

**American Bar Association  
Section of Taxation  
Transfer Pricing Committee**

**Comments Concerning Transfer Pricing "Services" Regulations**

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## **Comments Concerning Transfer Pricing "Services" Regulations**

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

These comments were prepared by individual members of the Committee on Transfer Pricing of the Section of Taxation. Principal responsibility was exercised by Steven C. Wrappe. Substantive contributions were made by David Canale, Darrin Litsky and John Warner. The comments were reviewed by Marc M. Levey, Chair of the Committee on Transfer Pricing. The comments were also reviewed by John Barrie as a member of the Section's Committee on Government Submissions and by David Raish, as Council Director for the Committee on Transfer Pricing.

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

One member who contributed to these comments is an employee of a company that could be affected by the proposed regulations. That person has not, however, been personally involved in lobbying or otherwise specifically trying to influence the development or outcome of specific aspects of these proposals.

### **Executive Summary**

We submit the following comments and suggestions to assist the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") with their announced intention to propose revised Section 482 regulations relating to the performance of intercompany services. The comments and suggestions focus on the following areas:

- Harmonization with the transfer pricing rules in Treas. Reg. § 1.482-1;
- Guidance regarding what constitutes a "stewardship expense;"
- Retention or modification of the cost safe harbor for "non-integral" services;
- Harmonization of the treatment of "headquarters expense allocation" with the OECD Transfer Pricing Guidelines' treatment of "cost contribution arrangements;"
- Guidance regarding employee know-how and other embedded intangibles transferred in connection with services; and
- Guidance regarding intercompany services using the Internet.

## **Harmonization With Other Transfer Pricing Rules**

Many taxpayers already attempt to apply the provisions of Treas. Reg. § 1.482-1 to transfer pricing analyses of intercompany services. The IRS should not only make Treas. Reg. § 1.482-1 applicable generally to the new services regulations, but also provide specific guidance on the application of the best method rule and on the comparability factors relevant for services. Because functions and risks bear different weight and meaning in the context of intercompany services, it would be helpful to point out differences in the application of traditional methods and comparability factors to services transactions. We recommend the IRS provide multiple examples to illustrate these new rules.

## **Guidance on Stewardship Expenses**

The current service regulations do not clearly define what types of services constitute “stewardship activities.” It is important that the proposed service regulations provide more direction to taxpayers regarding the treatment of services as stewardship activities in order to avoid mischaracterization and improper transfer pricing results. The rules should be complemented with multiple examples of services that are regarded as stewardship activities, as well as leave open the possibility that other types of services not mentioned may also be characterized as stewardship activities in the spirit of the regulations.

## **Cost Recovery Safe Harbor**

The current regulations contain a safe harbor concept for non-integral services which does not require a mark-up or profit element for certain services. This treatment is conceptually valid and practical under circumstances where intercompany services do not form a core part of a group’s trade or business activities with third parties. These types of services are more appropriately treated as generalized costs of doing business and not profit centers (i.e., not value-added functions, but simply back-office or centralized administrative support activities). The introduction of a profit element in these situations could actually distort income. Also, the current cost recovery safe harbor is not inconsistent with OECD Guidelines. Accordingly, the proposed service regulations should continue to include a cost recovery safe harbor, but should expand it to all situations in which the pricing of intercompany services at cost would clearly reflect income. This could be achieved by creating an affirmative safe harbor for purely administrative or back office services, or by more generally expanding the existing safe harbor rule.

In addition, the safe harbor rule should continue to encompass headquarters services. We urge that the proposed regulations sanction a headquarters services cost sharing model to reflect accurately the economic realities of integrated multinational companies (*i.e.*, recognizing economies of scale from centralizing administrative or back office functions), which result will also be consistent with the OECD Guidelines. The adopted model should incorporate flexible measures for charging out these services in order to reflect both a fair usage of the contributing parties and the benefits received by each party.

## **Embedded Intangibles**

Both U.S. regulations and OECD Guidelines recognize that, in certain circumstances, intangibles are embedded in the provision of services. Although the current regulations and OECD Guidelines are helpful and similar, Treasury should provide additional guidance, including examples, that would help taxpayers determine when a service transfers an intangible that has a separate and distinct value apart from the services performed.

## **Intercompany Services and the Internet**

In the post-Internet era, a new business environment reveals gaps in the old rules and creates uncertainty in the application of the rules. Specifically, the Internet has spawned two types of services-related transactions: truly new e-commerce services (such as application hosting, application service provider and web site hosting) and traditional services that are provided over the Internet (such as moving technical support for global operations to a single location). In this new environment, uncertainty in the application of rules will exist long after broad transfer pricing principles for the treatment of e-commerce services are agreed upon. We recommend that the proposed services regulations offer multiple examples to illustrate the Treasury's positions.

## COMMENTS CONCERNING TRANSFER PRICING “SERVICES” REGULATIONS

The IRS-Treasury Department 2001 Priority Guidance Plan, released April 26, 2001, gives priority to issuing revised Section 482 rules relating to the performance of intercompany services by June 30, 2002.<sup>1</sup> Subsequent to the issuance of the intercompany services regulations in 1968, significant changes have occurred in the manner in which multinational companies (MNCs) conduct business. Prominent among these changes is the increase in the significance of the service sector and the upsurge in e-commerce transactions.<sup>2</sup> Unlike the rest of the transfer pricing regulations, the intercompany services regulations have not been amended in over three decades to account for these changes. In light of the changes, we urge the Treasury to issue revised regulatory guidance and we offer comments on the following issues to assist in the development of the Section 482 services regulations:

- Harmonization with the transfer pricing rules in Treas. Reg. §1.482-1;
- Guidance regarding what constitutes a “stewardship expense;”
- Retention or modification of the cost safe harbor for “non-integral” services;
- Harmonization of the treatment of “headquarters expense allocation” with the OECD Transfer Pricing Guidelines’ treatment of “cost contribution arrangements;”
- Guidance regarding employee know-how and other embedded intangibles transferred in connection with services; and
- Guidance regarding intercompany services using the Internet.

We further suggest that the Treasury provide an ample comment period for any proposed regulations and that consideration be given to issuing the proposed regulations in draft form first, for discussion purposes.

### *I. Harmonization With Other Transfer Pricing Rules*

The current regulations governing intercompany services under Treas. Reg. § 1.482-2(b) do not describe how the general principles and guidelines in Treas. Reg. § 1.482-1 apply in the context of intercompany services. We recommend that language be added to any new intercompany services rules specifically incorporating all of the provisions of Treas. Reg. § 1.482-1, as appropriately supplemented and modified to apply in the context of intercompany services.<sup>3</sup> Further, we suggest the addition of services-specific examples throughout Treas. Reg. § 1.482-1 and current Treas. Reg. § 1.482-8.

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<sup>1</sup> Department of Treasury, “2001 Priorities for Tax Regulations and Other Administrative Guidance,” (April 26, 2001).

<sup>2</sup> Based on data from the Bureau of Economic Analysis of the U.S. Department of Commerce, the percentage of services in Gross Domestic Product increased from 16.7 percent in 1987 to 21 percent in 1998. In 1999, U.S. exports of services amounted to \$272 billion, or 28 percent of total U.S. exports of goods and services. U.S. imports of services were \$191 billion, 16 percent of total U.S. imports of goods and services. *See also* Announcement 2001-32, IRB 2000-17 (4/23/01), Table 11, (demonstrate that 28 of 103 transactions covered by APAs in FY2000 were services).

<sup>3</sup> For an example of how to incorporate Treas. Reg. § 1.482-1 by reference, see Proposed Treas. Reg. § 1.482-8(a)(1) (global dealing operations).

## **A. Transfer Pricing Methods**

The service provisions of the Section 482 regulations define an arm's length charge as "the amount which was charged or would have been charged for the same or similar services in independent transactions."<sup>4</sup> Other than the cost recovery safe harbor provisions described in Treas. Reg. § 1.482-2(b)(7), these provisions do not describe specified methods to determine an arm's length charge, although to the extent that comparable transactional data is available, transactional methods are preferred. Therefore, the methods that should be considered under the arm's length standard are traditional transactional methods such as the comparable uncontrolled price method ("CUP")<sup>5</sup> and the cost plus method ("Cost Plus")<sup>6</sup>, and profit methods such as the comparable profits method ("CPM")<sup>7</sup> and the profit split method ("PSM").<sup>8</sup>

### ***1. CUP***

Contracts between independent service providers and their uncontrolled customers could potentially be comparable transactions. However, critical information regarding publicly owned service providers, such as fees charged and detailed rights of the parties, generally are not disclosed in publicly available documents. Therefore, the application of the CUP method is generally not feasible due to lack of data or the failure of the data to satisfy the high comparability standards for the CUP method. Taxpayers with internal comparables or comparable services by and between unrelated parties may be able to satisfy the comparability standards of the CUP method.

