difficulty with the new example is that it is not clear why an unspecified method is appropriate at all. The facts seem to

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<sup>57</sup> The language in the example is not entirely clear on whether there are both controlled and uncontrolled customers. The third sentence of paragraph (i) of the example states that Company T does not sell its program to its customers. In the fifth sentence, the example describes the controlled services transaction between Company T and Companies U, V and W. As the example separately describes the transactions with all customers and the transactions with controlled customers, the implication of this language is that there are both controlled and uncontrolled customers. The recommended examples in the text below clarify this point by explicitly stating there are both controlled and uncontrolled customers. *See* Temp. Reg. § 1.482-9T(h) Example.

suggest that a CUSP would be appropriate as similar services are provided in controlled and uncontrolled transactions.

We recommend reworking the Temporary Regulation new example to provide a pair of examples. In one example, the facts would establish that it would be reasonable for the Commissioner to consider a sale structure as a realistic alternative when analyzing the controlled services transaction. In a second example, the facts would establish that it would be not reasonable for the Commissioner to look to a sale transaction. In both examples, the facts would establish that an unspecified method is the best method.

The following is a suggested pair of examples:

Example 1. (i) Company T, a U.S. corporation, develops computer software programs including a real estate investment program that performs financial analysis of commercial real properties. The primary business activity of Companies U, V and W is commercial real estate development. Company T sells the software (on a compact disk or via download through the Internet) to some of its uncontrolled customers. With other uncontrolled customers, Company T maintains the software program on its own server and allows customers to access the program through the Internet by using a password. The transactions between Company T and Companies U, V and W are structured as controlled services transactions whereby Companies U, V and W obtain access via the internet to Company T's software program for financial analysis. Each year, Company T provides a revised version of the computer program including the most recent data on the commercial real estate market, rendering the old version obsolete.

(ii) Company T prices its software sales to uncontrolled customers based on the customers' real estate development revenue. Company T prices its services to uncontrolled customers based on the value of the real estate properties that the customers seeks to analyze. This price depends on objective factors such as the square footage, age, and use of the property, as well as more subjective criteria such as location. Company T follows a similar procedure for establishing the pricing for each services customer, but the ultimate prices differs depending on the particular facts and circumstances. With respect to Companies U, V and W, Company T follows the same procedure for establishing the services price as it follows for uncontrolled customers.

(iii) In evaluating whether the consideration paid by Companies U, V and W to Company T was arm's length, the Commissioner considers whether a sale of the software to Companies U, V and W is a realistic alternative to the actual services transaction. In light of the fact that Company T both sells its software and provides access to its software as a service, the Commissioner may determine that a sale structure is a realistic alternative. The Commissioner determines that the controlled services transaction between Company T and Companies U, V and W are comparable to the sale of its software to uncontrolled customers. Subject to adjustments being made for material differences between the controlled services transaction and the uncontrolled sale transactions (*e.g.* the differences in

ownership rights and the allocations of risk between a services transaction and a sale transaction), the uncontrolled transfers of tangible property may be used to evaluate the arm's length results for the controlled services transactions between Company T and Companies U, V and W.

Example 2. (i) The facts are same as in Example 1, except that for business reasons, Company T does not sell the software to uncontrolled or controlled customers. The price to both uncontrolled and controlled customers depends on the particular facts and circumstances of the customer's real estate development business.

(ii) In evaluating whether the consideration paid by Companies U, V and W to Company T was arm's length, the Commissioner considers whether a sale of the software to Companies U, V and W is a realistic alternative to the actual license transaction. In light of the business reasons to structure the transactions as a services transaction and not a sale, the Commissioner determines that a sale structure is not a realistic alternative to the actual controlled services transaction.

(iii) The Commissioner compares the prices Company T charges to its uncontrolled customers and to Companies U, V and W. In particular, the Commissioner evaluates the differences in these prices, based on the objective and subjective criteria used by Company T to set the prices to each of its customers. Subject to a determination that the adjustments being made for material differences between the controlled and uncontrolled services transactions are reliable, the uncontrolled services transactions may be used to evaluate the arm's length results for the controlled services transactions between Company T and Companies U, V and W.

Finally, regarding including the "economically similar transactions" language in Reg. §§ 1.482-3(e)(1) and 1.482-4(d)(1), we recommend similar pairs of examples be added to assure that the realistic alternative language is applied appropriately by examining agents.

## **IX. Income Attributable to Intangible Property Ownership**

### **A. Ownership**

#### **1. Proposed Regulations**

The Proposed Regulations eliminated the celebrated “cheese examples” and modified the analytical approach of 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. The Proposed Regulations provided 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 Reg. § 1.482-1(d)(3). 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.

#### **2. Temporary Regulations**

Temporary Regulation § 1.482-4T(f)(3) is substantially the same as the Proposed Regulations. The Preamble clarifies that the Treasury and the Service intend that the “legal owner” under the Temporary Regulations will be the controlled party that possesses title to the intangible, based on all the facts and circumstances. The analysis would take into account applications filed with a central government agency, any contractual provisions between the controlled parties, and other legal provisions.

The Temporary Regulations add a new Example 5 in Temp. Reg. §1.482-1T(d)(3)(ii)(c) to illustrate factual circumstances in which contractual terms pertaining to intangible development activities are respected, although on examination the activities are found to be priced on a non-arm’s length basis. The Preamble states that this change, together with new Example 10, Example 11, and Example 12 in Temp Reg. §1.482-8 illustrating the best method rule, clarify that, subject to the economic substance requirement, controlled parties may adopt contractual compensation terms that will be given effect for purposes of Section 482.

