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PROPOSED SECTION 482 SERVICES AND INTANGIBLE PROPERTY OWNERSHIP REGULATIONS – SELECTED ISSUES

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I. **<u>On September 5, 2003, the Service issued proposed regulations under section 482 relating to the ownership of intangible property and controlled services transactions.</u>**

A. The proposed regulations contain an effective date provision providing that the proposed regulations will be applicable for taxable years beginning on or after the date of publication of the regulations as final regulations in the Federal Register.

II. **<u>Ownership of intangible property.</u>**

A. **<u>Ownership of intangible property under the current regulations</u>**.

1. The current section 482 regulation provision dealing with the ownership of intangible property is Treas. Reg. § 1.482-4(f)(3) issued as part of the 1994 regulations.

2. The current regulations provide a two-pronged analysis for ownership of intangible property: one set of rules for intangible property that is "legally protected intangible property" and another set of rules for intangible property that is not "legally protected."

a. Treas. Reg. §1.482-4(f)(3)(ii)(A) provides that the legal owner of a "right to exploit" an intangible ordinarily will be considered the owner for purposes of the regulations. That regulation further provides that legal ownership may be acquired "by operation of law" or "by contract under which the legal owner transfers all or part of its rights to another."

b. For intangible property that is not "legally protected, Treas. Reg. § 1.482-4(f)(3)(ii)(B) provides that the "developer" is the owner for purposes of the regulations. The developer is generally the controlled party that bore the largest portion of the direct and indirect costs of developing the intangible. That regulation further provides that if two or more taxpayers jointly develop an intangible, only one will be treated as the developer and owner,

with the others regarded as assisters. This is similar to the rule under the 1968 regulations.

3. The preamble to the proposed regulations states that the Treasury Department and the IRS are concerned that the current regulations may be misapplied to reach an "all or nothing" result, even though an arm's-length analysis might require that the income attributable to the intangible be divided among controlled taxpayers that made significant contributions to develop or enhance the intangible, and that hold legal rights with respect to the intangible.

4. The preamble states that the proposed regulations modify the "analytical framework" of the current regulation so that the rules for determining the ownership of intangible property should be distinct from the rules for determining the allocation of income from the intangible. The preamble states that such a framework will generally preclude an "all or nothing" result. This is presumably because the proposed analytical framework permits allocation of income to an owner of rights to an intangible such as a licensee, as well as to the owner of the intangible.

5. However, the current regulations seldom require an "all or nothing" result as to income attributable to an intangible. For example, the current regulations include examples where a U.S. subsidiary's contribution to enhancing an intangible are compensated through service payments or adjustments to the transfer price, consistent with arm's-length practice. Some commentators have suggested that a hidden agenda behind the proposed rules may be to require a profit-split approach where the present regulations may permit compensation under a services and/or CPM approach.

B. **<u>Ownership of intangible property under the proposed regulations</u>**.

1. Prop. Reg. § 1.482-4(f)(3)(i)(A) identifies the owner of intangible property for purposes of the regulations as follows:

   "The legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions."

2. The proposed regulation provides that if no owner is identified under the relevant intellectual property law or pursuant to contractual terms, included terms imputed by the Commissioner, or other legal provision,

then the controlled taxpayer who has "control" of the intangible, based on all of the facts and circumstances, will be considered the sole owner of the intangible for purposes of the regulations.

C. **Examples of proposed regulation's intangible property ownership rules**. This ownership rule is illustrated by two examples in the regulations:

1. **Example 1.** In Example 1, a foreign corporation is the registered holder of a trademark in the U.S. The foreign corporation licenses to a U.S. subsidiary the exclusive right to manufacture and market products in the United States using the trademark. The example states that the foreign corporation is the owner of the trademark pursuant to an intellectual property law, but that the U.S. subsidiary is the owner of the license pursuant to the contractual terms of the license, but is not the owner of the trademark. Thus, the example illustrates the proposed regulations' conceptual framework of treating a trademark and associated license rights as two separate intangibles. The preamble states the present regulations could be read to provide for multiple owners of the same intangible. See current Treas. Reg. § 1.482-4(f)(3)(iv), Example 4 ("Cheese" example).

