Play It Again, Sam – The IRS (More or Less) Finishes the Section 482 Services Regulations

By Patricia Gimbel Lewis

Almost 40 years after the current section 482 regulations governing intercompany services were promulgated, the Internal Revenue Service has issued updated temporary regulations on this subject (the "New Regulations").[1] The New Regulations improve upon 2003 proposed regulations (the "Proposed Regulations") that attracted serious criticism from the business community.[2] It is clear, and gratifying, that business's comments were heeded to a meaningful degree.[3] Since most multinational businesses entail some cross-border intercompany services — and since the New Regulations are quickly effective, beginning January 1, 2007, for calendar-year taxpayers — the new rules require close immediate attention. As temporary regulations, they have only a three-year life, to July 31, 2009. This will permit interim comments and potential further improvement to the rules, but could also necessitate a second round of comprehensive review and revisions by taxpayers.

Tips for Taxpayers

- ★ Move quickly to inventory, categorize, and review all intercompany service arrangements, identifying pertinent corporate objectives and using an evaluation template.[4] Contract revisions may be needed on an expedited basis.
- ★ Provide comments for the IRS hearings about legitimate interpretation or implementation problems.
- ★ Document and preserve analysis.

Key Topics

The New Regulations comprehensively address the transfer pricing of services rendered to related parties. Analytically, they can be broken down as follows:

- Critical Definitions: Revised principles for determining when services requiring intercompany compensation have been rendered.
- Services Cost Method (SCM): A new method for charging cost only, without any mark-up, for basic intercompany services, along with permitted cost-sharing arrangements for such services (Shared Services Arrangements or SSAs).
- Updated TPMs: Six other articulated transfer pricing methods for determining the arm's-length charge for intercompany services.
- Rules for Cost-Based TPMs: Cost calculations, allocations, and handling of passed-through third-party costs.
- Imputed Agreements: IRS approach to recasting transactions.
- Integrated Transactions: Standards for determining which set of intercompany pricing rules applies to transactions with multiple components.
- Effective Date Rules and Considerations
- Intangibles Framework: A separate, non-services-related part of the New Regulations addresses standards for determining the ownership of intangibles for transfer pricing purposes.

Tip for Taxpayers

- ★ Focus intently on SCM and whether it can be practically (or desirably) implemented.

A. Definitions[5] — Ring in the New

The New Regulations apply broadly to any "controlled services transaction." A controlled services transaction occurs when a commonly controlled party undertakes an activity that gives another controlled party a reasonably identifiable increment of economic or commercial value ("benefit"). Activities include the performance of functions, assumptions of risks, or use of tangible or intangible property or other resources, capabilities, or knowledge, including the ability to take advantage of particularly advantageous situations or circumstances.

The "benefit" concept adopts the OECD[6] test of whether an uncontrolled taxpayer in comparable circumstances would be willing to pay for the activity (on either a fixed or contingent payment basis) or would have performed the activity for itself. This approach replaces the "would-have-charged-for" test under the Old Regulations, which focused on whether the renderer would expect payment for the activity in question. The preamble to the New Regulations, however, clarifies that *valuation* of the charge is not limited to the recipient's perspective, but depends on the particular TPM used. As before, activities that confer "indirect or remote" benefits on affiliates are not considered chargeable services.

Of particular significance, the New Regulations change the emphasis in identifying "shareholder" activities which a parent company cannot charge to its subsidiaries. These activities are those that have the *sole* effect — changed from the "primary" effect in the Proposed Regulations — of protecting the renderer's investment in the group members and/or of facilitating compliance with reporting, legal or regulatory requirements applicable specifically to the renderer. (The broader concept of "stewardship" activities also includes "duplicative" activities, which likewise may not be charged out.[7])

Tips for Taxpayers

- ★ On the one hand, this change means that fewer shareholder-related activities will be non-allocable. On the other hand, it is still necessary to pass the "direct benefit" test before allocation to subsidiaries can be justified; the New Regulations confirm the Proposed Regulations' change in policy that "[i]n no event will an allocation of costs based on a generalized or non-specific benefit be appropriate,"[8] and reiterate that no allocations are permitted for indirect or remote benefits.[9] Implicitly, there remains a category of activities that, while not shareholder activities *per se* under the new definition, are still not direct enough to be allocable out and thus remain expenses just of the parent.

★ The intricate interplay between these offsetting effects and deductions, taxable income, tax rates, mark-up requirements and levels, foreign tax credit situations, and local law requirements makes it impossible to generalize about "typical" U.S. or foreign multinational preferences. Much will depend on how the direct benefit test is interpreted in practice.