The CUP method requires a detailed comparison of functions performed, risks borne, cost structures, and intangibles involved in the controlled and uncontrolled transactions. Comparability is most often found among controlled and uncontrolled transactions involving the same or substantially the same service provider (an "internal" comparable). Absent an internal comparable, a comparison may be derived from uncontrolled transactions of other service providers ("external" comparables).

### ***2. Cost Plus***

In practice, the Cost Plus method is the most common method applied to intercompany services. The fully absorbed costs of rendering the services are marked-up with an arm's length rate to reflect a return commensurate with the value and benefit of the services rendered. This rate is generally extrapolated from the returns of publicly reported service operations that provide reasonably similar services. These services may include contract research, marketing services, manufacturing services, certain technical services, and more. For these basic services, this approach has produced a reasonable approach to an arm's length result.

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<sup>4</sup> Treas. Reg. § 1.482-2(b)(3).

<sup>5</sup> Treas. Reg. § 1.482-3(b).

<sup>6</sup> Treas. Reg. § 1.482-3(c).

<sup>7</sup> Treas. Reg. § 1.482-5.

<sup>8</sup> Treas. Reg. § 1.482-6.

### 3. CPM

The CPM evaluates whether the amount charged in a controlled transaction is arm's length by comparing the profitability of the tested party to that of comparable companies. In most cases, the tested party should not use intangible property or unique assets that distinguish it from unrelated comparable companies.<sup>9</sup> Rather, the comparable party is likely a publicly reporting service company involved solely in marketing, distribution, manufacturing or R&D.

The degree of comparability affects the reliability of the CPM analysis. Reliability may be adversely affected by varying cost structures, differences in business experience, or differences in management efficiency. However, less functional comparability and product similarity is required than under traditional transactional methods. Although not specifically empowered by the current services regulations, taxpayers generally attempt to apply this approach to determine the appropriate transfer price for intercompany services. Any new regulations should give guidance and examples of the application of specified methods to intercompany services.

### 4. PSM

The PSM allocates operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses. Relative contributions may be determined by functions performed, risks assumed, resources employed, and costs incurred. The current regulations include two specified PSMs:

**Comparable PSM.** Transfer prices are derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Each uncontrolled party's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity between the related parties.<sup>10</sup>

**Residual PSM.** This method, best suited for analyzing the transfer of highly profitable intangibles,<sup>11</sup> involves two steps. First, operating income is allocated to each party in the controlled transactions to provide a market return for their routine contributions to the relevant business activity. Second, any residual profit is divided among the controlled taxpayers based on the relative value of their contributions of intangible property to the relevant business activity.

Application of the comparable PSM requires the identification of two unrelated companies that have functions, risks, and transactions similar to the transactions under analysis. It is extremely difficult to find two service providers whose functions, risks, and transactions are sufficiently comparable to the relationship between the related parties. Even if these service providers were found, it would be unlikely that data would be available to measure the profit on the comparable transactions. The residual PSM generally is not applicable when the related service provider does not contribute valuable intangibles in connection with its services or when

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<sup>9</sup> Treas. Reg. § 1.482-5(b)(2).

<sup>10</sup> Treas. Reg. § 1.482-6(c)(2).

<sup>11</sup> Treas. Reg. § 1.482-6(c)(3).

any ownership issues in the underlying technology are not identical. Therefore, its financial returns under the residual PSM should be identical to the returns under other methods. As discussed further in section IV below, however, an increasing number of services transactions involve the transfer of valuable know-how and intangibles.

## **B. Rules of General Application**

### ***1. Best Method Rule***

Possibly the most important of the Treas. Reg. § 1.482-1 rules of application is the “best method rule,” which dictates that the “arm’s length result...must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.”<sup>12</sup> The most reliable measure of an arm’s length result is determined by the degree of comparability between the controlled transaction and the uncontrolled comparables, and the quality of the data and assumptions used in the analysis.<sup>13</sup> The comparability factors and sensitivity to comparability and deficiencies in data and assumptions apply differently to intercompany services than to transfers of tangible or intangible property. The best method discussion should, therefore, include specific examples to illustrate the application to intercompany services under methods other than the cost recovery safe harbor. In particular, these examples should identify comparability factors and assumptions that determine which method provides the most reliable measure of an arm’s length result.

### ***2. Comparability***

Comparability of transactions and circumstances must be evaluated considering all factors that could affect profits in arm’s length dealings, including:

- Functions
- Contractual terms
- Risks
- Economic conditions
- Property or services<sup>14</sup>
- Embedded intangibles

A functional analysis of controlled and uncontrolled services is likely to focus on the breadth of services performed, the credentials of involved personnel, and whether any valuable intangibles are employed. A key determination will be required for services with valuable embedded intangibles as to whether the services or intangible property rules will apply. In some cases, the industry of the recipient will be important.

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<sup>12</sup> Treas. Reg. § 1.482-1(c)(1).

<sup>13</sup> Treas. Reg. § 1.482-1(c)(2).

<sup>14</sup> Treas. Reg. § 1.482-1(d)(1).

The contractual terms could affect the comparability of controlled and uncontrolled transactions. The contractual terms identified in Treas. Reg. § 1.482-1(d)(3)(ii) are relevant to intercompany services, but specific services examples are needed on this point.

Risk is a key element in determining the comparability for services. The relevant risks for services are expected to differ from those for the transfer of tangible or intangible property. A description and examples of risks common to services would be appropriate for any services regulations. One example could focus on transportation services, demonstrating the risk/reward relationship between guaranteed and non-guaranteed overnight delivery, expensive and inexpensive goods, and the inherent risk functions for toxic or perishable cargo.

The economic conditions are a relevant factor in the comparability determination. Comparability can be affected by special circumstances, such as start-up losses or a market share strategy employed by either the controlled or uncontrolled transactions. Further, critical items of know-how and items of intangible property embedded in the services rendered can significantly affect the anticipated return for these services.

Particularly for services providers, the start-up phase of operations is likely to involve material differences that adversely affect the reliability of the analysis, and thus a comparability adjustment is required if that adjustment can be made with sufficient accuracy. Start-up considerations may include the effort expended to provide initial services, the development of infrastructure, and whether the volume of services rendered has attained an initial level of productivity expected of a competent services operation (*i.e.*, sufficient economies of scale). For related party transfers of tangible property, the application of the resale price method, cost plus method, and CPM require the consideration of start-up issues in evaluating the comparability between controlled and uncontrolled transactions.<sup>15</sup>

In addition, the current services regulations support special consideration of start-up costs for purposes of determining whether integral services were received by a service recipient. The 25 percent test for the service recipient (described in section III below) may be applied, at the taxpayer's option, either (i) on an annual basis, (ii) using a multiple year average based on the current year and the prior two taxable years, or (iii) only after the first three years from the commencement of the service recipient's operations.<sup>16</sup> The proposed services regulations should similarly retain and expand these concepts (start-up considerations and who actually incurs costs) as a significant factor to be considered in evaluating comparability and the general application of the use of multiple year averages in all situations where the cost safe harbor would apply. Regulatory examples are needed here for both the cost safe harbor and start-up criteria.

Location savings (and dissavings) can affect comparability. Location savings is a term that describes significant cost differences attributable to geographic markets. Intercompany services, possibly delivered through the Internet, present issues of location savings when a substantial savings is generated by the location of the service provider in a low-cost location. An example of the impact of locations savings on services would be helpful.

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<sup>15</sup> Treas. Reg. § 1.482-3(c)(3)(ii)(B) (resale price method); Treas. Reg. § 1.482-3(d)(3)(ii)(B) (cost plus method); and Treas. Reg. § 1.482-5(c)(2)(iii) (CPM).