2. **Example 2**. The facts are the same as in Example 1. As a result of its sales and marketing activities, the U.S. subsidiary develops a list of several hundred creditworthy customers that regularly purchase the trademarked products. Neither the terms of the contract between the foreign corporation and the U.S. subsidiary nor the relevant intellectual property law specifies which party owns the customer list. The example concludes that because the U.S. subsidiary has knowledge of the contents of the list and has practical control over the use and dissemination of the list, the U.S. subsidiary is considered the owner of the customer list for purposes of the regulations. This example illustrates the "fallback" rule under the proposed regulations, which treats the controlled taxpayer that has "control" of the intangible, as the owner where neither the intellectual property law nor the contract between the parties specifies ownership.

3. Note the foregoing two examples imply that where intellectual property law of the relevant jurisdiction points to a particular controlled taxpayer as the legal owner, that taxpayer will remain the owner of the trademark for purposes of the regulations, even though another controlled party may be the owner of rights to use the trademark pursuant to a contract between the parties. Moreover, it appears that the proposed regulations do not provide for shifting ownership by contract of an intangible such as a trademark from a party owning the trademark under the relevant intellectual property law. Further, the proposed regulations do not permit shifting ownership of an intangible through application of a "developer" concept, which is the rule under the 1968 regulations, and is the fall-back rule under the current regulations.

D. **Contributions to the value of an intangible owned by another controlled party**.

1. Prop. Reg. § 1.482-4(f)(4)(i) provides that consideration for a contribution by one controlled party that develops or enhances the value of an intangible may be embedded within the contractual terms for a controlled transaction involving that intangible. If so, the proposed regulations provide that no separate allocation will be made with respect to the contribution; rather the contribution must be accounted for in evaluating comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's-length consideration in the controlled transaction.

2. The regulations include six examples of the operation of this rule for dealing with situations where one controlled party adds value to an intangible owned by another. The preamble states that this rule is intended to reach result that is "implicit" under the existing regulations, apparently referring to the developer/assister rule in current Treas. Reg. § 1.482-(f)(3)(iii). These examples appear intended to replace the "Cheese" examples in the current regulations.

3. **Example 1**. Example 1 involves one member of a controlled group allowing another member to use laboratory equipment in connection with the other member's development of an intangible that the other member owns. The example states that by furnishing the laboratory equipment, the controlled member makes a contribution to the development of an intangible requiring an arm's length charge that will be determined under the rules for use of tangible property in Treas. Reg. § 1.482-2(c), which includes provisions relating to determining arm's length rental charges.

4. **Example 2** involves a foreign producer of wrist watches that is the registered holder of the "YY" trademark for the watches in the U.S. and worldwide. The foreign corporation enters into a five-year distribution agreement with its U.S. subsidiary, granting the U.S. subsidiary the right to sell the YY trademarked wrist watches in the U.S. The distribution agreement provides for the U.S. subsidiary paying a fixed price for the watches to the foreign parent and obligates both the foreign parent and the U.S. subsidiary to undertake without separate compensation specified types and levels of marketing activities. The example states that the consideration for the foreign parent's and the U.S. subsidiary's marketing activities as well as for the U.S. subsidiary's license to sell the YY trademarked watches is embedded in the transfer price paid for the wrist watches. The example concludes that as such no separate allocation would be appropriate with respect to the "embedded contributions."

The example then states that whether an allocation is warranted as to the transfer price for the wrist watches would be determined under Prop. Reg. §§ 1.482-1 and 1.482-3 through 1.482-6, and that the comparability analysis would take into account the fact that the compensation of the marketing activities of the foreign parent and the U.S. subsidiary, as well as the consideration for the subsidiary's use of the YY trademark embedded in the transfer price for the wrist watches. The example then concludes that if it is not possible to identify uncontrolled transactions incorporating a similar range of "interrelated elements" <u>and</u> there are "non routine" contributions by both the foreign parent and the U.S. subsidiary, then the most reliable measure of an arm's length price for the watches may be the residual profit split method.

Thus, this example appears to reflect the bias in the proposed regulations towards a profit split methodology. Presumably, the U.S. subsidiary's marketing activities would not create a "non routine" intangible, but the Service could argue that the subsidiary's contractual right to use the YY trademark in the U.S. is such a "non routine" intangible. An additional issue would be whether the parent's manufacturing and marketing activities would be treated as creating "non routine" intangibles. A residual profit split methodology would allocate the combined operating profit from the sale of the wrist watches between the foreign parent and the U.S. subsidiary.

Under the current regulations, the challenge would be to test the transfer price for the watches and the embedded services and royalty components through disaggregating the components and applying the tangible property, services and intangible property provisions, including analyzing the royalty component through a CUT or CPM approach. This presumes that a comparable uncontrolled interrelated transaction could not be located, which is probable.