Benefits attributable to mere "passive association" as a member of a controlled group will, as first articulated in the Proposed Regulations, not constitute a service. In an effort to clarify the meaning of these terms, the IRS[10] has added several new examples. For instance, a "comfort letter" to a subsidiary's customer, affirming the parent's ownership and intent to maintain such interest until the contract is completed, does not provide a chargeable benefit.[11] Along the same lines, volume discounts granted solely because of the size of the controlled group constitute passive association benefits and do not support an intercompany charge, that is, the subsidiary keeps the discount without having to pay anything to the parent.[12] Interestingly, the latter example takes group membership into account for comparability (*i.e.*, determining which vendor price levels can be passed through), while simultaneously viewing group membership as not conferring a compensable benefit.

Tip for Taxpayers

★ The volume discount example may require changes in some groups' practice of recovering from affiliates part or all of the purchasing power benefit of centralized procurement or logistics.

The Preamble also comments on the inference drawn by some observers under the Proposed Regulations that financial guarantees are considered services. Noting that case law holds that guarantees are not considered services for *sourcing* purposes and that the IRS considers it inappropriate to uniformly treat guarantees as noncompensatory by making them eligible for the SCM method (discussed below), the Preamble defers the transfer-pricing characterization of services to forthcoming global dealing regulations.

B. SCM — Every Day in Every Way . . .

The most dramatic improvement from the Proposed Regulations is the replacement of the much-maligned Simplified Cost Based Method (SCBM) with the Services Cost Method (SCM).[13] SCBM had substituted a complex, graduated-rate approach for the Old Regulations' cost-only safe harbor for "non-integral" services. Because SCBM required a threshold determination of the arm's-length mark-up for subject services (*i.e.*, 6 percent or less), it trounced administrative simplicity and threatened heavy compliance burdens for even the most elemental services. (As TEI put it in its comments, "the SCBM method is neither simple nor safe".[14])

The New Regulations restore the cost-only approach for a reasonably broad category of back-office services and, in some respects, move past the often imponderable "non-integral" requirement and the related "peculiarly capable" / "significant element" concepts.

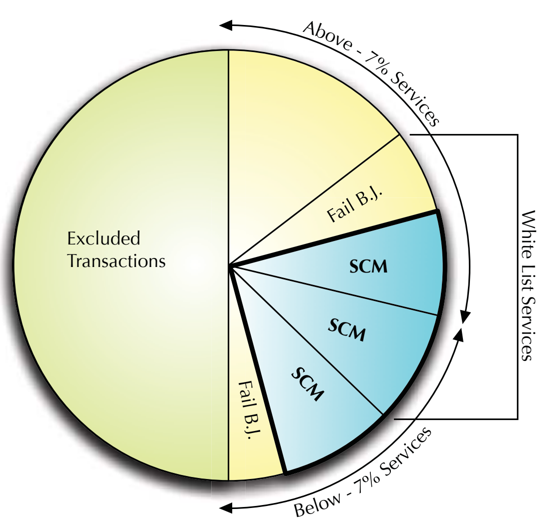
But there is no free lunch:

- A more restrictive "business judgment" test replaces the non-integral test, employing different, but still fuzzy, concepts.
- Specific new limitations on SCM are driven by the IRS perception that many intercompany services today have value significantly in excess of their cost.
- As with SCM's predecessors, there will be questions of international acceptance and harmonization problems.[15]

SCM applies to services that:

- Are *not* "excluded transactions" — A "Black List" of services will not qualify for SCM. This includes activities previously ineligible for the Old Regulations' cost-only safe harbor — manufacturing; production; extraction, exploration or processing of natural resources; and construction — as well as far-reaching new exclusions for reselling, distribution or similar agency or commission arrangements; research, development or experimentation; engineering or scientific; financial transactions (including guarantees); and insurance or reinsurance;
- Are either —
  - "Specified covered services" — A"White List" of common support services that generally do not involve a significant median comparable markup, as specified in a published revenue procedure, or
  - "Low margin covered services" — Services for which the median comparable markup does not exceed 7 percent;
- Pass the "business judgment" test — The 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 or the recipient; and
- Are covered by adequate books and records — Permanent records must be maintained to permit verification of pertinent costs, including a description of the services, various information and documentation, and a statement evidencing the taxpayer's intention to apply the SCM. Formal intercompany contracts are not required (but remain advisable).

Visually, the telescoping effect of these rules can be illustrated as follows:



ALL INTERCOMPANY SERVICES

The White List of eligible services responds to business's urging to retain a cost-only approach for relatively routine, back-office services that are supportive functions rather than part of the taxpayer's core competency. Although SCBM reflected a similar philosophy, it onerously required proof of low arm's-length margins before they could be ignored. The latter concept is retained in the "low margin covered services" leg above,[16] but is balanced by the purely definitional White List categories.