#### **3. Recommendations**

We support the approach taken in the Temporary Regulations to look to legal ownership of a particular intangible right as the fundamental touch point for section 482 analysis. The Regulations, when finalized, however 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 on intangible property. New Example 5 in Temp. Reg. §1.482-1T(d)(3)(ii)(c) includes a limited risk distribution arrangement, which is determined to be

mispriced by the Commissioner, but is still respected as it is undertaken under the terms of a contract assigning risk to the foreign parent, and the parties conduct is consistent with the contractual allocation of risk. New Example 5 appears to incorporate the substance of our recommendation.

## **B. Contributions to Develop or Enhance an Intangible**

### **1. Proposed Regulations**

Prop. Reg. § 1.482-4(f)(4)(i) provided 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. 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 consider 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. The Proposed Regulations contain a series of examples to illustrate the contribution principle and, in particular, the appropriate analysis for transfers with an embedded contribution to enhance an intangible and those with separate compensation for a contribution. Several of these examples conclude that where it is not possible to identify uncontrolled transactions with similar interrelated elements and there are nonroutine contributions by both parties to the transaction, then the residual profit split may be the best method. This approach should not be the norm but reserved for extraordinary cases.

### **2. Temporary Regulations**

The Temporary Regulations are substantially similar to the Proposed Regulations with an important change. The Temporary Regulations delete the language in Prop. Reg. § 1.482-4(f)(4)(ii) Examples 2, 3, 5 and 6 which conclude that the best method may be the residual profit split in the absence of good benchmarks and the presence of nonroutine contributions by both parties to the transaction. In three examples added to Reg. § 1.482-8 Examples 10, 11, and 12 and cross referenced in Temp. Reg. § 1.482-4T(f)(4)(ii) Examples 3, 5, and 6, the Temporary Regulation provides illustrations of the best method rule as applied in the context of a cost of service plus method ("Cost of Service Plus Method"), a comparable profit method, and a residual Profit Split Method.

### 3. Recommendation

The language in Reg. § 1.482-4(f)(4)(ii) Examples 2, 3, 5, and 6 places too much reliance on the residual Profit Split Method to determine arm's length method for contributions that enhance intangibles. While The Temporary Regulations generally attempt to rectify this issue, it is unclear, why a cross reference to Reg. § 1.482-8 Examples 10, 11, and 12 is not included in Temp. Reg. § 1.482-4T(f)(4)(ii) Example 2. We recommend adding the cross reference.

## X. Shareholder Activities

### 1. Proposed Regulations

Under the Proposed Regulations, any “activity” that provides a “benefit” to a related party was viewed as a chargeable service.<sup>58</sup> “Activity” was defined broadly to include the performance of functions, assumption of risks or the use by the service provider 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.”<sup>59</sup>

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.”<sup>60</sup> The critical question is whether an uncontrolled recipient would have been willing to pay for, or perform for itself, the activity in question.<sup>61</sup> The Proposed Regulations identify four non-compensable scenarios:

(1) activities providing a benefit to the recipient so indirect or remote that an uncontrolled recipient would not have been willing to pay for the service at the time the service is performed;<sup>62</sup>

(2) activities duplicating functions already performed by the services recipient;<sup>63</sup>

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<sup>58</sup> Prop. Reg. § 1.482-9(l)(1).

<sup>59</sup> Prop. Reg. § 1.482-9(l)(2).

<sup>60</sup> Prop. Reg. § 1.482-9(l)(3)(i).

<sup>61</sup> *Id.*

<sup>62</sup> Prop. Reg. § 1.482-9(l)(3)(ii).

(3) shareholder activities,<sup>64</sup> undertaken primarily to protect capital investment or to achieve compliance with reporting, legal, or regulatory requirements applicable specifically to the parent; and

(4) benefits arising from passive association as a member of the corporate controlled group (such as a favorable credit rating).<sup>65</sup>

Under the Proposed Regulations, an activity is considered a shareholder activity if the primary effect of that activity is to protect the renderer's capital investment in the recipient or in other members of the controlled group, or if the activity relates primarily to compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, where the renderer controls every other member in such group.

Prop. Reg. § 1.482-9(l)(3)(iv)(emphasis added).

## 2. Temporary Regulations

The provisions of Prop. Reg. § 1.482-9(l) have remained largely unchanged in the new Temporary Regulations, with the exception of the definition of shareholder activities. An activity is now regarded as a shareholder activity if

the *sole* effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Temp. Reg. § 1.482-9T(l)(3)(iv)(emphasis added).

The change of word from “primary” to “sole” is significant, as will be discussed further below.

## 3. Recommendations

Thirty-five years ago, in 1968, the Treasury promulgated regulations interpreting section 482 for intercompany service transactions.<sup>66</sup> The Regulations do not adequately address the

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<sup>63</sup> Prop. Reg. § 1.482-9(l)(3)(iii).

<sup>64</sup> Prop. Reg. § 1.482-9(l)(3)(iv)(emphasis added). Activities that constitute “day-to-day management,” by contrast, are specifically excluded from the definition of “shareholder activities.”

<sup>65</sup> Prop. Reg. § 1.482-9(l)(3)(v).