5. **<u>Example 3</u>**. Example 3 involves a foreign producer of athletic gear that is the registered holder of the "AA" trademark in the United States and in other countries. In year 1, the foreign producer licenses a newly organized U.S. subsidiary with the exclusive rights to use certain manufacturing and marketing intangibles to manufacture and market the athletic gear in the United States under the AA trademark. The license agreement requires the U.S. subsidiary to pay a royalty based upon sales of the AA trademarked merchandise. The license agreement also obligates the foreign producer and the U.S. subsidiary to perform without separate compensation specified types and levels of marketing activities. The example concludes that ordinarily a separate allocation would not be appropriate for the foreign producer's and U.S. subsidiary's respective marketing activities that are embedded within the contractual terms of the license.

As to the separate royalty, the example states that whether an allocation is warranted would be analyzed under Prop. Reg. §§ 1.482-1 through 1.482-6, with the comparability analysis taking into account all relevant factors, including the nature of the intangibles subject to the license, the term and geographic exclusivity of the license and the nature of the marketing activities required to be undertaken under the license. The comparability analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty, rather than provided for in a separate services agreement.

As with the preceding example, this example concludes that if it is not possible to identify uncontrolled transactions that incorporate a similar range of "interrelated elements" and there are "non routine" contributions by both the foreign parent and U.S. subsidiary, then the most reliable measure of an arm's length royalty may be the residual profit split method. The Service could be expected to contend that the U.S. subsidiary's contractual rights to use the parent's manufacturing and marketing intangibles are "non routine" intangibles. Thus, the remaining issue might be whether the parent's marketing activities and any unlicensed manufacturing intangibles used by the subsidiary in manufacturing the watches should be treated as resulting in contributions of non routine intangibles by the parent. Presumably, if the U.S. subsidiary obtained all of necessary manufacturing processes through the license and the parent was not performing extraordinary marketing activities, there would be no "non routine" contribution from the parent, and therefore the residual profit split method would not be appropriate.

6. **Example 4**. The facts in example 4 are the same as in the preceding example 3 with the following exceptions. In year 2, the U.S. subsidiary undertakes certain "incremental" marketing activities in addition to those required under the license agreement. The parties do not execute a separate agreement with respect to the "incremental" marketing activities. The license agreement executed in year 1 is of sufficient duration that it is reasonable to anticipate that the U.S. subsidiary will obtain the benefits of the "incremental" activities in the form of increased sales or revenues of the AA trademarked products in the U.S.

From these facts, the example concludes that to the extent that it was reasonable to anticipate that the U.S. subsidiary would benefit from its "incremental" marketing activities through increasing the value of its intangible, i.e., its license right to use the trademark, the incremental activities do not constitute a contribution for which a separate allocation to the U.S. subsidiary would be warranted.

7. **Example 5**. The facts in this example are the same as in the preceding Example 3 except that in year 2 the foreign parent and the U.S. subsidiary enter into a separate services agreement obligating the U.S. subsidiary to perform certain "incremental" marketing activities to promote the AA trademarked athletic gear in the U.S. The example concludes that whether a separate allocation is warranted with respect to the U.S. subsidiary's incremental marketing activities covered by the separate services agreement would be evaluated under Prop. Reg. §§ 1.482-1 through 1.482-9, including an analysis under the proposed services regulations, which are renumbered as § 1.482-9 in the proposed regulations.

   The example further states that whether an allocation is required with respect to the royalty paid by the U.S. subsidiary will be determined under Prop. Reg. §§ 1.482-1, 1.482-4 through 1.482-6, taking into account the fact that the compensation for the incremental service activities is provided for in a separate services agreement, rather embedded in the royalty as in the earlier example. This example similarly concludes, however, that if it is not possible to identify uncontrolled transactions that incorporate a "similar range of interrelated elements" <u>and</u> there are "non routine" contributions by the foreign parent and the U.S. subsidiary, then the most reliable measure of an arm's length royalty may be through use of the residual profit split method. Thus, again, the example seems to reflect a bias toward use of the residual profit split method.

8. **Example 6**. The facts are the same as in the preceding Example 3, except that in year 2 the foreign parent and the U.S. subsidiary enter into a separate services agreement obligating the foreign parent to perform "incremental" marketing activities by advertising AA trademarked athletic gear at selected international sporting events, such as the Olympics and the Soccer World Cup. The foreign parent's corporate advertising department develops and coordinates these special promotions. A separate services agreement obligates the U.S. subsidiary to pay an amount to the foreign parent for the benefit the U.S. subsidiary may reasonably anticipate as a result of the foreign parent's incremental activities. The example states that the separate services agreement is not a qualified cost sharing agreement under Treas. Reg. § 1.482-7.