White List. The White List, set forth on a proposed basis in IRS Announcement 2006-50,[17] is detailed but clearly limited to fairly mechanical, administrative, and non-creative services. This could give rise to difficult segregation and allocation issues, since it is unlikely that support services will be exclusively so constituted. As a general matter, it would have helped to incorporate a "primarily" approach, or perhaps a de minimis exception, in the White List, despite a predictable IRS "slippery slope" concern. One particular concern is computer-related services. "Database administration" and "network and computer system administration" include technical assistance to users, but specifically exclude "analyzing user needs or developing hardware or software solutions (such as systems integration, website design, writing computer programs, modifying general applications software, or recommending commercially available software)." The IRS may not have captured the right dividing line for either practical or policy purposes; absent some changes when the list is finalized, compliance could be thorny.

Because of these limitations, the low margin leg may, ironically, prove more administrable. As the test is based on general section 482 approaches and principles such as CPM, multi-year averages, etc., the determinant will be whether reasonable groupings of services are permitted and how much of a stickler the IRS is with respect to comparables. There will undoubtedly be pressure on the IRS for more guidance on these aspects.

Business Judgment Test. The new business judgment test is designed to prevent taxpayers from claiming cost-only treatment for core competencies. It replaces the non-integral standard (which looked, among other things, to whether the same services were rendered to third parties, were relatively large, or utilized special skills, relationships, or intangibles) with similarly directed but differently expressed concepts. The new test has the potential to breed significant uncertainty and audit risk. In the first place, it involves terminology — "key competitive advantages," "core capabilities," and "fundamental risks of success or failure" — that lack clear precedents or boundaries. Moreover, although the IRS took great pains in the Preamble to stress the high level of deference to be given to the taxpayer's judgment,[18] this is not reflected in the text of the regulations and could become a bone of contention on audit. Taxpayers are well advised to memorialize their views and justification on this aspect in their SCM documentation.

Tips for Taxpayers

- ★ Watch for clarification of whether dedicated service entities can qualify for SCM, or whether their services, albeit routine, will be considered a prohibited core competency. The integral services test under the Old Regulations permitted a consolidated group analysis for determining whether services were a principal activity of the renderer,[19] but this approach is, so far, missing from SCM. The IRS informally appears sympathetic to correcting this anomaly.
- ★ The terminology used in the White List is geared to routine services performed by individuals, *e.g.*, "performing data entry," "operating…office machines," "processing…inquiries," "providing technical assistance,"etc. Initial indications are that this functions-based approach effectively excludes the costs of management and executive activities related to the listed activities. This is likely to create difficult identification and allocation tasks, and seems a likely area for taxpayer push-back.
- ★ To illustrate the tough line-drawing exercises here, consider a group in the call center business (clearly SCM-ineligible) compared with a call center unit that provides exemplary, albeit routine and low-margin, customer service for group-made products. Would the latter be caught by the business judgment rule?
- ★ Companies whose business consists of excluded-transaction-type activities (*e.g.*, financial services, insurance, construction, etc.) may face added challenges in qualifying White List or low margin services for SCM. (See discussion below of Examples 5-7.)
- ★ To avoid any inadvertent election or rejection of the SCM, be very explicit — whatever the choice — in pertinent documentation.

Thus, the new rules add three areas of audit risk: interpretation of White List services, implementation of the 7-percent low-margin test, and in all cases satisfaction of the business judgment rule. Cost pool calculations and allocation methodologies, discussed in D below, are also potentially controversial, but not new issues.

Shared Services Agreements. The new concept of Shared Services Arrangements (SSAs) opens the door to a potentially useful administrative mechanism — cost-sharing arrangements for services. Foreshadowed by the permissive "cost contribution arrangements" under the OECD Guidelines,[20] the requirements for SSAs are relatively simple:

- There must be at least two participants
- All controlled taxpayers that reasonably anticipate a benefit from the covered services must participate
- At least one participant must benefit from each covered service (or reasonable aggregation of services), and
- The subject services must constitute "covered services" eligible for SCM.

Under an eligible arrangement, the costs of the services are allocated among the participants in proportion to their respective shares of the reasonably anticipated benefits (whether or not in fact realized). This allocation must be applied on a consistent basis for all participants and services. Deference is given to the taxpayer's "reasonable conclusion" as to the reliability of the measurement keys. Specified documentation requirements apply. Aggregation of covered services is permitted for allocation purposes, taking into account whether relative benefits are reasonably reflected, and need not follow the same groupings used for evaluating low-margin services.

Tips for Taxpayers

★ The difference between an SSA and simply allocating costs of centralized services under SCM may be subtle. The principal SSA advantages are an effective relaxation of the direct benefit test and a potentially simplified allocation mechanism. These result from the liberalized aggregation rule together with explicit permission (in the Preamble) to cover "activities that provide benefits on only an occasional or intermittent basis."

★ Inapplicability to non-SCM services and the consequent need to maintain two (or more) allocation systems may limit the appeal of SSAs. Includibility of marked-up services in SSAs may be too much to expect from the near-term round of IRS last-minute modifications, but perhaps favorable experience with SCM-based SSAs will lead to expanded coverage down the road.