<sup>66</sup> Reg. § 1.482-2(b).

contours of “stewardship” activities in a parent-subsidary relationship, and how these activities ought to be compensated if performed by controlled entities other than the corporate parent. The Regulations provide that “[n]o allocations shall be made if the probable benefits to the other members were so indirect or remote that *unrelated parties would not have charged for such service.*”<sup>67</sup> Further, no allocation will be made “if the service is merely a *duplication* of a service which the related party has independently performed or is performing for itself.”<sup>68</sup> These references address the treatment of “stewardship”-type expenses, which typically are characterized as encompassing: (1) duplicative activities; (2) oversight functions, and (3) shareholder services. The stewardship provisions of the Regulations have been construed in case law, and the Service has published some, albeit limited, technical guidance. Reg. § 1.861-8(e)(4), which deals with the allocation and apportionment of expenses, supplements the Regulations’ guidance on stewardship expenses:

[T]he regulations under section 482 (§1.482-2(b)(2)(ii)) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute “stewardship” or “overseeing” functions undertaken for the corporation’s own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself.

While the Regulations do not explicitly define oversight functions or shareholder services, courts generally have taken a broader view than the Service as to the scope of stewardship activities.<sup>69</sup> In Technical Advice Memorandum (“TAM”) 8806002 (Sept. 24, 1987), the Service amplified its definition of “stewardship” as: (1) duplicative review or performance of activities already undertaken by a subsidiary; (2) periodic visitations and general review of a subsidiary’s performance (of the type allowed by the *Rubicam* decision); (3) complying with reporting requirements or other legal requirements of the parent shareholder, which the subsidiary would not incur if it were not a member of the affiliated group; and (4) financing or refinancing the parent’s ownership participation in the subsidiary. This TAM stands as the most comprehensive guidance on this aspect of the Regulations from the Service. Certain categories of intercompany services could well be

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<sup>67</sup> Reg. §1.482-2(b)(2)(i)(emphasis added).

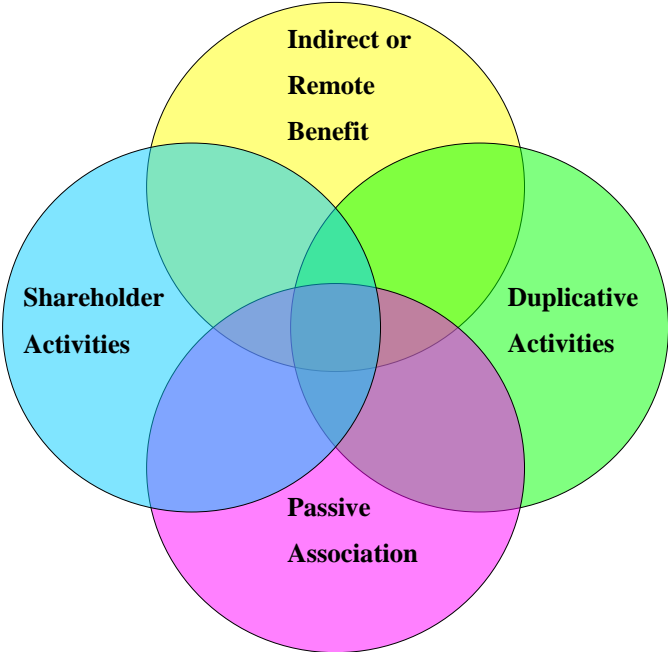
<sup>68</sup> Reg. §1.482-2(b)(2)(ii)(emphasis added).

<sup>69</sup> See *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1247-1249 (Ct.Cl, 1969) [hereinafter *Rubicam*]; *Columbia Rope Company v. Commissioner*, 42 T.C. 800, 813-814 (1964) [hereinafter *Columbia Rope*].

viewed as “stewardship” under a fair reading of the *Columbia Rope* and *Rubicam* holdings, while compensable under the language used in the TAM.

The Temporary Regulations address the appropriate differentiation of “stewardship expenses” from the universe of activities that may be performed for a related party for which an intercompany charge should be assessed at arm’s length.<sup>70</sup> Unfortunately, the Temporary Regulations have departed from the Proposed Regulations in some respects, and in this context may have departed from the salutary objective of the Proposed Regulations - - to achieve better alignment with the *OECD Guidelines*.

The enumeration of categories of stewardship in the Temporary Regulations is, one would assume, intended in the disjunctive, as illustrated by the Venn Diagram below.



That is, an activity will constitute nonchargeable expense if it satisfies any one or more of the four enumerated subcategories of “stewardship.” To read the Temporary Regulations any other way would render one or more of the subcategories a nullity. Moreover, all of the categories must be read in context of the overarching principle that chargeable services

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<sup>70</sup> Temp. Reg. §1.482-9T(l).

are those for which the recipient would be willing to pay at arm's length, or would otherwise have performed for itself.

The substitution of the word “sole” in Temp. Regs. § 1.482-9T-(1)(3)(iv) for “primary” (the adjective used in the Proposed Regulations), in the definition of “shareholder activities” appears to be a material change. The language change from “primary” to “sole” might be relatively innocuous, except that the Temporary Regulations do not, in the Preamble, the text or the accompanying Examples, make it clear that a disjunctive evaluation is being applied.

For instance, while the exploration of strategic alternatives or even an organizational restructure, as discussed in Examples 3 and 13 of the Temporary Regulations, may have a salutary effect on the business of a particular subsidiary, one could fashion a very credible argument that the effect is too “indirect or remote” to warrant an intercompany charge at arm's-length for the study itself, and we suspect that treaty partners of the United States might feel likewise. That does not mean the subsidiary should not fund the costs of implementation of the restructure, of course.