   The example states that whether an allocation is warranted with respect to the foreign parent's marketing activities at the international sporting events would be evaluated under Prop. Reg. § 1.482-9 dealing with controlled service transactions. The example further states that under the circumstances it is reasonable to anticipate that the foreign parent's marketing activities would increase the value of both the U.S. subsidiary's license as well as the value of the foreign parent's trademark. The example then concludes that the parent's "incremental" marketing activities may

constitute in part a controlled services transaction for which the U.S. subsidiary must compensate the foreign parent.

With respect to the royalty, the example states whether an allocation is appropriate would be evaluated under §§ 1.482-1 and 1.482-4 through 1.482-6, taking into account the nature of the license, the marketing activities and the fact that the compensation for the foreign parent's marketing activities was provided for in a separate license agreement. The example again concludes that the residual profit split method may be the most reliable method if it is not possible to identify uncontrolled transactions incorporating a similar range of interrelated elements and there are non routine contributions by both the foreign parent and the U.S. subsidiary.

E. **Definition of "non routine" intangibles under the proposed regulations**.

1. The proposed regulations include new language defining "non routine contributions" for purposes of the residual profit split method. Prop. Reg. § 1.482-6(3)(i)(B)(1) defines a "non routine contribution" as:

   A contribution that cannot be fully accounted for by reference to market returns or that is so interrelated with other transactions that it cannot be reliably evaluated on a separate basis. Thus, in cases where such nonroutine contributions are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section [i.e., allocation to routine functions].

2. The underscored language does not appear in the current regulations and may result in a return to a controlled party's routine functions being improperly being included as part of the residual profit. It could also be used by the Service to support the use of a residual profit split method despite the absence on a true non routine contribution by one or both of the parties.

3. Prop. Reg. § 1.482-6(3)(i)(B)(2) generally provides that the relative value of nonroutine intangible property contributed by taxpayers may be estimated by the capitalized cost of developing the intangible property, less an appropriate amount of amortization based on the useful life of each intangible. The regulation further provides that if the intangible development expenses are relatively constant and the useful life of the intangible property contributed by the parties is approximately the same, the amount of the actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions. This language tracts the language in current Treas. Reg. §1.482-6(c)(3)(B).

III. Proposed controlled service transaction regulations

A. The preamble to the proposed services regulations states that Treasury and IRS believe that guidance is necessary to mitigate the extent to which a "characterization of a transfer of intangibles as the rendering of services can lead to inappropriate results."

1. This concern is reflected in a number of the proposed regulation provisions and examples, including what appears to be an over reliance on the use of the residual profit split method as a pricing methodology for services.

B. The predisposition to find an intangible transfer arising from the performance of services appears to be inconsistent with prior guidance from Treasury and the Service.

1. For example, the Treasury Department Technical Explanation of Article 12, paragraph 4 of the United States/Australia Income Tax Treaty states that the term "royalty" implies a "property right as distinguished from personal services." The Explanation includes the example of an engineer or architect who prepares a design for a customer and is therefore treated as performing personal services, rather than transferring intangibles. The explanation includes a counter example of an engineer or architect supplying pre-existing designs or blueprints. Under such circumstances, the engineer or architect is described as furnishing knowledge or information and therefore transferring an intangible. Thus, the Technical Explanation implies that no intangible transfer would result from an engineer or architect developing a new design or blueprint as opposed to simply supplying a pre-existing design or blueprint from memory or otherwise.

2. The Treasury Department Technical Explanation of the United States Model Income Tax Convention, at Article 12, paragraph 2, provides similar guidance in its description of the term "royalties":

   The term "royalties" also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software, development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 14 (Independent personal Services) or Article 15 (Dependent Personal Services).

C. Simplified Cost-based Method.

1. The proposed service regulations include a methodology for low-margin services intended to permit taxpayers to charge costs or cost plus a small mark-up for qualifying services. This Simplified Cost-Based Method ("SCBM") is intended to replace the cost safe harbor in the present regulations for services that are not an "integral part of the business."