Twenty-six examples are provided to clarify the mechanics and interpretation of SCM and its related provisions; some may raise more questions than they answer. Among the more important are:

- Routine data entry regarding medical information (*SCM-eligible*) vs. collection of data on "smart cards" for marketing purposes (*not eligible per business judgment test*). (Examples 1 and 2)
- Routine recruiting services at job fairs, etc. (*SCM-eligible*) vs. recruitment of well-connected celebrity agents (*not eligible per business judgment test*). (Examples 3 and 4)
- Routine credit checks for clothing distributors and retail customers (*SCM-eligible*) vs. specialized credit analysis for assessing high-risk customers to issue high-rate leases (*not eligible per business judgment test*) vs. credit analysis used by bank affiliate in making loan decisions (*not eligible because part of an excluded "financial transaction"*). The last example suggests special bifurcation challenges for taxpayers whose business consists of excluded transactions, *e.g.*, financial institutions or insurance companies. (Examples 5-7)
- Routine data verification services, *e.g.*, reviewing accounts payable data (*SCM-eligible*) vs. data mining services that also constitute a significant portion of the renderer's business (*not eligible per business judgment test*). (Examples 8 and 9)
- General in-house legal services (*SCM-eligible*) vs. a legal department with experienced attorneys in critical specialty areas, *e.g.*, representation of nuclear utilities before the U.S. Nuclear Regulatory Commission (*not eligible per business judgment test*). (Examples 10 and 11)
- Groups of services:
  - Both SCM-eligible and ineligible services — ERP system maintenance (*eligible*) and modification (*not eligible*). (Example 12)
  - All eligible services — Purchasing, payment, and inventory tracking services. (Example 13)
  - All ineligible services — State-of-the-art inventory management system that significantly reduces costs and is touted by the taxpayer as critical to the company's success. (Example 14)
- Allocation keys for SSAs:
  - Volume processed or processing unit time as a better measure for automated invoice processing than the value of merchandise invoiced. (Example 18)
  - Employee headcount or total compensation as more reliable for human resources function than subsidiaries' revenues. (Example 19)
  - Several examples that judge appropriate allocation methods by reference to the results that would flow if relative reasonably anticipated benefits were precisely known. These examples are less than elucidating, since the latter assessment is often difficult and somewhat circular, but they do helpfully tolerate some approximations. (Examples 20-23)

C. Other Transfer Pricing Methods — RPSM Descending?

As under the Proposed Regulations, the New Regulations detail various standard transfer pricing methodologies (TPMs) for pricing intercompany services that are not covered by SCM.[21] These TPMs largely parallel the methods developed in 1994 for intercompany transfers of tangible and intangible property:

- Comparable uncontrolled services price method (CUSP) — similar to the comparable uncontrolled price (CUP) method for tangible property and the comparable uncontrolled transaction (CUT) method for intangible property.
- Gross services margin method — similar to the resale price method for tangible property.
- Cost of services plus method — similar to the cost-plus method for tangible property.
- Comparable profits method (CPM) — with a new "net cost plus" profit level indicator emphasized.
- Profit split method — focusing on the residual profit split method (RPSM).
- Unspecified methods.

Several aspects of these rules are noteworthy.

Profit Split Method. In reaction to pervasive comments, the IRS backpedaled on the Proposed Regulations' perceived emphasis on profit split methods (specifically, RPSM) by revising several examples both here and in the intangibles rules discussed in G below.[22] The Preamble now states clearly that the profit split method is not to be considered a "default" method for high value services. Rather, the focus of RPSM's utility for services transactions is changed to situations involving "non-routine contributions" by multiple controlled parties, *i.e.*, functions for which market returns cannot be identified. Even this modified approach, however, broadens the applicability of RPSM beyond situations involving intangibles.[23]

The New Regulations also substitute a new example[24] of when RPSM is appropriate for one under the Proposed Regulations relating to integrated oil exploration services. The new example, dealing with hazardous waste services, involves multiple non-routine contributions in the nature of (a) research and development leading to novel technology, specialized technical knowledge and project managers, and commitment to perform under the contract, and (b) reputation for completing projects responsibly, knowledge of and contacts with pertinent local officials, and licenses to handle certain types of waste. This example emphasizes the unavailability of reliable comparables for the full range of services provided by each party in a complex transaction, but does not explain how to value the various contributions to determine the profit split ratio.

Tip for Taxpayers

★ Despite the IRS's professed deemphasis of RPSM, complex situations like those in the new example are not uncommon. Increased use of RPSM may be inevitable.