<sup>16</sup> Treas. Reg. § 1.482-2(b)(7)(iv).

### **3. Range**

Treas. Reg. § 1.482-1(e) contains rules that govern the statistical analysis to develop an appropriate arm's length range. These rules should govern services without any change.

### **4. Scope of Review**

Treas. Reg. § 1.482-1(f) contains rules that describe the appropriate level of aggregation of controlled transactions as well as the consideration of multi-year data for controlled and uncontrolled transactions. These rules should govern services without any change.

### **5. Deference to Contractual Terms**

Under Treas. Reg. § 1.482-1(d)(3)(B), the terms of a pre-transaction written contract between commonly controlled parties is given effect provided the terms of the agreement reflect the economic substance of the transaction as demonstrated primarily by the conduct of the parties and their respective legal rights (including rights relating to ownership of intangible property). Absent a written agreement, the IRS on audit is authorized to impute an agreement on the transaction consistent with the economic substance of the transaction – again, primarily the conduct of the parties and their respective legal rights (including rights relating to ownership of intangible property).

Because of the ubiquity of intercompany service arrangements and the critical need for certainty as to the transfer pricing results of those arrangements, it is especially important to defer to the terms of written intercompany agreements relating to intercompany services provided those terms are consistent with the economic substance of the transaction.<sup>17</sup> This deference should extend to the functions performed, as well as the allocation of risks and the use and ownership of assets employed in connection with the services. Absent a written agreement, the IRS when characterizing the parties' relationship should consider not only the conduct of the parties and their respective legal rights but also all other indicia of the parties' intent. For example, in imputing an intercompany agreement for intercompany services, the regulations should specifically direct the IRS to consider the terms of post-transaction written contracts between the parties as to the provision of similar services under similar circumstances, provided the terms of those written agreements comport with the economic substance of the transaction.

## **C. Overall Recommendation**

We understand that, as a practical matter, many taxpayers already attempt to apply the general provisions of Treas. Reg. § 1.482-1 to transfer pricing for intercompany services. The proposed services regulations should provide guidance on the application of the "best method rule" and comparability factors for services, and make clear the circumstances and application of other general provisions of the Treas. Reg. § 1.482-1 in the context of intercompany services. Further, examples should be developed to illustrate those rules in the context of services.

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<sup>17</sup> See Michael C. Durst, "The Role of Intercompany Contracts in the Transfer Pricing System," 90 *Tax Notes* 513 (2001).

## ***II. Guidance on Stewardship Expenses***

Under the current services regulations, the basis for determining which expenses for intercompany services must be allocated to related parties is the “benefit test.”<sup>18</sup> The benefit test essentially provides that when a member of a group of controlled entities provides services for the benefit of another member, the service provider is to receive an arm’s length charge for that service.<sup>19</sup> An allocation may generally be made if the service was intended to benefit another member, either alone or with other members of the group.<sup>20</sup> Allocations between related entities are to be consistent with the relative benefits intended from the services, hence the term, “benefit test.”

On the contrary, if the probable benefit to the related member is so indirect or remote that unrelated parties would not have charged for the same services, no allocation under section 482 should occur.<sup>21</sup> Furthermore, although the current regulations do not use the term “stewardship,” an allocation generally should not occur if the service constitutes a stewardship or oversight-type activity undertaken by a parent corporation.

The current services regulations recognize certain types of activities of a parent corporation that are not considered to be for the benefit of any related corporation, but rather constitute a stewardship or oversight-type function undertaken by the parent. A parent corporation will generally assume stewardship-type functions to protect its investment in the related entity. Accordingly, the parent corporation, as an investor, is the primary beneficiary of the stewardship services, and, under the benefit test, is prohibited from charging its affiliates for those activities.

The only guidance provided by the regulations to assist companies to identify stewardship-type activities relate to “duplicative” activities, which are activities already performed by, or able to be performed by, the related entity.<sup>22</sup> To distinguish between supportive and stewardship services, the regulations provide that taxpayers must consider the related entity’s ability to independently perform the activity (*i.e.*, in terms of qualification and availability of personnel). A broad definition does not provide taxpayers with much guidance and increases the risk of improper characterizations by taxpayers.

In addition, Treas. Reg. § 1.861-8<sup>23</sup> cross-references the services regulations to provide that stewardship expenses are, by definition, duplicative. Consistent with the services regulations, Treas. Reg. § 1.861-8 views the expenses resulting from stewardship functions as incurred by the parent as a result of, or incident to, the ownership of the related corporation and thus, allocates such expenses to dividends received or to be received from the related corporation.

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<sup>18</sup> See generally Treas. Reg. § 1.482-2(b)(2).

<sup>19</sup> Treas. Reg. § 1.482-2(b)(1).

<sup>20</sup> Treas. Reg. § 1.482-2(b)(2)(i).

<sup>21</sup> Treas. Reg. § 1.482-2(b)(2)(i). See Treas. Reg. § 1.482-2(b)(2)(i), Ex. 3.

<sup>22</sup> Treas. Reg. § 1.482-2(b)(2)(ii). The regulations should note that in certain factual situations these activities may constitute exceptions to the general rule.

<sup>23</sup> Treas. Reg. § 1.861-8(e)(4).

Other guidance provided by the IRS regarding stewardship services can be found in TAM 8806002 (September 24, 1987). Specifically, the IRS noted that stewardship expenses include, but are not necessarily limited to, the following costs:

- Duplicative review or performance of activities already undertaken by the subsidiary;
- Periodic visits and general review of the subsidiary's performance;
- Meeting reporting requirements or other legal requirements of the parent shareholder that the subsidiary would not incur, but for being part of the affiliated group; and
- Financing or refinancing the parent's ownership participation in the subsidiary.

The IRS emphasized in the TAM that stewardship services are those activities that do not benefit the related subsidiary in the conduct of its day-to-day business operations. The IRS added, however, that there may be instances in which the benefits derived from a single, indivisible activity are “proximate and direct” to both the businesses of the parent and the subsidiary. Consequently, the IRS acknowledged that in certain circumstances, the line between stewardship services and other supportive activities is blurred.

TAM 8806002 described four separate classes of expenses, resulting in differing tax treatment:

Class I consists of those expenses which are for the direct benefit of one or more of the subsidiary corporations...

Class II consists of those expenses which are stewardship expenses such as the expenses of the U.S. tax return or information report filings with the Service and the Securities and Exchange Commission.

Class III consists of the expenses which are for the benefit of the operating members of the group as a whole...

Class IV consists of expenses which are the parent's expenses but are not properly includible as stewardship expenses.

Like Section 482, the OECD Guidelines do not provide significant guidance in defining “stewardship activity.”<sup>24</sup> The Guidelines only state that a stewardship activity may be distinguishable as a *broader* term than “shareholder activity,” which covers a range of activities by a shareholder, including the provision of services to other group members. The more narrowly defined OECD term, shareholder activity, is more analogous to the U.S.’s application of the term, stewardship activity, (*i.e.*, one that is properly attributed to the parent-shareholder rather than for the benefit of an affiliate). The OECD Guidelines provide three examples of activities that constitute shareholder activities:

- Activities relating to the juridical structure of the parent company, such as shareholder meetings, issuing shares of parent company stock, and activities of the supervisory board;

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<sup>24</sup> OECD Guidelines ¶ 7.9.

- Activities relating to fulfilling reporting requirements of the parent; and
- Raising funds for the acquisition of the parent’s participations.<sup>25</sup>

Consistent with the IRS’ approach, the OECD Guidelines generally consider activities undertaken by one group member that duplicate a service performed by another group member, either for itself or by a third party, as non intra-group service activities.<sup>26</sup> However, the Guidelines include within intra-group services certain temporary duplication of services such as when a multinational corporation group is centralizing its management functions.<sup>27</sup>

The current U.S. services regulations provide little guidance as to what constitutes stewardship. In addition, existing non-regulatory guidance, while more helpful than the regulations, can still obscure the distinction between services for which allocations must occur and stewardship activities for which allocations should not occur. We recommend that the IRS clarify what activities constitute stewardship services by providing conceptual guidance as well as further examples (e.g., treatment of common corporate expenditures such as annual corporate and tax filings, management accounting activities, salaries of corporate officers and directors) that illustrate but leave the flexibility necessary to promote compliance with the spirit of the rules. One possible approach to provide conceptual guidance while maintaining flexibility would be to specifically incorporate the expense classifications from TAM 8806002 and develop a number of examples consistent with the conceptual guidance contained therein.