While supplemental parental oversight of legal advice, local budgets and recruitment decisions may “benefit” the subsidiary (thus, precluding characterization of the parent as “sole” beneficiary), as discussed in Examples 6 and 14, one might argue that this benefit is too attenuated to warrant an intercompany charge (as distinct from the situation where the function is not being performed at the subsidiary level, in which case a charge is indisputably warranted, as other Examples make clear). We question whether duplicative expenses that provide an incidental benefit would be viewed as chargeable if one looks at these from the perspective of the recipient, as our treaty partners would.

In summary, we recommend that the Regulations when finalized make the intended disjunctive evaluation clear. Additionally, the Regulations when finalized should reconsider the use of the word “sole” with reference to shareholder activities. In today's complex business environment, it would be highly unusual that an activity would not serve multiple objectives. Accordingly, “predominant” would seem to be a more appropriate term.

## **XI. Stock-Based Compensation**

The most readily identifiable instances where stock-based compensation could be an issue under the Temporary Regulations are in the application of the Cost Plus Method, comparable profits, services cost, and Profit Split Methods.

## **1. Proposed Regulations**

### **a) Cost of Service Plus and Comparable Profit Method**

Under the Proposed Regulations, the Cost of Service Plus Method introduced the concept of “comparable transaction costs” in applying this method.<sup>71</sup> The Proposed Regulations recognized that comparable transactions costs may or may not equal total services costs and may in fact be a subset of total services costs.<sup>72</sup> The Examples in the Proposed Regulations illustrating the application of the CPM did not include examples to highlight the importance of appropriate consistency in measuring net profits to total services costs, as do the new Temporary Regulations. See below.

### **b) Services Cost Method**

The Services Cost Method was not part of the Proposed Regulations.

### **c) Profit Split Method**

The Proposed Regulations provided 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 Reg. § 1.482-6; however, Proposed Regulation § 1.482-9(g) provides specific guidance on the application of Reg. § 1.482-6 in the context of controlled services transactions. For example, the Proposed Regulations would 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. "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.

## **2. Temporary Regulations**

### **a) Cost of Services Plus and Comparable Profits Methods**

The relevant provisions of the Cost of Service Plus Method remained unchanged. Under the CPM, four new examples in the Temporary Regulations seek to ensure appropriate

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<sup>71</sup> Prop. Reg. § 1.482-9T(d)(2)(iii).

<sup>72</sup> *Id.*

consistency in measuring net profits to total services costs.<sup>73</sup> Total services costs include stock based compensation.<sup>74</sup>

### **b) Services Cost Method**

Unlike the application of the Cost Plus Method and CPM, the SCM determines a service charge by reference to total services costs and without reference to an uncontrolled transaction.<sup>75</sup> Charging a recipient of services total services costs, as defined by Temp. Reg. § 1.482-9T(j), may result in a charge that is not arm's length due to the impact of stock-based compensation on total services costs.

### **c) Profit Split Method**

The second Example in Temp. Reg. § 1.482-9T(g)(2) was replaced with a new Example, but the relevance of this change is outside the scope of the discussion of stock-based compensation. A more thorough discussion of the Profit Split Method is provided *supra*.

## **3. Recommendations**

### **a) Cost of Services Plus and Comparable Profit Methods**

The comparability of the cost base in applying the Cost of Services Plus Method is the control that ensures a consistent comparison between the controlled and uncontrolled transactions for purposes of evaluating whether prices charged in the controlled transactions are arm's length. There is little chance that comparable transaction cost would ever include stock-based compensation (*e.g.*, no agreement in the *Xilinx*<sup>76</sup> case was ever uncovered to demonstrate that stock option costs were ever shared by third parties in unrelated transactions).

As discussed above, four new examples in the Temporary Regulations seek to ensure appropriate consistency for the CPM in measuring net profits to total services costs.

While consistent cost bases are important for comparability purposes, the inclusion of stock-based compensation can create distortions. A tested party's results are derived

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<sup>73</sup> Temp. Reg. § 1.482-9T(f)(3) Examples 3 through 6.

<sup>74</sup> Temp. Reg. § 1.482-9T(j).

<sup>75</sup> Temp. Reg. § 1.482-9T(b)(1). Although in the case of low-margin covered services, uncontrolled comparable transactions are used to determine whether the services qualify for the SCM.

<sup>76</sup> *Xilinx v. Commissioner*, 125 T.C. 37 (2005).

necessarily from a tested party's "most narrowly identifiable business activity for which data incorporating the controlled transaction is available."<sup>77</sup> If the tested party represents only one business of a taxpayer's multiple businesses, the stock-based compensation earned by employees within the tested segment may have no relation to the tested segment or the comparables, which are selected based on comparability to the tested segment. For example, a taxpayer's stock could have risen due to an entirely different business of the taxpayer. Another example is that in the case of stock-options, volatility of a taxpayer's other businesses will have the effect of increasing the value of stock options issued to all employees of the taxpayer.

The fact that stock-based compensation may or may not correlate well to the tested segment is a concern. Therefore, we recommend that consideration be given to addressing the reliability of comparability adjustments related to stock-based compensation in Examples 3 through 6 of Temp. Reg. § 1.482-9T(f)(3). More specifically, we recommend that Examples 3 through 6 be clarified to state that the taxpayer is engaged in only one business. Also, we recommend that an example be included to demonstrate that it is not appropriate in all instances to include stock-based compensation in the cost base in applying both the Cost Plus Method and CPM.