Comparable Profits Method (CPM). Several examples have been added under the CPM to clarify that the existence of stock-based compensation (*e.g.*, stock options), granted either by the taxpayer or comparable companies, should be taken into account and adjusted for comparability purposes.[25] This elaboration is consistent with 2003 revisions to the general CPM regulations,[26] and dispels any notion that silence on this point in the Proposed Regulations meant that the IRS would not apply this concept to services transactions. Although directionally sound, these examples assume that option amounts expensed for financial statement purposes equate with fair value for comparability purposes, a position debated by some commentators.[27]

Gross Services Margin Method. As under the Proposed Regulations, this method focuses on situations where one related party acts as agent or intermediary for another. The New Regulations permit the use of buy-sell distributors as comparables for these kinds of services transactions, if functionally similar, which may be pertinent in commissionaire situations.[28]

Unspecified Methods. The generally applicable need to consider "realistic alternatives" to the transactions[29] is explained here as including economically similar transactions structured as other than services transactions. An example involves a company that developed a real estate investment software program for commercial real estate and maintains it on its own server for access by customers over the Internet. When affiliates use the same program, the IRS is permitted to consider non-services alternatives such as sale or download from the Internet.[30]

Contingent Payment Arrangements. While not a TPM *per se*, pre-arranged contingent payment contractual terms are recognized by the New Regulations if they are consistent with the economic substance of the transaction and the conduct of the parties. The Proposed Regulations' additional requirement to show that uncontrolled taxpayers would enter into similar arrangements has been removed, but the IRS may still consider alternatives reasonably available to the parties as part of the arm's-length test.

The permissibility of these arrangements may prove handy for taxpayers, particularly for research services. The flip-side risk that the IRS may impute such arrangements to adjust results in situations where the parties did not explicitly so contract remains, with only a very limited IRS disclaimer in the Preamble (see E below).

D. Rules for Cost-Based TPMs — Not Out of Sight . . .

Calculation of Costs. SCM, SSAs, CPMs using a net cost plus PLI, and other cost-based TPMs are based on "total services costs."[31] Total services costs include all costs in cash or kind that are directly identified with, or reasonably allocated to, the services, including stock-based compensation. The latter addition attempts to legitimatize the IRS's losing position in the context of intangibles cost-sharing arrangements,[32] and may engender further controversy. No particular accounting methods govern; GAAP and federal income tax accounting rules "may provide a useful starting point but will not necessarily be conclusive."

Tip for Taxpayers

★ The prescription to include stock-based compensation in costs injects administrative allocation and tracking complexities, exacerbated by the absence of permissible timing or valuation methods. For the moment, the tax-deduction-based method currently set forth in the cost-sharing regulations[33] seems the implicit rule of choice. Perhaps the next version of the cost-sharing regulations will extend to services the optional audited-financial-statement-based method set forth in the currently proposed cost-sharing revisions.[34] Pending clarification by the IRS, comprehensive facts tracking grants, pricing, vesting, and exercise should be preserved.

A key cost-related concern of commentators was whether required mark-ups must be applied to significant third-party charges borne by the service provider, for example, where the related party merely facilitates group sharing of one or more externally provided services such as systems provision/management, payroll management, consulting, etc. Rather than permitting "pass-through" of these costs without mark-up, however, the New Regulations take a more complex tack of allowing disaggregation of transactions that involve "material"[35] third-party costs for separate testing, *if* appropriate and reliable comparable transactions exist.[36] One example posits that the third-party contract may be treated as an internal CUSP, implying that the pass-through of that amount would not be further adjusted. Careful review of the related service provider's actual involvement in the third-party services is suggested, which could create cumbersome monitoring requirements.

Tip for Taxpayers

★ An important "basket" to capture when reviewing services transactions is situations involving significant external service costs, preparatory to separate, more complicated compliance analysis.

Allocation of Costs. There is often a need for a method to allocate costs between multiple beneficiaries. The New Regulations do not break much new ground or provide new guideposts in this regard.[37] As under the Old Regulations, "[a]ny reasonable method may be used," considering all bases and factors, and apportionment can be based on reasonable overall estimates or by applying reasonable departmental overhead rates. It is reiterated that allocations must be made on the basis of full cost, not incremental costs (for example, in the case of database license fees that do not vary by volume[38]). Practices used for management, financial statement, reporting, or other external purposes will be considered potentially reliable — but the New Regulations add that these indicators will not necessarily be conclusive.

Tip for Taxpayers

★ Allocations also involve simultaneous consideration of the "direct benefit" principle as well as the "pass-through" concepts and the stewardship and "passive association" non-allocation principles discussed in A above.

E. Imputed Agreements — The Lurking Leveler

The Proposed Regulations embellished existing provisions that permitted the IRS to review controlled parties' dealings and impute agreements between them to more accurately reflect the economic substance of their conduct, even if contrary to express contractual agreements.[39] Examples were provided stating that alternative IRS approaches could include imputation of contingent payment compensation, long-term exclusive distribution agreements, or compensation for termination of a long-term license.[40] These examples focused on intangibles-like situations where atypical marketing services or research-sharing led to premium returns in later years. Critics asserted that the IRS was exceeding its authority and applying commensurate-with-income principles to transactions outside of the intangible property context. One underlying concern was that recasting transactions could potentially permit transfer pricing adjustments well beyond the statute of limitations for the initial transaction year.