For taxpayers, the importance of properly characterizing different types of services cannot be overemphasized because the characterization mandates the taxpayer’s tax consequences. The limited guidance provided by the current regulations leaves open the possibility that taxpayers will inadvertently mischaracterize certain activities as either stewardship or supportive services. Improper and possibly inconsistent characterizations may lead to distortions in the transfer prices charged between related entities as well as the foreign tax credit calculations of U.S. entities.

### ***III. Safe Harbor Provision***

#### **A. Background**

The current regulations under Section 482 permit taxpayers to charge the cost of services rendered for the benefit of related parties provided such services are not “integral” to the business operations of either the service provider or the recipient. For this purpose, cost is defined to include all direct operating costs and an allocable portion of all indirect operating costs (other than cost of goods sold) related to the services.

A service is considered to be “integral” to the business activity of the relevant entities, and therefore not subject to the cost recovery safe harbor, if (i) either the provider or the recipient of the services is engaged in the trade or business of providing the same or similar services to

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<sup>25</sup> OECD Guidelines ¶ 7.10.

<sup>26</sup> OECD Guidelines ¶7.11

<sup>27</sup> *Id.*

unrelated parties;<sup>28</sup> (ii) the provider renders services to related parties as one of its principal activities, generally determined based on all facts and circumstances but, for non-manufacturing, production, extraction, or construction services, subject to a presumption that such services are not a principal activity if no more than 25 percent of the service provider's total costs (other than cost of goods sold) is attributable to the provision of services to related parties;<sup>29</sup> (iii) the service provider is "peculiarly capable" (by virtue of special skills, reputation, influence over customers, or use of intangible property) of rendering the services if those services are a principal element of the recipient's operations and the value of the services is substantially greater than their cost;<sup>30</sup> or (iv) the recipient has received the benefit of a substantial amount of services from related parties, which is generally considered to be the case if the costs incurred by the related party service provider in providing the services exceeds 25 percent of the recipient's total costs or deductions (not including cost of goods sold, but grossed up to consider the service provider's cost of providing the services).<sup>31</sup>

If the safe harbor does not apply, the arm's length price for related party services is equal to the amount that was charged or would have been charged by unrelated parties for the same or similar services under similar circumstances. Taxpayers that qualify for the safe harbor may, at their option, choose to set an arm's length price.<sup>32</sup>

The OECD Guidelines contain no similar safe harbor for intercompany services. Instead, the Guidelines generally provide that an arm's length price for intercompany services normally contains a profit element.<sup>33</sup> The OECD Guidelines contemplate that the market value of intra-group services might not exceed the service provider's costs if "the service is not an ordinary or recurrent activity of the service provider but is offered as a convenience to the ... group."<sup>34</sup> The OECD Guidelines also acknowledge other situations in which a profit element may not be required, but those situations appear to be limited to cases where the service recipient has less expensive alternatives available to it or where the service provider is trying to expand its market or more fully utilize fixed assets or existing personnel.<sup>35</sup>

## **B. General Considerations and Issues**

Any regulation dealing with transfer pricing for services should consider three major principles, the application of which may be at odds with each other: (1) the concept of an arm's length allocation of income and profits; (2) the ability of taxpayers to comply with the rules through reasonable efforts;<sup>36</sup> and (3) the need for standards that conform to international norms to minimize the risk of double taxation.

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<sup>28</sup> Treas. Reg. § 1.482-2(b)(7)(i).

<sup>29</sup> Treas. Reg. § 1.482-2(b)(7)(ii).

<sup>30</sup> Treas. Reg. § 1.482-2(b)(7)(iii).

<sup>31</sup> Treas. Reg. § 1.482-2(b)(7)(iv).

<sup>32</sup> Treas. Reg. § 1.482-2(b)(3).

<sup>33</sup> OECD Guidelines ¶ 7.33.

<sup>34</sup> *Id.* at ¶ 7.34.

<sup>35</sup> *Id.* at ¶ 7.33.

<sup>36</sup> *Cf.* Treas. Reg. § 1.6662-6(d)(2)(ii)(B) (explaining that a taxpayer, in determining the scope of a reasonably thorough search for data, will weigh the expense of additional efforts to locate new data against the likelihood of finding additional data...) and T.D. 8656, 1996-1 C.B. 329, 330-31 (indicating the thoroughness of a taxpayer's

The Section 482 regulations governing administrative, managerial, and other “back office” services should address the following issues: (1) whether there should continue to be a cost recovery safe harbor for such services; (2) what types of services should be covered by a safe harbor; (3) whether qualified cost sharing arrangements should be an available option for the allocation of headquarters expenses; and (4) which costs should be considered in determining the safe harbor arm’s length price and the extent to which the safe harbor price affects acceptable alternative transfer prices for these services.

### ***1. Cost Recovery Safe Harbor***

The services regulations should retain the concept of a safe harbor within which a profit element is required. The concept of a transfer price that does not necessarily entail a profit element is conceptually valid for related party services that are not an integral part of an income-producing activity, for at least two reasons. First, where the volume of these services is relatively small, the reduction in taxpayer compliance burdens that can be realized from pricing based exclusively on the taxpayer’s existing accounting data outweighs any potential income distortion caused by the failure to return a profit to the service provider. For example, taxpayers with affiliates in diverse geographic areas face a difficult and expensive burden to establish an appropriate mark-up to adjust for currency fluctuations. Second, intercompany services that are not a core part of the group’s trade or business activities with third parties are more appropriately viewed as generalized costs of doing business, and not profit centers (*i.e.*, not value-added functions, but simply back office or centralized administrative support activities).

It is commonplace for controlled groups to centralize administrative services to take advantage of economies of scale. The efficiencies that result from these shared service centers are typically attributable to the group structure itself rather than to the efforts or any inherent advantages of any particular member of the group. Requiring a profit element in intercompany charges for purely administrative services would arguably introduce an element of income distortion to these transactions.

We understand that the IRS is considering the elimination of the current cost recovery safe harbor because it is believed to be inconsistent with the OECD Guidelines, which generally disfavor transfer pricing safe harbors.<sup>37</sup> A cost recovery safe harbor for intercompany administrative services, however, would avoid most of the pitfalls that the OECD Guidelines associate with transfer pricing safe harbors. First, a safe harbor would comport with the arm’s length standard in that these services may properly be viewed as generalized costs of doing business and any profit element is properly considered a function of the group structure as a whole. Second, the appropriate safe harbor “price” would be based on an objectively determinable standard that would not be easily manipulated by taxpayers; namely, costs actually

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search for comparable uncontrolled data that is required to avoid potential transfer pricing penalties with respect to a transaction depends on the dollar amount at stake in the taxpayer’s transfer pricing of such transaction in relation to the taxpayer’s taxable income); Treas. Reg. § 1.6662-6(d)(2)(ii)(G) (stating that a taxpayer's consideration of the size of a net TP adjustment in relation to the size of the controlled transaction out of which the adjustment arose, is a factor demonstrating the taxpayers application of a specified method in a reasonable manner ).

<sup>37</sup> OECD Guidelines ¶ 4.121.

incurred by the group. Moreover, as is discussed in detail in III.B.3. below, the OECD Guidelines specifically contemplate the use of cost contribution arrangements for certain centralized services.<sup>38</sup> Therefore, the OECD Guidelines are by no means incompatible with a safe harbor for non-integral intercompany services.

Notwithstanding any safe harbor, taxpayers should retain the current option of setting transfer prices as equivalent to those that would be charged in independent transactions between unrelated parties for similar services under similar circumstances.<sup>39</sup> Further, some consideration should be given to the cost plus safe harbor approach for non-integral services. The current regulations governing intercompany transfers of tangible and intangible property contemplate that a range of prices will satisfy the arm's length standard. Since not all jurisdictions consider the mere recovery of costs as an arm's length charge for intercompany services, a rule that precludes inclusion of an arm's length profit element in the price for intercompany administrative services could lead to double taxation.<sup>40</sup> A situation could arise where a U.S. corporation charges its affiliates for services at cost while the same U.S. corporation is paying its affiliates for similar services with a profit element. In this circumstance, use of a cost recovery safe harbor produces a result that appears inequitable to the U.S. One possible solution would be a cost plus safe harbor (e.g., cost plus 5%) on non-integral services. This cost plus safe harbor would remove the administrative burden of preparing documentation while maintaining a measure of revenue neutrality.