#### **b) Services Cost Method**

The most troublesome area involving stock-based compensation is in the application of the Services Cost Method. The Tax Court in *Xilinx* has already held that the sharing of stock option costs is not arm's length in the context of cost sharing arrangements. In *Xilinx*, the parties were unable to identify third party agreements where the cost of stock options was shared.

The Preamble to the 2003 revisions to the cost sharing regulations requiring the inclusion of stock-based compensation indicated that government contractors receiving Cost Plus compensation do not include stock option costs as part of the cost base because they are subject to less entrepreneurial risk than the participants of cost sharing arrangements.<sup>78</sup> In contrast, the court in *Xilinx* found as a factual matter that unrelated parties would not share stock option costs that were "difficult to estimate, unpredictable, and potentially large in amount."<sup>79</sup> Whether it is a lack of entrepreneurial risk or reasons cited by the *Xilinx* court, a service recipient would not compensate a service provider for stock-based compensation. Therefore, we recommend that total services costs exclude stock-based compensation. This

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<sup>77</sup> Reg. §1.482-5(b)(1).

<sup>78</sup> T.D. 9088, 2003-2 C.B. 841-842.

<sup>79</sup> 125 T.C. No. 4, at 35.

recommendation is made notwithstanding that the government has sought an appeal to this *Xilinx* Tax Court opinion.

### **c) Profit Split Method**

For purpose of the residual profit split, we reiterate our Comments for the CPM for purposes of assigning routine returns. For the use of a cost base to allocate residual returns, the inclusion of stock-based compensation for purposes of dividing residual returns is inconsistent with the arm's length standard for the same reasons as the court cited in *Xilinx*.

### **d) Further Inquiries**

In addition to the Comments related to specific methods, we request that the Service provide clarification on two general issues.

First, the various examples elucidating the requirement that stock options be included in the cost base all use the grant date valuation. The Service should state whether taxpayers may also use the section 83(h) value looking to the exercise date.

Second, a charge from a U.S. service provider including stock option costs may trigger transfer pricing penalties in the recipient jurisdiction if the local rules do not allow a deduction for compensation attributable to stock options. Penalties are generally not amenable to competent authority relief. The Service should provide guidance as to how taxpayers can comply with the new U.S. rules, while avoiding double tax and penalties. The Service should also state its position whether penalty relief will be provided by the Mutual Agreement process, and if not, why.

## **XII. Contingent-Payment Contractual Terms for Services**

### **1. Proposed Regulation**

Proposed Reg. § 1.482-9(i) provided guidance on the treatment of contingent-payment arrangements, namely that the Service may impute a contingent-payment arrangement under the principles set forth in Reg. § 1.482-1(d)(3)(ii)(B).<sup>80</sup> The Proposed Regulations also provide that if certain conditions are satisfied, the Service will respect a taxpayer's contingent-payment arrangement.

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

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<sup>80</sup> Prop. Reg. § 1.482-9(i)(3).

"Economic Substance Requirement").<sup>81</sup> 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").<sup>82</sup>

#### **a) Economic Substance Requirement**

The Proposed Regulations create a two-pronged test to determine whether a contingent-payment arrangement meets the Economic Substance Requirement. First 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 activity or group of activities constituting the controlled services transaction (the "Written Agreement Requirement").<sup>83</sup>
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").<sup>84</sup>
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").<sup>85</sup>
4. The conduct arising from the Written Nexus Requirement must be evaluated based on all the facts and circumstances (the "Nexus Conduct Requirement").<sup>86</sup>
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").<sup>87</sup>

Once an arrangement qualifies as a "contingent-payment arrangement," it still must be determined whether uncontrolled parties operating under similar conditions would

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<sup>81</sup> See Prop. Reg. §§ 1.482-9(i)(1) and (2).

<sup>82</sup> See Prop. Reg. § 1.482-9(i)(4).

<sup>83</sup> Prop. Reg. § 1.482-9(i)(2)(i); cf. 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.")

<sup>84</sup> Prop. Reg. § 1.482-9(i)(2)(ii).

<sup>85</sup> Prop. Reg. § 1.482-9(i)(2)(iii).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

reasonably adopt a similar contingent consideration payment arrangement (the "Similar Arrangement Test").<sup>88</sup>

### **b) Arm's-Length Requirement**

Once the economic substance of a contingent-payment arrangement is recognized, Prop. 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.

## **2. Temporary Regulations**

The Temporary Regulations remove the requirement to demonstrate that uncontrolled taxpayers engage in similar transactions as well as the references to the economic substance requirements. Otherwise, the language was not changed.

## **3. Recommendations**

We submitted a number of comments on, and proposed changes to, the Proposed Regulations on services and intangibles related to the guidance on the treatment of contingent-payment arrangements. The Service acted on a number of these comments, including removing the requirement to demonstrate that uncontrolled taxpayers engaging in similar transactions as well as removing redundant and confusing references to the economic substance requirements. These changes materially enhance the contingent-payment rules and help ensure a more straight-forward application of these rules.

Certain of our comments and proposed changes, however, were not addressed. One related to the ability of the taxpayer, in absence of a written agreement, to present facts to demonstrate that a contingent-payment arrangement best reflects the economic substance of the underlying transaction. We believe that this should be the case under Reg. § 1.482-1(d)(3)(ii)(B). While the Temporary Regulations do not expressly address this point the Preamble states that "in given facts and circumstances, it may be possible to rely on evidence that the taxpayer brings forward."