2. The SCBM limits the ability of the IRS to make an adjustment to circumstances where the arm's-length markup exceeds the taxpayer's markup by at least the "applicable number of percentage points." The "applicable number of percentage points" is 6 if the taxpayer's markup is zero, and declines ratably to zero by 1 percentage point for every increase of 2 percentage points in the taxpayer's markup, up to a maximum mark-up of 10%. Treas. Req. § 1.482-9(f)(2)(i) & (ii). The regulations include a formula expressing this limitation as:

$$Z = X + Y = \min((6\% + 0.5 \text{ x } X), 10\%) \text{ where } X \geq 0.$$

For this formula, (Z) is the minimum arm's-length markup necessary for the IRS to make an allocation, "X" is the markup charged by the taxpayer and "Y" is the "applicable number of percentage points."

3. This foregoing formula is illustrated by the following table, which shows for markups charged by the taxpayer from 0 to 9%, the number of percentage points that the taxpayer must understate the arm's-length markup before the Commissioner may make an adjustment.

Markup charged by taxpayer (X)	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%
Applicable number of percentage points (Y)	6	5.5	5	4.5	4	3.5	3	2.5	2	n/a
Arm's length markup necessary for allocation by the Commissioner (Z)	6%	6.5%	7%	7.5%	8%	8.5%	9%	9.5%	10%	10%

4. Limitations on applicability of SCBM. The proposed regulations provide that notwithstanding the foregoing percentage point rules, the IRS may make an adjustment under the following circumstances:

   a. Where the amount charged by the taxpayer is less than the total cost for the services.

   b. Where the markup charged by the taxpayer exceeds the arm's-length markup.

c. Where the taxpayer's method of allocating and apportioning total service costs to the controlled service transaction is not consistent with the method used in determining the arm's-length markup or otherwise does not constitute a reasonable method of allocation and apportionment.

5. Moreover, the SCBM may be used only if the following conditions are met:

   a. The taxpayer maintains books and records adequate to permit the IRS to verify the total service cost rendered, including verification of the allocation and apportionment methods.

   b. The taxpayer has a written contract in place during the period when the service costs are incurred providing for the following:

   c. That the controlled recipient of the services is unconditionally obligated to pay the cost of the services plus, to the extent provided in the contract, any markup on the services.

   d. A general description of the classes of controlled services transactions subject to the contract.

6. There is a *de minimus* exception to the requirement that a contract must exist for the SCBM to apply if the taxpayer establishes that (i) the aggregate gross income of the members of the controlled group that are U.S. persons is less than $200 million; or (ii) the aggregate cost of controlled group members evaluated under the SCBM is less than $10 million.

7. Finally, the SCBM does not apply to the following transactions. It appears that this provision is intended to roughly approximate the transactions that are treated as "integrally related to the business" in the current regulations:

   a. Services rendered to uncontrolled parties. Where the renderer, the recipient, or another controlled taxpayer in the same controlled group renders, or has rendered, similar services to one or more uncontrolled parties, other than such services rendered on a "*de minimus* basis."

   b. <u>Services rendered in significant amounts</u>. Where services are rendered to a recipient that receives services from controlled taxpayer in "significant amounts." The regulations provide that the recipient may be "presumed" to have received services in "significant amounts" unless the taxpayer establishes that the amount paid by the recipient for such services is less than 50% of the total cost of the recipient, excluding cost of good sold.

c. Services involving the use of intangible property. Where the renderer's valuable or unique intangible property or "particular resources or capabilities (such as the knowledge or an ability to take advantage of particularly advantages situations or circumstances)" contribute significantly to the value of the services and the renderer's costs associated with the services do not include cost with respect to use of its intangible property or resources that are significant.

8. Non-services transactions included in integrated transactions. Where transactions other than a services transaction, such as a transfer of tangible property, account for more than a *de minimus* amount of value in a transaction structured as a controlled services transaction. In such cases, the arm's-length charge for only the services element of the integrated transaction may be determined under the SCBM.

9. Specified transactions. The SCBM may not be used for the following categories of transactions:

a. manufacturing;

b. production;

c. extraction;

d. construction;

e. reselling, distribution, acting as a sales a purchasing agent, or acting under a commission or other similar arrangements;

f. research, development or experimentation;

g. engineering or scientific;

h. financial transactions, including guarantees; and

i. insurance or reinsurance.