The Preamble to the New Regulations states that various criticisms (without mentioning the timing issue) were seriously considered but were ultimately dismissed. The Preamble stresses that taxpayers have the upper hand in being able, in the first instance, to expressly set forth the economic substance of the transaction in contractual terms, and that the IRS can only impute different arrangements if the taxpayer fails to specify contractual terms or if the specified terms do not accord with economic substance. An example has been added stating that merely being outside the arm's-length range is not enough, without more, for the IRS to impute alternative arrangements, but that the situation would differ if the compensation paid is outside the range by a substantial amount.[41] Despite platitudinous professions of restraint, the IRS's authority is not meaningfully hobbled, and the potential scope and threat of its imputation powers remain (subject, of course, to IRS resource constraints).

Tip for Taxpayers

★ The importance of clearly establishing responsibilities, risks and intended relationships by contract cannot be overstated. But even this will not save the day unless consistent and reasonable arm's-length pricing methods and ranges are determined and complied with.

F. Integrated Transactions — The Still-Sleeping Giant

In the case of transactions which combine different elements, the New Regulations, in the same manner as the Proposed Regulations, look first to whether there are sufficiently similar features in comparable transactions that can be used to evaluate the transaction as a whole.[42] Significantly, the Preamble states that "if a taxpayer structures a transaction so that it constitutes a controlled service, the transaction will generally be analyzed under the principles of" the services regulations, without regard to other provisions of the section 482 regulations. Reliability concerns may nevertheless in some cases call for separate evaluation of the separate elements under pertinent transfer pricing rubrics.

Services transactions with an intangible property element must run an additional gauntlet. Any "material element" relating to intangible property must be corroborated or determined under the intangibles rules of Treas. Reg. § 1.482-4. Commendably, the New Regulations dropped a confusing provision referring to services transactions that "may have an effect similar to the transfer of intangible property," lest the phrase be interpreted as improperly expanding the intangibles provisions of the existing regulations to non-intangible transactions.

Tip for Taxpayers

★ Mixed transactions (*i.e.*, services utilizing intangible property) are increasingly common and may present knotty analytical challenges. Despite the IRS's cosmic concern with hidden intangibles, minimal guidance has been proffered. Taxpayers should take advantage of the deference afforded the taxpayer's chosen structure to be very specific about characterization and nomenclature and to conduct themselves consistently.

G. Intangibles — Resetting the Stage

This set of regulations goes beyond intercompany services to address certain threshold concepts in pricing intangibles. Despite some criticism, the New Regulations continue the rule that legal ownership of intangibles is usually the foundation for assessing appropriate transfer pricing. In this regard, the Preamble clarifies that *title* is the determinative factor in this regard, taking into account contractual provisions as well as government registry protection such as for patents, trademarks, or copyrights, without resort to judicial doctrines and common law principles under substantive intellectual property law.[45] The restated rules also stress the ability to slice up an intangible into separate items of intangible property for transfer pricing purposes, *e.g.*, (a) the trademark itself and (b) discrete license rights thereunder.[46]

As under the Proposed Regulations, the ownership of intangibles that are not legally protected will henceforth be based on "practical control," rather than the "developer/assister" approach of the Old Regulations.

The modified rules also adopt a "contribution" approach that requires consideration for activities that increase the value of an intangible owned by a related party.[47] Compensation for such contributions may variously be embedded within the terms of another transaction, stated separately, or applied to reduce another payment.[48] This "contributor" rule replaces the so-called cheese examples in the Old Regulations, which suggested that extraordinary marketing expenditures could create an "intangible" for transfer pricing purposes. The Preamble explains that "incremental marketing activities" that enhance the value of another's intangible and thus may require compensation are those that are quantitatively greater (in terms of volume, expense, etc.) than activities undertaken by comparable uncontrolled parties in the transactions used to analyze the controlled transaction.

Tips for Taxpayers

- ★ One notable change from the Proposed Regulations is to downplay any apparent thumb on the scale for RPSM as a preferred method in cases involving a contribution to the value of an intangible where there are no ready comparable transactions.[49]
- ★ Again, the Preamble notes "heightened deference" to taxpayers' contractual arrangements, reinforcing the desirability of comprehensive review of existing contracts or creation of new ones.
- ★ The full implications of the new intangibles rules are a topic unto themselves, beyond the scope of this article.

H. Effective Date Rules & Considerations – Tough Choices

The Temporary Regulations are effective for taxable years beginning after December 31, 2006, and remain in effect until July 31, 2009. Given the broad scope of the rules, the close-at-hand effective date affords precious little time for the necessary comprehensive review, particularly with further last-minute changes (including finalization of the White List) possible under the proposed regulation comment process.