Another related to the written basis for payment requirement. This was not changed. According to Temp. Reg. § 1.482-9T(i)(2)(i)(C), the contract specifying the arrangements has to provide for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. This requirement should be eliminated or substantially modified. Implicit in any arm's length arrangement is that the payment between the parties should be arm's length. This provision raises the specter of the

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<sup>88</sup> Prop. Reg. § 1.482-9(i)(1).

government disregarding the entire contingent payment arrangement and recharacterizing the transaction because there is a disagreement about pricing of a contingent arrangement. Example 3 in the Temporary Regulations<sup>89</sup>, which seeks to illustrate this provision, is not very helpful because it portrays an extreme case where the payment is clearly not arm's length. The consequence should not be recharacterization of the arrangement as something else (*e.g.* a licensing agreement), but rather to adjust the contingent payment amount to reflect the recipient's benefit and the risks borne by the renderer.

Finally, we also suggested that the requirement to evaluate whether the specified contingency bears a direct relationship to the controlled services transaction based on all the facts and circumstances be combined with the specified contingency requirement for clarity purposes. While this is not a significant issue, we believe that it would help clarify the language in the regulations.

### **XIII. Economic Substance Principles**

#### **1. Current Law**

For the concept of economic substance, the relevant provisions of the Regulations are:

- 1 Reg. §1.482-1(f)(2)(ii)(A), constraining the Commissioner to make allocations based on the transaction as actually structured, unless the transaction as structured “*lacks economic substance*” (emphasis added); and
- 2 Reg. §§1.482-1(d)(3)(ii)(B) and –(d)(3)(iii)(B), addressing the “*economic substance*” of purported contractual risk allocations between related parties (emphasis added).

These rules establish a threshold determination of whether the related parties (i) have documented their allocation of risk at a time when the outcome of the risk is neither known nor reasonably knowable, and (ii) conducted themselves in accordance with that contractual risk allocation.

#### **2. Temporary Regulations**

The Temporary Regulations permit the Service to impute contractual terms to accord with the economic substance of the controlled parties' activities where controlled taxpayers specify contractual terms that are not consistent with economic substance. According to the preamble, the “economic substance of a transaction between related parties necessarily turns on an examination of all the facts and circumstances.” The Preamble further asserts that the “commensurate with income” principle of section 482 fundamentally relates to the

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<sup>89</sup> Temp. Reg. § 1.482-9T(i)(5) Example 3.

underlying economic substance and “true” risk allocations inherent in the relevant controlled transactions.

### 3. Recommendations

In considering the implications of the Temporary Regulations, we should assume that the threshold requirements of the Regulations have been met. Under the Preamble to the Temporary Regulations, controlled taxpayers have substantial freedom to adopt contractual terms, and those terms are to be given effect provided they are consistent with the economic substance of the controlled parties' dealings.

Of particular moment is Temp. Reg. § 1.482-1T(d)(3)(ii)(C), Example 5, in which the United States taxpayer performs certain incremental marketing activities and the parties' written agreement reflects the intent of the parties that the United States taxpayer receive compensation for those incremental activities without regard to the success or failure of the promotional activities. The Service determines that the magnitude of the specified Cost Plus X% markup for those activities is outside the arm's length range and makes an allocation to require payment of additional compensation based on the median of the interquartile range of the arm's length markups charged by uncontrolled comparables. The Example goes on from there, however, and states:

In other facts and circumstances, had the compensation paid to USSub been *significantly* outside the arm's length range, that might lead the Commissioner to examine further whether, despite the contractual terms that require cost-plus reimbursement of USSub, the economic substance of the transaction was not consistent with FP's bearing the risk associated with promotional activities in the United States market. (emphasis added).

This language is troublesome. Taxpayers expect to be able to structure their global affairs in a business like manner, subject to the consistent application of arm's-length principles to the resulting intercompany transactions. The Temporary Regulations fail to honor these reasonable expectations. The Service and Treasury should clearly define the “facts and circumstances” under which the contractual undertakings will not be respected. Vague and ambiguously defined terms such as “significant” deviation from arm's length compensation does not provide meaningful guidance, and may give rise to proposed adjustments and controversies at odds with the views of our treaty partners.

## **XIV. Coordination with Transfer Pricing Rules for Other Transactions**

### **A. Services Transactions and Intangible Property**

#### **1. Proposed Regulations**

Prop. Reg. § 1.482-9(m)(1) established a general principle under which “ordinarily, an integrated transaction . . . may be evaluated under this section and its separate elements need not be evaluated separately” as long as each element of the transaction may be adequately accounted for. Paragraph (m)(2), on the other hand, singles out for specific treatment all transactions that “may result in a transfer . . . of intangible property, or may have an effect similar to the transfer of intangible property, or may include an element that constitutes the transfer of intangible property.” If this element is “material” to the evaluation of the transaction, it must be tested separately from the service element under principles of Reg. § 1.482-4.

To illustrate the treatment of services transactions involving the transfer of intangible property, Example 4 in Prop. Reg. § 1.482-9(m)(6) described a situation where one controlled party performed research and development for another controlled party and then transferred to the other party the rights to intellectual property arising out of that activity.

#### **2. Temporary Regulations**

Temp. Reg. § 1.482-9T(m)(2) omits the phrase “may have an effect similar to the transfer of intangible property” from the description of transactions that would potentially fall under separate analysis under Reg. § 1.482-4, thereby potentially narrowing the definition. By contrast, Treasury and the Service added the introductory phrase “[n]otwithstanding paragraph (m)(1) of this section” to the second sentence of paragraph (m)(2), which prescribes the potential need of an analysis of intangible elements under Reg. § 1.482-4. The new language underscores the different treatment for intangibles, in contrast to the general principle for integrated transactions laid out in paragraph (m)(1). The “material” standard of paragraph (m)(2), introduced in the Proposed Regulations, was maintained in the Temporary Regulations.