10. Examples. The regulations include the following examples applying the SCBM:

a. **Example 1**. A parent company renders accounting services for its subsidiaries and charges its cost with no markup. The IRS determines that the arm's-length markup is 4%. Because the arm's-length markup of 4% exceeds the taxpayer's markup of zero by fewer than the "applicable number of percentage points, 6 (i.e., 6-0), the IRS may not make an allocation.

b. **Example 2**. A parent company performs "logistics-coordination" services for its subsidiary and charges cost plus a 5% markup. The IRS determines that the arm's-length markup is 9%. Because the arm's-length markup, 9%, exceeds the taxpayer's markup, 5%, by more than the "applicable number of percentage points," 3.5% (6 - 1/2 of 5%), the IRS may make an allocation.

c. **Example 3**. A parent company renders "administrative services" to its subsidiary and charges cost plus 5%. The IRS applies the comparable profits method using operating profit to total service cost as the profit level indicator and determines an arms length inter-quartile range, with a median of 9%. Because the arm's-length markup, 9%, exceeds the taxpayer's markup, 5%, by more than the "applicable number of percentage points," 3.5% (6 - 2.5), the IRS may make an allocation. Presumably, the allocation would be to the median of the inter-quartile range.

d. **Example 4**. A parent company renders "administrative services" to its subsidiary, charging cost plus 6%. The IRS determines that the inter-quartile range of arm's-length markups for comparable companies is between 3 and 5%, with a median of 4.5%. Because the arm's-length markup, 4.5% is less than the markup applied by the taxpayer, the SCBM does not apply and the IRS is free to make an allocation.

e. **Example 5**. A parent company provides "administrative services" to its subsidiary and charges its cost of providing the services minus a "markdown" of 1%. Because the markup is less than zero, the SCBM does not apply, and the Commissioner is free to make an allocation.

f. **Example 6**. A parent company performs "custodial and maintenance" services for a subsidiary and charges cost plus 8%. The IRS determines that an arms length markup is cost plus 4%. Because the taxpayer's markup, 8%, exceeds the arms length markup, 4%, the SCBM does not apply.

g. **Example 7**. A parent corporation performs "logistics-coordination" services for its subsidiary, charging cost plus 4%. The IRS determines that the arm's-length markup is 8.5%. Because the arm's-length markup, 8.5%, exceeds the taxpayer's markup, 4%, by more than the "applicable number of percentage points, 4 (6 - ½ x 4), the SCBM does not apply and the IRS is free to make an allocation.

h. **Example 8**. A parent corporation performs "administrative services" for its subsidiary using the SCBM and determines a cost plus 4% markup. The parent corporation allocates and apportions to the administrative services total costs of 300x and reports a total price of 312x, reflecting the 4% markup. The IRS determines that an arms length markup is 4%. The example states that as the arm's-length markup equals the taxpayer's markup, the SCBM would generally prevent an allocation by the IRS. However, the example states that on examination the IRS determines that the allocation of costs should have been 325x rather than 300x, and because the allocation and apportionment method was not "reasonable under the facts and circumstances," the SCBM does not apply and the IRS may make an allocation.

i. **Example 10**. A parent corporation performs "supply-chain management" services for its subsidiary. The parent corporation uses the SCBM and determines a cost plus 8% markup. The IRS determines that an arm's-length markup is 18%. Because the arm's-length markup exceeds 10%, the SCBM does not apply.

D. Profit-Split Method.

1. The proposed regulations provide that the profit-split method is ordinarily used in controlled service transactions involving "high value services or transactions that are highly integrated and that cannot be reliably evaluated on a separate basis." Treas. Reg. § 1.482-9(g)(1).

2. The proposed regulations examples of the operation of the profit split method are as follows:

3. **Example 1**. Company A, a resident in Country X, auctions spare parts by means of an interactive database. Company A develops the software used to run the database. Company A has a wholly-owned subsidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A's interactive database. Company B also solicits unrelated companies to auction spare parts on Company A's database, and solicits customers interested in purchasing spare parts online. Company B owns and maintains a computer server in Country Y and has designed a specialized communications network that connects its data center to Company A's data center in Country X. The example states that Company B bore the risk and costs of developing a specialized communication network. The example states that both Company A and B possess valuable intangibles used in conducting the spare parts auction business.

From that premise, the example concludes that the residual profit-split method will provide the most reliable measure of an arms-length result. The example states that under the residual profit-split method, the profits are first allocated to routine contributions, including the general sales, marketing and administrative functions performed by Company B for Company A, for which it is possible to identify market returns. Any residual profit would then be allocated based upon the non-routine contributions, which presumably would be based upon the relative value of such non-routine contributions, although that is not stated in the example.