Taxpayers may elect to apply the new rules retroactively to any taxable year beginning after September 10, 2003 (the publication date of the Proposed Regulations). Such an election would apply to all intervening years and, implicitly, to all intercompany services transactions involving the taxpayer. Evaluating the desirability, and implications, of such a choice will likely be a Herculean task, given the imprecision of the old rules and many unexplicated standards of the new ones. While an election might desirably button down a cost-only method for clearly SCM-eligible services, the counterweight is the requirement for full-blown arm's-length analyses of ineligible categories. An election to apply the rules retroactively must be made on the taxpayer's return for the first taxable year after December 31, 2006 (*e.g.*, probably in September 2008 for calendar year taxpayers).

Tips for Taxpayers: GET STARTED!

- ★ Evaluation of the prospective application of the rules is more time-sensitive than assessing a retroactive election, since past years' transactions are already completed whereas restructuring/repricing decisions may need to be made *by December 31, 2006*[50] (*e.g.*, to get necessary contracts in place or otherwise to assure consistent foreign acceptance).
- ★ Retroactive elections are obviously complicated, perhaps incurably, by the bilateral aspect of transfer pricing and the necessary involvement of foreign tax rules and authorities.
- ★ Keep in mind the potential for further revisions when the Temporary Regulations expire in 2009.

Conclusions

The IRS has tried hard to make the services regulations more user-friendly in routine situations and to add more examples. Eligibility for SCM and SSAs, however, needs considerable broadening to make practical sense for many taxpayers. Ways to do this include expansion of the White List, narrowing of ineligible categories, modification of the business judgment rule, or incorporation of some "primarily" standards. Absent some modifications, taxpayers may shift to broad CPM studies demonstrating less-than-7-percent margins, hoping for IRS forbearance on aggregation rules, or may have to reluctantly[51] seek valuations of many separate categories of intercompany services, both for SCM and non-SCM purposes. It seems inevitable that fewer services will be chargeable at cost than under current rules, that more "robust" analyses will be needed, and that taxpayers must undertake considerably more work and prepare considerably more documentation than seen in typical current levels of section 6662(e) compliance with respect to services.

One way or another, taxpayers will eventually get comfortable with the final rules or develop coping mechanisms. The compressed adoption period for such pervasive, bilateral transactions, however, as well as the potential for further changes within that period,[52] is quite troubling.[53]

That said, the increased harmonization with OECD standards has positive implications for reduction of international inconsistency and controversies. This is a good thing, since the Competent Authority mechanism for resolving cross-border disputes may not be practical for typical cases involving relatively small individual adjustments among many countries.

Integrated or overlapping transactions having intangible elements — an important genesis for the regulatory revisions — remain in murkier territory. It will probably take more time to develop, through guidance, experimentation, and litigation, a reasonable understanding of the application of the new rules. Since integrated transactions are increasingly prevalent in today's high-tech world, the potential for troublesome audits remains significant. Advance Pricing Agreements should become increasingly attractive for non-routine situations.

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1. Temp. Reg. § 1.482-9T and related provisions, T.D. 9278 (8/4/06). Temporary regulations have the same effect as final regulations for their limited life. As required by section 7805(e) of the Internal Revenue Code, the regulations were simultaneously issued in proposed form, which allows further commentary before the effective date. In this article, the IRS's extant services regulations, originally issued in 1968, are sometimes referred to as the "Old Regulations.")
2. Prop. Reg. §§ 1.482-1, -4, -6 and -9 (Sept. 10, 2003). *See* Lewis, *Markers and Musings: The Proposed Section 482 Services Regulations*, 55 The Tax Executive 448 (Nov.-Dec. 2003).
3. Tax Executives Institute submitted extensive comments on the Proposed Regulations in December 2003 (56 The Tax Executive 49 (Jan.-Feb. 2004)) ("TEI Comments"), as well as a detailed list of "per se" services that the organization proposed be permitted to be charged at cost (13 Tax Management Transfer Pricing Rep. 215 (July 7, 2004)).

TEI's comments undoubtedly influenced the redrafting of the regulations, which reflect many, if not all, of TEI's suggestions.