Example 4 in Prop. Reg. § 1.482-9(m)(6) was replaced with a new Example 4, found in Temp. Reg. § 1.482-9T(m)(5). Critics had noted that the recipient of contract research and development would typically retain all rights to any intellectual property developed by the other party, so no transfer would be necessary. To avoid confusion, Treasury and the Service responded by replacing this example with one in which both affiliated parties perform research and development independently. After one party has developed intellectual property in the form of know-how, it enters into a service agreement with the other and, as part of that agreement, transfers its know-how to the other party.

### 3. Recommendations

In our comments to the Proposed Regulations in January, 2004, we set forth the following criticisms:

1. The “commensurate of income” standard of Reg. § 1.482-4(a) is harsh when applied too broadly because it may affect a transaction properly described as a service transaction even if it lacks an identifiable transfer of an intangible asset;
2. The risk of an overbroad application is increased because paragraph (m)(2) applies a “material” standard instead of the well-established “substantial” standard of Reg. § 1.482-4(b).

The Preamble to the Temporary Regulations, apparently views the “material” standard as not being inconsistent with the “substantial” standard of Reg. § 1.482-4(b). The Preamble depicts the list of specified intangibles and other similar items of Reg. § 1.482-4(b), where the “material” standard applies, as contrasting with Temp. Reg. § 1.482-9T(m)(2), which “applies after it is determined that an integrated transaction includes an intangible *component* that is material.”<sup>90</sup> However, this view is problematic because a component can only be an intangible component if it involves one of the items listed in Reg. § 1.482-4(b). Because an item either falls under Reg. § 1.482-4(b) or it does not, the only issue should be whether the element of the transaction containing the item has a substantial value. This treatment creates consistency between Temp. Reg. § 1.482-9T(m)(2) and Temp. Reg. § 1.482-4.

Therefore, we reiterate our recommendation that the “material” standard in paragraph (m)(2) of Temp. Reg. § 1.482-9T be replaced with the standard in Reg. § 1.482-4(b).

#### B. Disaggregation of Integrated Transactions

##### 1. Proposed Regulations

A transaction subject to the Prop. Reg. § 1.482-9(m) is described as “[a] transaction structured as a controlled services transaction [which] may include other elements . . .,” or as “an integrated transaction,” *i.e.*, one transaction that may or may not have to be disaggregated for analysis.<sup>91</sup>

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<sup>90</sup> TD 9278; FR 44466-01, 44475, (emphasis added).

<sup>91</sup> Prop. Reg. § 1.482-9(m)(1), (emphases added).

## **2. Temporary Regulations**

No changes were made to the language reflecting the relevant transactions as single, integrated transactions subject to potential disaggregation.

## **3. Recommendations**

Treasury and the Service should clarify the interplay between Temp. Reg. § 1.482-9T(m)(1) and Reg. § 1.482-1(f)(2)(i), which sets the rule for the aggregation of transactions. The two provisions initially seem to address two distinct issues. The latter regulatory provision addresses two or more transactions that are so interrelated that they may be aggregated; the former addresses one service transaction that includes an element of a different transaction, which is allowed to be aggregated under certain conditions. The line of distinction between the two regulatory rules, however, is not easy to discern.

The first three Examples of Prop. Reg. § 1.482-9(m)(6) and Temp. Reg. § 1.482-9T(m)(5), all related to a services transaction with an element of transfer of tangible property, recognize this blurry condition. The Examples acknowledge that the determination whether an integrated transaction should be viewed as one or two transactions “depends on which approach will provide the most reliable measure of an arm's length result.”

The distinction is important because Reg. § 1.482-1(f)(2)(i) allows aggregation of two or more sufficiently related transactions without further requirements. By contrast, Temp. Reg. § 1.482-9T(m)(1), addresses an “integrated transaction” from the outset, but poses an additional requirement before the taxpayer may avoid disaggregation. The latter regulation provides that “each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction.” This is followed by a cross reference to Reg. § 1.482-1(d)(3).

We request that Treasury and the Service clarify this dichotomy and further address whether Temp. Reg. § 1.482-9T(d)(1) sets a higher standard than Reg. § 1.482-1(f)(2)(i) and, if so, why the higher standard is justified.

## **XV. Delay of Effective Date; Transition Rules**

### **A. Delay of Effective Date**

#### **1. Proposed Regulations**

Prop. Reg. § 1.482-9(n) contained an effective date making those provisions generally applicable for taxable years beginning on or after the date of publication as final regulations in the Federal Register.

## 2. Temporary Regulations

The Temporary Regulations are effective for taxable years beginning after December 31, 2006.

## 3. Recommendations

Although there have been indications that a delay in the effective date is not under serious consideration, we urge a reevaluation of this position in consideration of the points outlined below. It would be more realistic to delay the effective date for the Temporary Regulations so that they apply for taxable years beginning after December 31, 2007.

The Temporary Regulations were published in early August, when most multinational taxpayers were occupied with the filing of their 2005 federal tax returns. As practitioners began to analyze the new Temporary Regulations, an increasing number of questions arose concerning the proper interpretation of the regulations' provisions. As compared to the Proposed Regulations' Simplified Cost Based Method ("SCBM"), the Temporary Regulations' Services Cost Method ("SCM") represents a significant improvement. It is clear that the concerns expressed about the SCBM were considered by the government.