## ***2. Services Eligible for Cost Recovery Safe Harbor***

The general thrust of the current regulations is that a profit element is generally required only for intercompany services that are an integral part of the service provider's or recipient's business activities. This standard provides a valuable starting point for determining the types of intercompany services that should be eligible for any safe harbor. However, the current regulations embody the compliance burden rationale for cost recovery pricing for these services more effectively than they embody the notion that such pricing clearly reflects income.

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<sup>38</sup> OECD Guidelines ¶ 8.7; *see also* ¶ 7.23.

<sup>39</sup> Although in most cases such prices would include a profit element, the revised regulations should permit taxpayers in certain situations to set transfer prices for intercompany services that may generate a loss for the service provider. For example, where the services are provided pursuant to a market share strategy, unrelated service providers might generate a loss.

<sup>40</sup> Although the OECD Guidelines contemplate the use of cost sharing for certain intercompany services, those guidelines do not set forth detailed principles. In light of the statement in the OECD Guidelines that service providers at arm's length generally charge a profit element and the lack of specific OECD guidance as to when a price equal to the service provider's cost represents an arm's length result, it is likely that many jurisdictions will continue to require that an intercompany service provider earn a profit. Therefore, to preclude markups on purely administrative intercompany services would be to deny taxpayers deductions for the profit element that is required by many foreign jurisdictions on payments to related service providers that are resident in such jurisdictions. Paragraph 7.34 of the OECD Guidelines states that "it may be the case that the market value of intra-group services" that are not "ordinary and recurrent" activities of a service provider could be less than the provider's cost where such services are "offered incidentally as a convenience." A close reading of this statement, however, suggests that it is intended more as an observation of the value of such services in certain circumstances than as the appropriate legal standard for all extraordinary or non-recurrent services that are offered as a convenience to related parties.

To reflect the fact that purely administrative services are more accurately characterized as generalized costs of doing business than as profit centers, the services regulations should be modified to provide, as a general rule, that purely administrative or back office services may be priced at the provider's costs and deductions incurred in rendering those services unless the service provider is engaged in the trade or business of rendering the same or similar services to unrelated parties. Absent an affirmative provision of this nature, the current regulations could be modified to craft an exception to the safe harbor rule for services of a type that are rendered by either the renderer or the recipient as part of a trade or business carried on with unrelated parties.<sup>41</sup> The current exception requires that a profit element be generally charged on all intercompany services performed by the recipient as part of its trade or business, even if the service provider does not perform similar services for unrelated parties. However, it is not clear why a profit element is required merely because the recipient provides similar services to certain third parties. It may be that these services are not resold or otherwise an integral part of the service recipient's income-producing activities. If so, a safe harbor should be available for those exceptional circumstances. For example, a taxpayer that purchases equipment from a third party vendor may agree to provide as a convenience transportation of similar equipment purchased for internal use by an affiliate in the shipping business from the same vendor at the same time. There should be no reason to require the taxpayer to earn a profit on the shipping services so provided.

The exception to the safe harbor for services that are a principal element of the service provider's activities should be limited so that special purpose back office or administrative coordination entities would not be required to charge a profit element for services that are appropriately viewed as generalized costs of doing business.<sup>42</sup> The current regulations apply a facts and circumstances standard for determining whether non-manufacturing, production, extraction, or construction services (or other services, the cost of which exceeds 25 percent of the providing group's total costs) to related parties are outside the safe harbor. The factors cited in the regulations (*i.e.*, the time involved in rendering the services and the regularity of rendition), however, add little to the determination of whether those services are integral parts of the core income-producing activity of the group. The regulations should focus more on the nature of the services and their relation to the core income-producing functions of the group. Given the current documentation requirements for these transactions under Section 6662(e), the IRS should have little difficulty examining the reasonableness of a taxpayer's determination.<sup>43</sup>

The exception to the safe harbor for services that the provider is peculiarly qualified to furnish and that are a principal element of the recipient's operations should be clarified.<sup>44</sup> The current exception mandates a profit element where, due to factors associated with core income-producing attributes (*i.e.* the service provider's special skill, reputation, influence over customers, or use of intangible property), the provider is in a particularly advantageous situation to furnish the services and those services have a value substantially in excess of their cost. Either

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<sup>41</sup> See Treas. Reg. § 1.482-2(b)(7)(i).

<sup>42</sup> See Treas. Reg. § 1.482-2(b)(7)(ii).

<sup>43</sup> Key in this regard is the requirement in Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(1) that the taxpayer include in its transfer pricing documentation a description of its business and provide an analysis of the legal and economic factors that affect the pricing of the goods and services sold pursuant to that business.

<sup>44</sup> See Treas. Reg. § 1.482-2(b)(7)(iii).

through regulatory mandate or example, there should be some definition and illustration of these peculiarly capable services. Further, there should be guidance as to when these services actually convey know how or items of intangible property such that the intangible property rules should be used in order to benchmark the value of the services. See Section IV below. If these beneficial functions that the provider is peculiarly qualified to perform are actually considered “services”, further guidance should be given as to how to benchmark the value of the services. For example, should corporate hurdle rate, a standard investment rate of return over cost, or some other recognizable benchmark be employed.

Peculiarly qualified services by definition should not be expanded to cover all intercompany administrative services simply because their value may substantially exceed their cost due, for example, to the provider's use of intangibles, outlays of capital, or familiarity with the operations of the recipient. This expansion could lead to income distortions because purely administrative or back office services, regardless of their value in relation to cost, are generalized costs of doing business. To mandate any profit element in the intercompany charge would artificially create a profit for the provider and an excess business expense for the recipient.

### ***3. Headquarters Expense Allocation***

The revised services regulations should continue to apply the cost recovery safe harbor to “headquarters” services (*i.e.*, centralized general and administrative services that benefit the entire corporate group). These services, which derive their name because the headquarters or parent of the corporate group usually provides the services, ordinarily consist of activities such as accounting, financial, legal, management, marketing, internal audit, and computer or information technology services that benefit, or are intended to benefit, individual members of the corporate group or the group as a whole.

We understand that multinational corporations have increasingly provided headquarters services internally, rather than by outsourcing, because those necessary services can be performed more efficiently and at less cost. In deciding whether to provide the administrative services internally or through third parties, the taxpayer is faced with the classic “make or buy” decision for headquarters-type services. Necessary headquarters-type services are generally performed at a lower cost if provided internally. These costs are minimized for various reasons, for example, due to volume or the inherently superior knowledge that an affiliate, as opposed to a third party, has about internal operations. The entire corporate group benefits by avoiding the costs a third party would charge for such services. The transfer price should reflect the primary reason for incurring these costs internally (*i.e.*, to minimize costs). A cost contribution arrangement (“CCA”) or qualified cost sharing arrangement (“QCSA”) permits the taxpayer and its affiliates the opportunity to obtain the efficiency objective of a centralized internal service provider.

We recommend that the IRS expressly sanction a headquarters services cost sharing model similar to intangible property development QCSAs under Treas. Reg. § 1.482-7 and to the concept of CCAs under the OECD Guidelines. Both approaches will reflect the economic realities of integrated global groups. It is important, however, that if a cost sharing model is sanctioned, some flexibility as to formulas for charging out these services should be permitted in

order to reflect both a fair usage of the contributing parties and the benefits received by each party. Allocations based on some measure of usage should accomplish this goal. Allocations linked to revenues like those found in many CCAs may lead to distortions. Expenditures properly classified as stewardship expenses should not be shared.

By adopting a cost sharing approach, the IRS will accomplish two goals: (1) the adoption of a transfer pricing methodology that provides a true economic depiction of the globally integrated corporate group, and (2) consistency between the U.S. transfer pricing laws and the OECD Guidelines followed by many of our treaty partners.

Strong support for using a QCSA approach to pricing headquarters services is found in the OECD Guidelines. Paragraph 8.7 of the guidelines provides:

While CCAs for research and development of intangible property are perhaps most common, CCAs need not be limited to this activity. CCAs could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services. For example, business enterprises may decide to pool resources for acquiring centralized management services, or for the development of advertising campaigns common to the participants' markets.