4. Taxpayers should not overlook in-force Advance Pricing Agreements with the IRS, if they might contain provisions inconsistent with the new rules. *See* §§ 11.06(3) and 11.07 of Rev. Proc. 2006-9, 2006-2 I.R.B. 278.
5. Temp. Reg. § 1.482-9T(l).
6. The Organisation for Economic Cooperation and Development (OECD) has issued extensive guidance over the years for the international implementation of transfer pricing rules. The most current guidance for services is contained in Chapter VII (Special Considerations for Intra-Group Services, issued in March 1996) of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (OECD Guidelines). *See* OECD Guidelines ¶ 7.6.
7. Temp. Reg. §§ 1.482-9T(l)(3)(iii) and (iv) and 1.861-8T(e)(4)(ii).
8. Temp. Reg. § 1.482-9T(k)(1); the IRS' previously preferred "general benefit" approach was detailed in TAM 8806002 (Sep. 24, 1987).
9. Temp. Reg. § 1.482-9T(l)(3)(ii).
10. As used in this article (and unless context requires otherwise), the term "IRS" generally includes the Treasury Department, which jointly promulgates the regulations.
11. Temp. Reg. § 1.482-9T(l)(5), Ex. 18.
12. Temp. Reg. § 1.482-9T(l)(5), Ex. 19.
13. Temp. Reg. § 1.482-9T(b).
14. TEI Comments, *supra*, at 49.
15. Foreign legal patterns range from prohibiting any payment for certain headquarters services to requiring cost-plus charges for all types of services.
16. The 7-percent median limit is higher than the 6-percent limit under SCBM, presumably based on economic information provided in the public's comments.
17. 2006-34 I.R.B. __ (to be finalized by January 1, 2007).
18. "[T]his is a business judgment preeminently within the business person's own expertise. Exact precision is not needed and it is expected that the taxpayer's judgment will be accepted in most cases."
19. Treas. Reg. § 1.482-2(b)(7)(ii)(C).
20. §§ 8.3 and 8.7 of Chapter VIII (August 1997).
21. Temp. Reg. §§ 1.482-9T(c)-(h).
22. Temp. Reg. § 1.482-4T(f)(4)(ii).
23. *Cf*. Treas. Reg. § 1.482-6(c)(3)(i).
24. Temp. Reg. § 1.482-9T(g)(2), Ex. 2.
25. Temp. Reg. § 1.482-9T(f)(3), Exs. 3-6.
26. Treas. Reg. § 1.482-5(c)(2)(iv).
27. Chandler, Herr & Subramanian, *Adjusting for Stock Options*, 12 Tax Management Transfer Princing Rep. 593 (October 29, 2003).
28. This language is analogous to that under the resale price method for transfers of tangible property, in Treas. Reg. § 1.482-3(c)(3)(ii)(D).
29. Treas. Reg. § 1.482-1(f)(2)(ii).
30. The facts of this example are confusing, however, because there is no indication why identical services transactions with unrelated customers are not considered the most reliable comparison.
31. Temp. Reg. § 1.482-9T(j).
32. *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005).
33. Treas. Reg. § 1.482-7(d)(2)(iii).
34. Prop. Reg. § 1.482-7(d)(3) (2005).
35. This qualifier is used in the Preamble but not in the text of the New Regulations.
36. Temp. Reg. § 1.482-9T(l)(4); *see* Temp. Reg. § 1.482-9T(l)(5), Exs. 20 and 21.
37. Temp. Reg. § 1.482-9T(k).
38. Temp. Reg. § 1.482-9T(k)(3), Ex. 1.
39. Treas. Reg. § 1.482-1(d)(3)(ii)(B).
40. Prop. Reg. § 1.482-1(d)(3)(ii)(C), Exs. 3-5 (2003).
41. Temp. Reg. § 1.482-1T(d)(3)(ii)(C), Ex. 5.
42. Temp. Reg. § 1.482-9T(m).
43. Temp. Reg. § 1.482-9T(m)(2).
44. The New Regulations also revise some confusing facts in an example regarding the transfer of intangible property through technical manuals, by specifying that the renderer owned the subject intangibles before transferring them in a report as part of a technical assistance agreement. Temp. Reg. § 1.482-9T(m)(5), Ex. 4.
45. *See generally* Temp. Reg. § 1.482-4T(f)(3)(i)(A).
46. Temp. Reg. § 1.482-4T(f)(3)(ii), Ex. 1.
47. Temp. Reg. § 1.482-4T(f)(4).
48. The Preamble indicates that discounted cash-flow analysis (DCF) may be particularly useful in valuing such contributions, and notes that consideration is being given to adopting DCF as a specified method in its own right.
49. *Compare* Temp. Reg. § 1.482-4T(f)(4)(ii), Ex. 6 *with* Prop. Reg. § 1.482-4(f)(4)(ii) (2003). *See also* Temp. Reg. § 1.482-4T(f)(ii)(4), Exs. 3-6 (referring to Temp. Reg. § 1.482-8T(b), Exs. 10-12).
50. Presumably this language means the first year *beginning* after December 31, 2006.
51. While the imposition of mark-ups cuts both ways, those for whom a mark-up is desired or desirable presumably already have studies in place.
52. Areas as to which the IRS is specifically seeking comment include the White List of specified covered services for SCM, the Black List of excluded transactions for SCM, use of a discounted cash flow method for valuing contributions to other parties' intangibles, and interaction of the services rules with the pending rules for cost-sharing arrangements. These topics cover a lot of territory.
53. Although the IRS in one sense simplified this task by not making many changes to the Proposed Regulations outside of SCM, taxpayers undoubtedly deferred costly comprehensive analyses in the face of the controversy engendered by the Proposed Regulations and their potential interaction with the even more controversial proposed cost-sharing regulations.