However, the environment that existed during the two years the Proposed Regulations were outstanding did not give practitioners and taxpayers a sense for the rules that would ultimately apply to back-office services. During this time, the Service indicated in many public forums that taxpayers' comments were being considered, that the regulations *could* be reissued in re-proposed or some other form and that a "white" list of services chargeable at cost was carefully being considered. It is highly unlikely that a taxpayer could get its management's approval to expend corporate resources to prepare to implement Proposed Regulations that were likely to change. Further, the Temporary Regulations will require that contractual arrangements be entered into or existing agreements be modified. This arises out of the logistics of providing inter-company services to a large number of affiliates. It is also required by the Temporary Regulations for certain service arrangements.

Multinational taxpayers often render services to large numbers of affiliates. It is typical for these services to be provided pursuant to written service agreements. As a practical matter, the terms of service arrangements should be memorialized *prior* to the provision of services. Foreign tax authorities often look to the terms of those service agreements when evaluating the deductibility of service charges and may prohibit payment for these services absent a written agreement. Thus, these agreements most often must be in place prior to the provision of services. Some foreign governments, *e.g.*, Brazil and Columbia, even require the authentication of cross-border contracts prior to their being given effect. The authentication process can add weeks to implementing an inter-company services agreement.

In reliance upon the existing cost safe harbor, of the 1968 regulations, taxpayers may have inter-company service agreements that specify that all historically at-cost services are to be provided at cost or, perhaps, at a very low mark-up. These agreements will need to be modified, possibly prior to the services' being provided in 2007. If foreign affiliates' governments require the authentication of the agreements, the effective date of the agreements may be further delayed.

Moreover, the Temporary Regulations require that certain tasks be completed prior to services being rendered. In particular, the contingent payment arrangement provision in Temp. Reg. § 1.482-9T(i) requires that a contingent payment arrangement be "set forth in a written contract entered into prior to, or contemporaneous with the start of the activity or group of activities constituting the controlled services transaction." These arrangements are to be entered into by a large number of controlled parties, the logistics of implementation can be complex and time consuming.

As an ancillary point, large taxpayers generally design billing processes and related computing systems so that inter-company services are handled most efficiently. As services are increasingly being provided from locations all over the world, sophisticated billing processes and computing systems are critical to enable tracking of the flow of services and billings. Where mark-ups on cost are added for the first time, systems may have to be modified to permit the mark-up to be tracked separately from a service's cost. This is necessary particularly in cases where foreign jurisdictions permit the deduction of cost but not any mark-ups.

All these factors place considerable pressure on taxpayers to complete transfer pricing studies during a very short period of time. The completion of these studies is only the beginning of the process of implementing the Temporary Regulations.

#### Financial reporting requirements

A January 1, 2007 effective date is also problematic for financial reporting purposes. If taxpayers were to determine transfer pricing outcomes under the Temporary Regulations after financial disclosures for 2007 have begun, any material changes from financial results initially forecast could require interim accounting corrections. Thus, it is important to taxpayers to have time to comprehend the rules (some of which we anticipate will need to be clarified) and apply them with a reasonable degree of certainty.

#### Summary

The Temporary Regulations make significant changes to regulations that have been in place for over 38 years. A key change to the existing transfer pricing rules is the elimination of the section 1.482-2 cost safe harbor. Although the Temporary Regulations contain the SCM, the number of services for which transfer pricing studies will, for the first time, be required under the Temporary Regulations is considerable. We suggest providing a

reasonable and sufficient period for taxpayers to comply with the new regulations is essential. Thus, the proposed effective date of the regulations should be delayed.

## **B. Transition Rules**

If the Treasury and the Service decides not to delay the effective date, transition rules designed to alleviate the burdens outlined above should be adopted. At a minimum, penalties should not be imposed (or should be waived) for a taxpayer's initial tax year that is subject to the provisions of T.D. 9278. Additionally, any adjustment made by the Commissioner pursuant to T.D. 9278 should be spread over a five-year period starting with the year of the adjustment, in a manner similar to section 481. We welcome the adoption in Notice 2007-5 of (i) a one-year delay in implementation of the Temporary Regulations' SCM method, except application of the business judgment rule, and (ii) one-year transition relief from the application of penalties under section 6662(e) and (h) if a taxpayer makes "reasonable efforts" to comply with the Temporary Regulations (as modified by the Notice).

Because elimination of penalties and the spread of any adjustment would not address incremental costs (*e.g.*, potential lost foreign deductions) of a January 1, 2007 effective date, one of the following transition rules should be adopted. Either alternative would grant more time for performing comparables studies, amending inter-company services agreements, and modifying systems and processes.

For a taxpayer's initial tax year beginning after December 31, 2006, T.D. 9278 will not apply if a binding contract was established prior to the issuance of the Temporary Regulations. Services provided pursuant to such binding contracts will not be subject to T.D. 9278 for that initial tax year. Alternatively, if the government chooses not to adopt a binding contract rule, at a minimum, the following rule should be adopted: For a taxpayer's initial tax year beginning after December 31, 2006, services that would otherwise qualify for at-cost pricing under existing Reg. § 1.482-2(b)(7), will qualify for the SCM. All other provisions of the temporary regulations continue to apply, including the expanded list of excluded services. This transition rule would effectively permit taxpayers to use the existing cost safe harbor's integral test for many services (except those on the excluded list) in light of the uncertain scope of the business judgment test (*i.e.*, does the test apply on an entity level or controlled group level?).