By adopting a CCA or QCSA approach for headquarters services, the revised regulations would have the practical advantage of permitting MNC groups to manage their transfer pricing results by implementing a methodology that allocates costs based on the proportionate share of overall benefits.

Application of the principles of the QCSA regulations to headquarters services arrangements should be relatively straightforward. The QCSA regulations adopt a benefit test to determine how costs associated with the development of intangibles should be allocated. That benefit test is also applied under the services regulations for determining whether there should be any charge for intercompany services. Because the likely benefit to intercompany headquarters services recipients is a reduction in costs they would otherwise incur, the benefits derived by an affiliate from the receipt of these services should be closely correlated to the extent to which that affiliate uses the services. Thus, the regulations should permit allocation of cost shares based on any reasonable measure of use that is consistently applied.<sup>45</sup>

#### ***4. Costs Included for Cost Recovery Safe Harbor***

For purposes of the cost recovery safe harbor, the current services regulations require that the costs include all direct and indirect costs associated with the services. Indirect costs include an allocation of the compensation of top management and an allocation of overhead to the costs of supporting departments and other general and administrative expenses that are allocated to the

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<sup>45</sup> See, e.g., Treas. Reg. § 1.482-2(b)(6)(i) (“a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice”).

services. The regulations also make it clear that the costs considered are all-inclusive, and not merely the incremental costs incurred by the taxpayer in rendering the services.<sup>46</sup>

The indirect cost allocation principles applicable to cost recovery pricing under the safe harbor should be simplified to allow for administrative feasibility. One of the major justifications for the cost recovery safe harbor is that it minimizes taxpayers' compliance burdens. To the extent that these allocations go beyond the allocation of indirect costs made for the taxpayer's financial cost accounting system, they require the taxpayer to create a separate cost accounting system solely for compliance with the safe harbor and thus defeat the goal of compliance burden minimization. Therefore, the regulations should permit a taxpayer to allocate indirect costs based on the method it uses for financial accounting purposes provided that method allocates a reasonable overhead burden to the direct costs of providing the relevant services.

The services regulations should also provide that, even though the safe harbor cost recovery price must consider all direct and indirect costs related to the relevant services, and not only incremental costs, the safe harbor price does not place a floor on the arm's length intercompany price determined outside the safe harbor, even for services that qualify for the safe harbor. CUPs for services may well be based on a mark-up over incremental costs or might otherwise reflect a loss in relation to fully loaded costs, particularly where the service provider is entering a new market, attempting more fully to utilize existing personnel or fixed assets, or the service recipient has less expensive alternatives.

#### ***IV. Embedded Intangibles in the Provision of Services***

##### **A. Background**

In limited circumstances, the performance of intercompany services may result in the transfer of valuable know-how and other intangibles between different tax jurisdictions. Know-how and other intangibles transferred in the performance of services are referred to as "embedded intangibles."<sup>47</sup> The revised services regulations should contain more specific guidance on where employee know-how and other embedded intangibles are transferred through services and how the values so transferred should be benchmarked. The 1988 Treasury Department White Paper acknowledged this issue and stated as follows:

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<sup>46</sup> Treas. Reg. §§ 1.482-2(b)(3) and 1.482-2(b)(4)(i) provide the general rule that all "costs or deductions" directly or indirectly related to the services must be taken into account "on some reasonable basis." The cost or deduction standard potentially raises significant questions with respect to the timing and measurement of personnel costs attributable to stock options, restricted property and other equity-based compensation. Among those issues are whether the appropriate measurement is based upon accounting, or economic concepts of cost or Internal Revenue Code deduction principles, or some combination thereof. See *Seagate Technology, Inc. v. Commissioner*, T.C. Memo 2000-388 (Dec. 22, 2000) and FSA 200003010 as to a similar issue in the context of QCSAs. Although we make no specific recommendations as to the appropriate treatment of equity-based compensation as a cost for purposes of determining the arm's length charge for intercompany services, we believe that any guidance should allow taxpayers some flexibility in their treatment of such compensation so long as the method chosen is applied consistently.

<sup>47</sup> The concept of embedded intangibles also is found in the transfer of tangible property (e.g., a trademark affixed to a tangible good). See Treas. Reg. §1.482-3(f).

Intangibles may also be transferred in the form of services. In some circumstances, taxpayers have attempted to shift large amounts of income to tax haven subsidiaries by “loaning” a few key employees to a tax haven affiliate. By loaning employees, the parent company may simultaneously provide services and transfer valuable intangible know-how. In a transaction that is structured as intangibles transfer, it is difficult to value services rendered in connection with the transfer of intangible property, which may be necessary for purposes of determining the source of the income.<sup>48</sup>

A critical issue is whether the performance of these services should be characterized as a service, a transfer of an intangible, or a combination thereof (*e.g.*, where continuing services are provided concurrent or subsequent to the intangible property transfer). If the transaction is characterized solely as a service, the services regulations under Treas. Reg. § 1.482-2(b) will apply. If the transaction transfers valuable know-how and other embedded intangibles, then the intangible property regulations under Treas. Reg. § 1.482-4 will apply and one must consider whether a separate charge for services in connection with the intangible property transfer is warranted. Alternately, the intangible property rules may be used to benchmark the arm’s length return for this “peculiarly capable” service.

## **B. Characterization**

The characterization of intercompany services performed may result in vastly different tax treatments. To the extent characterized as services, these services may qualify for the cost safe harbor provided for in Treas. Reg. § 1.482-2(b). However, to the extent services rendered are considered the transfer of valuable know-how, that transfer is subject to the commensurate with income standard of Section 482 embodied in Treas. Reg. § 1.482-4, and the use of such know-how may be subject to withholding tax under Section 881, as reduced or eliminated by an applicable treaty. In addition, sourcing rules under Sections 861 and 862 differ for the provision of services compared to the transfer of intangible property, thereby affecting a taxpayer’s foreign tax credit limitation. Of course, these characterization issues may not be consistent from country-to-country; thus, it is possible that one country will consider that there exists a transfer of intangibles while the other considers the same as a provision of services, leading to two distinct results.

As a general rule, the performance of services does not necessarily mean that there has been a transfer of valuable know-how. The current transfer pricing regulations and the OECD Guidelines include know-how in the definition of intangible property.<sup>49</sup> The OECD Guidelines cite Commentary from the OECD Model Tax Convention, which defines know-how as:

[A]ll undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what

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<sup>48</sup> Department of the Treasury, *A Study of Intercompany Pricing under Section 482 of the Code* (“1988 White Paper”), Notice 88-123, 1988-2 C.B. 458, 463.

<sup>49</sup> Treas. Reg. § 1.482-4(b); OECD Guidelines, ¶ 6.2, 6.5.

a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.<sup>50</sup>

The Commentary distinguishes the transfer of know-how from the provision of services. That is, transfer of know-how involves imparting knowledge to the transferee so that the transferee can use the know-how for its own account,<sup>51</sup> whereas the provision of services occurs when “one party undertakes to use customary skills of his calling to execute work himself for the other party.”<sup>52</sup> The IRS should elaborate on these basic principles to provide more guidance, perhaps, for example, drawing a distinction between the loaning of an executive with inventory experience to develop new inventory control software and the loaning of an executive to install the inventory control software developed by a related corporation.

### C. Current Section 482 Regulations

Under the current Section 482 regulations, an intangible asset must have “substantial value independent of the services of any individual...”<sup>53</sup> This language presumes a close relationship between services rendered and any intangibles transferred, although it must be recognized that services create intangible property. Where the intangible property has value independent of the services provided, the transaction will be characterized under the intangible property regulations of Treas. Reg. §1.482-4, and services provided outside the transfer of intangible property may be subject to a separate services charge. If there is no independent value, then the transaction will be characterized as a service.