4. **Example 2**. This example involves a U.S. corporation, Company A, which is described as a "large, multinational corporation engaged in oil and mineral exploration, development in extraction/mining." The example states that Company A uses teams of specialists who are drawn from its employees and employees of two of its wholly-owned subsidiaries, Company B and Company C. Company B is a U.S. corporation providing general construction contracting services and Company C performs mining and extraction operations and is located in Country C. Through a long-term relationship with Country C, Company C obtains drilling rights on attractive land for which it already owns mining rights. Because Company C lacks the expertise and personnel to perform oil exploration, Company C enters into an agreement with Companies A and B to provide certain services to facilitate exploration for oil on the tract. Company A provides management services and Company B provides all necessary labor and equipment for the exploration. All three controlled companies provide their own administrative support for the respective functions.

From these facts, the example concludes that Companies A, B and C all make "non-routine contributions." Further, because the transactions between Companies A, B and C are "highly integrated," the example states that it is difficult to reliably evaluate them on a separate basis. Therefore, the example concludes that the residual profit-split method should be used to determine the arm's-length charges for the services involved.

The example then states that under the residual profit split, Companies A, B and C would receive "market returns" for the routine functions, including any general, sales, marketing and administrative functions. Any residual profits would be allocated based upon the non-routine contributions, which for Company C would include its drilling rights. The example does not identify the "non-routine contributions for the U.S. Company, Company A, but this would presumably be its management expertise involved in providing the management services to Company C." Moreover, the example does not identify the intangibles of Company B, which provides only labor and equipment. Thus, this example appears to

reflect a bias towards a profit-split approach, even though other pricing methodologies might produce as reliable, if not more, result.

The concern with this example is that Company A, the U.S. company, might be allocated a greater portion of the residual profit than warranted based upon its economic contribution in providing the management services. Thus, this example reflects the Services seeming predisposition to treat the performance of certain services as involving a transfer of intangible property even though all that may be involved is simply knowledgeable employees performing services.

E. Unspecified methods.

1. The proposed services regulations generally incorporate the unspecified method provisions of § 1.482 as a method that may be used to determine an arm's-length charge for controlled services transactions, taking into account the limitations discussed in § 1.482, including that realistic alternatives, such as outsourcing a particular service function, should be taken into account in connection with the use of an unspecified method.

F. Contingent-payment arrangements.

1. The regulations provide that the arm's-length result for a "contingent-payment arrangement" would not require payment in the tax accounting period for which the services are rendered, where the services are conditioned upon a specified contingency, which does not occur in that period, provided that it is reasonable to conclude that uncontrolled taxpayers would engage in similar transactions under similar circumstances. The regulation further provides that if the specified contingency occurs in a later accounting period, the arm's-length result would require a payment to the renderer reflecting the recipient's benefit and the risk borne by the renderer.

2. The regulations provide that an arrangement will be treated as a "contingent-payment arrangement" if:

   a. There is a written contract entered into prior to the start of the controlled services transaction.

   b. The contract states that the payment is contingent upon the happening of a future benefit to the recipient related to the controlled services.

   c. That the contract provides for a payment that reflects the recipient's benefits from the services rendered. The regulation provides that one factor that is especially important is whether the contingency and the basis for payment are "consistent with the

economic substance of the controlled transaction and the conduct of the controlled parties."

3. Notably, the regulations permit the Commissioner to impute a contingency-payment contract if the "economic substance of the transaction is consistent with the existence of such terms." Treas. Reg. § 1.482-9(i)(3). This could be used by the Service to propose an adjustment in open years based upon an imputed contingency arrangement for non-arm's-length prior statute barred years.

4. The regulations include two examples of a contingent-payment arrangement.

   a. The first example involves a pharmaceutical company that enters into an agreement to perform research and development services for a related company. The agreement provides that the related company will own any patent or other rights resulting from the research activities and will make payments only if the activities result in commercial sales of one or more derivative products. If such sales occur, the related party will make payments of a specified percentage of its gross sales of the derivative products beginning with the first year of such sales and continuing for six years thereafter. The example discusses the underlying facts and circumstances and concludes that the contingent-payment arrangement is consistent with economic substance.

   b. The example concludes that in determining whether the specified charge is arm's-length, the risks borne by the company performing the R&D should be taken into account as well as the alternative of the R&D company performing the research on its own behalf and licensing any resulting products. Therefore, the example concludes, the Commissioner may consider royalties charged for comparable intangibles in determining the arm's-length contingency payments to the R&D company. This result would, in effect, convert the R&D contingent service provider into a licensor, which, again, reflects the Services' inclination to treat the performance of "high value" services as transfers of intangibles.

   c. Example 2 assumes the same facts as the preceding example, except that the payments in the event of the contingency are only cost-plus payments for Years 1-5, with a Year 6 payment based upon a percentage of sales of the derivative products in Year 6. The example concludes that such a payment arrangement is not consistent with the terms that uncontrolled parties would have agreed under similar circumstances and therefore the contingent-payment arrangement is not consistent with "economic substance."