Where services are considered a transfer of intangible property, no separate allocation for services is required if the services are ancillary and subsidiary to the intangible property transfer.<sup>54</sup> Examples of ancillary and subsidiary services include the demonstration and use of the property transferred, assistance in the start-up use of the property transferred, and performance under a guarantee relating to the start-up use of property.<sup>55</sup> The continuing provision of services after the intangible property has been integrated into a licensee’s operations, however, would require a separate allocation for services.<sup>56</sup>

Ancillary and subsidiary services are considered part of the intangible property transfer. This treatment is consistent with the aggregation concept of Treas. Reg. §1.482-1(f)(2)(i)(A), where multiple interrelated transactions are treated in the aggregate, and consideration in the aggregate is the most reliable means to determine arm’s length consideration.

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<sup>50</sup> OECD Guidelines ¶ 6.5 (citing Commentary on Article 12 of the OECD Model Tax Convention (1997) ¶ 11). Although it is clear that the OECD Commentary contemplates the transfer of manufacturing know-how, the concept of know-how need not be so limited, but may also include marketing know-how. For example, a unique or new type of distribution channel may be considered know-how.

<sup>51</sup> Commentary on Article 12 of the OECD Model Tax Convention (1997), ¶ 11.

<sup>52</sup> *Id.*

<sup>53</sup> Treas. Reg. §1.482-4(b).

<sup>54</sup> Treas. Reg. §1.482-2(b)(8).

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

The current Section 482 regulations fail to provide any guidance as to the considerations for determining whether a service transfers an intangible that has a separate and distinct value apart from the services performed. In addition, the 1988 White Paper (citing the experience of international examiners) criticized the current services regulations for failing to provide adequate guidance as to whether services provided in connection with an intangible property transfer require a separate services charge.<sup>57</sup>

In preparing the 1988 White Paper, the IRS and Treasury Department studied samples of publicly available license agreements and published its findings as an appendix.<sup>58</sup> In discussing its findings, the White Paper cited the extent of technical support as a major factor affecting a licensor's return from licensing intangibles.<sup>59</sup> In addition, this survey of publicly available license agreements found a variety of arrangements providing for a certain level of "free" technical support based on a set time period and additional support on a time and expense basis.<sup>60</sup> In charging for additional technical support, some licenses required "reimburse[ment] at cost, a fixed rate, or at the lowest rate charged by the licensor to third parties."<sup>61</sup>

#### **D. OECD Guidelines**

For the transfer of intangible property along with the provision of services, the OECD Guidelines indicate that it may be necessary to evaluate the transfer of intangibles and the provision of services separately.<sup>62</sup> While the OECD Guidelines provide no guidance for determining whether to evaluate such a transaction as an intangible property transfer, a provision of services, or when separate compensation for each would be required, the OECD guidelines do refer to commentary published with the OECD Model Tax Convention, which reads in pertinent part:

...In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchiser imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible

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<sup>57</sup> Notice 88-123, 1988-2 C.B., 458, 463 n. 58, at 466.

<sup>58</sup> *Id.* at 524.

<sup>59</sup> *Id.* at 525.

<sup>60</sup> *Id.* at 526. See also, Ruge v. Commissioner, 26 T.C. 138 (1956) (60 man-days of consulting services were held ancillary and subsidiary to the intangible property transfer and no additional compensation was required for such services).

<sup>61</sup> *Supra*, footnote 56.

<sup>62</sup> OECD Guidelines at ¶ 6.18.

to apply to the whole amount of the consideration the treatment applicable to the principal part.<sup>63</sup>

Although the Commentary provides no guidance as to when the provision of services rises to the level of an intangible, the guidance regarding ancillary services, as part of a more significant transfer of intangible property, is similar to the guidance contained in Treas. Reg. § 1.482-2(b)(8).

## E. Recommendations

To establish whether an intangible asset has substantial value independent of the services of any individual, we are guided by the touchstone arm's length principle of "a taxpayer dealing at arm's length with an uncontrolled taxpayer."<sup>64</sup> To evaluate the arm's length nature of controlled transactions, the IRS is required to analyze the terms of a controlled transaction as structured.<sup>65</sup> Therefore, if a taxpayer has characterized a controlled transaction as an intangible property transfer and is able to demonstrate that the comparable uncontrolled transaction (CUT) method under Treas. Reg. §1.482-4(c) would be the best method under Treas. Reg. §1.482-1(c), then the IRS should respect the taxpayer's characterization of the transaction as a transfer of intangible property. Similarly, if a taxpayer has characterized a controlled transaction as an intercompany service and is able to demonstrate that the comparable uncontrolled price (CUP) method or some other approach or method would be the best method under Treas. Reg. §1.482-1(c), then the IRS should respect the taxpayer's characterization of that transaction as an intercompany service.<sup>66</sup>

Both of these methodologies provide the most reliable and direct measure of an arm's length result when there is a high level of comparability between the controlled transaction and the uncontrolled transaction(s).<sup>67</sup> There should not be confusion between the characterization of the transaction and the method used to benchmark the arm's length results.

If a taxpayer cannot establish that either the CUT or CUP method would be the best method under its characterization, then a facts and circumstances test should apply in determining whether an intangible asset has substantial value independent of the services of any individual. The following facts and circumstance lead towards a conclusion that an intangible asset has substantial value independent of services rendered:

- Evidence that uncontrolled third parties would have structured a transaction as an intangible property transfer (*e.g.*, evidence of a license agreement between unrelated parties incorporating similar know-how as the controlled transaction). This evidence need not meet the relatively high level of comparability required to apply the CUT method.

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<sup>63</sup> OECD Model Tax Convention, Commentary on Article 12, ¶ 11.

<sup>64</sup> Treas. Reg. §1.482-1(b)(1).

<sup>65</sup> Treas. Reg. §1.482-1(f)(2)(ii).

<sup>66</sup> For this purpose, although the CUP method is specified as a tangible property methodology under the current Section 482 regulations, it is presumed that the CUP or similar type method would satisfy the arm's length standard under either Treas. Reg. §1.482-2(b)(3) or subsequently proposed regulations. See section I.A.1, *supra*.

<sup>67</sup> Treas. Reg. §1.482-3(b)(2)(ii)(A); Treas. Reg. §1.482-4(c)(2)(ii).

- The benefits obtained extend beyond one year from the time the services rendered were completed.
- The terms of the controlled transaction convey the right to exploit the know-how transferred. Exclusivity should be considered in determining the weight of this factor. While an exclusive right is stronger evidence to conclude that an intangible asset has substantial value independent of the services rendered than a non-exclusive right, the fact that a non-exclusive right was transferred does not preclude such a conclusion. This factor is consistent with similar guidance provided for embedded intangibles related to tangible property transfers.<sup>68</sup>
- A services-type fee would not reflect the value of the know-how transferred -- for example, evidence that the know-how has value substantially greater than a fee typical for the same general type of know-how provided.
- The know-how transferred has been legally protected or could be legally protected in the jurisdiction where it is used.

The following facts and circumstances lead towards a conclusion that an intangible asset transferred does not have substantial value independent of services rendered, and therefore should be characterized as a service:

- Evidence that uncontrolled third parties would have structured a transaction as a services arrangement (*e.g.*, evidence of a customary fee charged in performing the same or similar type services as the controlled transaction). This evidence need not meet the relatively high level of comparability required to apply the CUP method.
- The benefits obtained do not extend beyond one year from the time the services rendered were completed.
- The know-how provided is readily available to the general public for a fee typical of what could be expected for customary services without any features of a licensing-type arrangement (*e.g.*, the fee is not contingent upon revenues, units produced, or profits).<sup>69</sup> For example, the training of employees in a recognized profession, craft, or trade would generally be considered a service.<sup>70</sup>
- The know-how provided has been developed specifically for the recipient of the know-how.<sup>71</sup>

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<sup>68</sup> Treas. Reg. § 1.482-3(f).

<sup>69</sup> See OECD Model Tax Convention (1997), Commentary on Article 12, ¶ 11. Similarly, computer software is excluded as an intangible under Section 197 if it is “readily available to the public on similar terms, is subject to a non-exclusive license, and ha[s] not been substantially modified. Computer software will be treated as readily available to the public if the software may be obtained on substantially the same terms by a significant number of persons that would reasonably be expected to use the software.” Treas. Reg. § 1.197-2(c)(4).

<sup>70</sup> Rev. Rul. 64-56, 1964-1 C.B. 133 (1964).

<sup>71</sup> *Id.*, citing *Regenstein v. Commissioner*, 35 T.C. 183 (1960).

If it is determined that any part of a transaction should be characterized as a intangible property transfer, we then recommend maintaining the current rule of not imposing a separate allocation for services that are ancillary and subsidiary to the intangible property transfer.<sup>72</sup> This approach is consistent with the OECD's approach to these issues,<sup>73</sup> the aggregation principle in Treas. Reg. § 1.482-1(f)(2)(i), and the stated IRS policy of proposing section 482 adjustments only where there has been a substantial deviation from the arm's length standard.<sup>74</sup>

Ancillary or subsidiary services would normally be included as part of the intangible property transfer between unrelated parties; therefore, no separate allocation should be required. For the provision of services that are not ancillary and subsidiary to an intangible property transfer, these services should be subject to a separate allocation as is currently provided for in Treas. Reg. § 1.482-2(b)(8).

## ***V. Intercompany Services Over the Internet***

The Internet has emerged as a dominant medium for business transactions. The proliferation of e-commerce has encouraged the expansion of international businesses. E-commerce has also given rise to substantial new tax issues surrounding these transactions, including characterization, sourcing, permanent establishment, trade or business, whether income is "effectively connected," withholding, and the appropriate allocation of income and expenses.

E-commerce has also given rise to a number of transfer pricing issues surrounding services, including the characterization of new transactions, the difficulty of applying transactional approaches, and divergent positions taken by various countries on the tax treatment of e-commerce issues.

### **A. Characterization of New Transactions**

The Internet has, among other things, spawned two types of services-related transactions: truly new e-commerce services and traditional services that are provided over the Internet. Examples of the former include:

- ***Application hosting (with separate license)*** - The user, which owns a perpetual license to use a software product, enters into a contract with a host entity where the host entity loads the software on servers owned and operated by the host. The host provides technical support to protect against system failures. The user can remotely access, execute, and operate the software application. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement could apply, for example, to financial management, inventory

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<sup>72</sup> Treas. Reg. § 1.482-2(b)(8).

<sup>73</sup> OECD Model Tax Convention, Commentary on Article 12, ¶ 11, discussed *supra*, footnote 62.

<sup>74</sup> IRM Handbook 4.3.1.2, Section 3.1.

<sup>75</sup> Bert Kamlnski and Gunther Strunk, "Transfer Pricing Features of Transactions Over the Internet," *Tax Planning International* (1999). See also, Marc M. Levey, Thomas O'Donnell and J. Pat Powers, "Cyberspace Transactions Presenting Interesting International State and Local Tax Issues" 49 *The Tax Executive* No. 6, 476 (1997).

control, human resource management, or other enterprise resource management software applications.<sup>76</sup>

- **Application hosting (with bundled contract)** - For a single, bundled fee, the provider (also the copyright owner) allows access to one or more software applications, hosts the software applications on a server owned and operated by the host, and provides technical support for the hardware and software. The user can access, execute, and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.<sup>77</sup>
- **Application service provider** - The provider obtains a license to use a software application in the provider's business as an application service provider. The provider gives the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods or services, but merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.<sup>78</sup>
- **Web site hosting** - The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content. The provider is compensated by a fee based on the passage of time.<sup>79</sup>

Constantly decreasing telecommunications costs and competitive pressures encourage MNCs to move traditional functions to a single location for operational efficiency. Examples of opportunities to provide traditional services over the Internet include the following:

- Replacing traditional distribution activities with a web server in each country tied to a centralized order-processing center;
- Moving technical support for global operations to a single location; and
- Transferring all currency risk to be managed from a single location.

The initial difficulty with these new services is their characterization for tax purposes. Characterization sets in motion a number of tax determinations, but the main impact on transfer pricing is in the determination of the applicable transfer pricing method and the selection of

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<sup>76</sup> Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs, "Tax Treaty Characterization Issues Arising From E-Commerce," Annex 2 (February 1, 2001).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

comparable transactions or companies. Many of these services could be classified under the four categories described in TAM 8806002.<sup>80</sup> The IRS should consider examples in its regulations to address these new services.

It has been asserted that many of these new e-commerce transactions are structured to create income in low-tax jurisdictions, raising new issues on the topics discussed in earlier sections of this paper. For example, headquarters expenses (often with a mark-up) may be moved to a low-tax jurisdiction.<sup>81</sup> The new e-commerce services provided might also involve the use of embedded intangibles. For example, application hosting involves the payment of a single, bundled fee for the service and use of certain software intangibles. When drafting the services regulations, the Treasury should attempt to demonstrate e-commerce applications.

## **B. Transfer Pricing Methodologies**

For these types of internet services, traditional transactional methods may be difficult to apply because of lack of comparable transactions or the complexity of making appropriate adjustments. Due to the relative newness of the Internet and Internet Service Providers, comparability is an even larger obstacle regarding intercompany services over the Internet.

For profit-based methods, it may be impossible to attribute the profit to specific transactions, or to value the relative contributions of the parties. Further, this approach may rely upon internal data that the IRS has often considered inappropriate or unreliable. Because services over the Internet are usually provided by a large number of participants and different transactions are handled simultaneously, or bundled, these problems are significant.

The global formulary apportionment method applied by certain U.S. states treats a MNC engaged in a controlled transaction as a single business entity, and allocates the MNC global profits among the associated enterprises on the basis of a predetermined formula. This method is arbitrary because profits would be allocated without reference to market conditions, unique facts surrounding the transaction, and ownership of intangible property. It would generally lead to double taxation by reaching profits earned by non-US MNCs in foreign countries, profits already taxed by foreign jurisdictions. Furthermore, it would violate the arm's length principle, and would result in significant political and administrative issues between treaty countries.

## **C. Comparability**

Comparability is a key factor in any transfer pricing determination. Comparables may be particularly difficult to find in the case of services provided over the Internet largely because the types of services offered over the Internet may still be new enough that CUTs with Internet service companies may be difficult to obtain. Further, the profitability of Internet service companies may be extremely volatile so that reference to industry standards under a profit based methodology may lead to unexpected results. In fact, many Internet service providers endure years of start-up losses before achieving even minimal profits.<sup>82</sup>

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<sup>80</sup> See section II *supra*.

<sup>81</sup> See section III.B.3 *supra*.

<sup>82</sup> See Section I.B.2 *supra*.

On the other hand, it is difficult to make a reliable comparison between Internet and non-Internet providers of services. In the above example, a countrywide distribution network could potentially be replaced by a web server tied to a centralized order-processing center. A transfer pricing determination for the new server-based approach based on non-Internet distribution comparables faces some challenging comparability issues. Adjustments should be made for differences in the levels of service offered to the customer; however, these adjustments are difficult to reliably quantify. Further, the fiscal authorities of the host country might assert that an intangible is transferred to the parent corporation in the restructuring transaction. The comparability of non-Internet and Internet services can be expected to diverge further each year as e-commerce business models continue to evolve and adapt.

#### **D. Governmental Differences**

Fiscal authorities have viewed with great concern the emergence of the Internet as the dominant medium for future business transactions. The OECD has discussed at length the threshold question regarding what e-commerce activities lead to the existence of a permanent establishment.<sup>83</sup> The follow-up question regarding what profits can be attributed to e-commerce activities is the subject of a recent OECD discussion paper.<sup>84</sup>

Even after the OECD members agree on the broad principles to govern the transfer pricing treatment of e-commerce transactions, questions surrounding the application of those principles by the various governments will persist for years to come. In this environment of uncertainty, the new services regulations should offer numerous examples to illustrate the Treasury's positions to taxpayers and other fiscal authorities. In any event, taxpayers with difficult to resolve e-commerce issues will need to pursue bilateral resolution through either the competent authority or advance pricing agreement procedures.

#### **VI. Conclusion**

The current transfer pricing regulations governing intercompany services are over 30 years old. Structural and business changes in the global economy and new issues involved in the transfer of services have increased the need for reconsideration of the services regulations and for contemporary guidance by the IRS.

This report has reviewed the current regulations regarding intercompany provision of services and made a number of specific recommendations on topics of known importance. Given the length of time and the magnitude of change in the area of services, we recommend that any proposed regulations be issued first in draft form to provide ample time for discussion among the government, taxpayers, and practitioners.

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<sup>83</sup> OECD Committee on Fiscal Affairs, "Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5" (December 22, 2000).

<sup>84</sup> Discussion paper issued by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" (February 2001).