Based upon this premise, the example concludes that the Commissioner may impute terms whereby the research company is allocated a payment based upon a percentage of sales or products derived from the research for each of the Years 6-9, which are the years under examination, and apparently are the only open years.

G. <u>Determining allocable service costs.</u>

1. The regulations include provisions relating to appropriate methods for allocating and apportioning costs to the controlled services transaction. Treas. Reg. § 1.482-9(k), *et. seq.* The regulations provide that the practices used by the taxpayer to apportion costs in connection with preparation of statements for use by management, creditors, shareholders, and others will be considered as "potential indicators of reliable allocation methods," but will not be accorded "conclusive weight" by the Commissioner.

H. **<u>Definition of "controlled service transactions</u>**."

1. Regulations defines a "controlled services transaction" as any activity by one member of a group of controlled taxpayers that results in a benefit to one or more other members of the controlled group. Prop. Reg. § 1.482-9(l)(1).

2. The regulations define the term "activity" as follows:

   An activity that includes the performance of functions, assumptions or risk, for use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of an ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.

3. This definition is significant as it attempts to incorporate intangible property concepts, such as the use of "knowledge," as a category of services, consistent with the general theme of the services regulations to capture presumed intangible property transfers arising from the performance of services.

4. The proposed regulations provide that an activity is considered to provide a benefit to the recipient if the activity:

   Directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so.

5. The regulations further provide that an activity will generally be considered to confer a benefit if an uncontrolled taxpayer in comparable circumstances would be willing to pay an uncontrolled party to perform the same or similar services. Thus, the regulations focus on the recipient, rather than the renderer, of the services, for purposes of the benefit test.

6. Services not Providing a Benefit. The regulations identify the following categories of activities as not providing a benefit to the recipient:

   a. Indirect or remote benefits.

   b. Duplicative activities.

   c. Shareholder activities.

7. "Passive association."

   a. Proposed § 1.482-9(l)(3)(v) provides that a member of the controlled group benefiting solely on account of its status as a member of the group (for example, by obtaining favorable commercial terms from an uncontrolled party by reason of its membership in the controlled group) is generally not considered to receive a benefit for purposes of the regulations.

   b. The Service could reference this language in arguing that the receipt of volume discounts as a consequence of a controlled party being a member of a controlled group does not confer a "benefit" for purposes of the regulations. Note, however, that this language should not preclude a "benefit" where, for example, an affiliate provides procurement services such as identifying and qualifying component part vendors.

8. Regulations Examples. The proposed regulations contain several examples that are relevant to the question of when a member of a control group will be treated as receiving a "benefit."

   a. Identifiable Benefit. In Example 3, a U.S. parent corporation performs a study and decides to change the management structure and compensation of its subsidiaries in order to increase their profitability. As a result, the U.S. company implements substantial changes in the management structure and compensation of its subsidiaries, which are anticipated to increase the profitability of the subsidiaries. The example concludes that the benefit to the subsidiaries is "specific" and "identifiable" and therefore the subsidiaries received a "benefit" from the study within the meaning of the proposed regulations.

b. Identifiable Benefit. Example 4 deals with a U.S. parent corporation performing certain treasury functions for itself and its subsidiaries, including raising capital, arranging medium and long term financing for general corporate needs and cash management. The example states that these treasury functions do not duplicate functions performed by the subsidiaries' staff. The example concludes that the subsidiaries receive a "benefit" from the Treasury functions for purposes of the proposed regulation.

c. Identifiable Benefit. Example 6 involves a U.S. parent corporation that has an in-house legal staff specializing in several areas, including intellectual property law. The U.S. Company's foreign subsidiary is involved in complex joint venture negotiations with a third party involving multiple licenses and cross-licenses of intellectual property. The foreign subsidiary retains outside counsel specializing in intellectual property law to review the transaction documents, but also has the transactions reviewed by the legal staff of the U.S. parent corporation. The example concludes that while the U.S. parent corporation's legal review substantially duplicated the legal services obtaining by the foreign subsidiary, the parent corporation's review nonetheless "reduces the commercial risk" associated with the transaction, and therefore the foreign subsidiary is treated as having obtained a "benefit" for purposes of the regulations.

d. Shareholder Activities. Example 7 makes clear that "shareholder activities," sometimes called "stewardship" activities, such as compiling and analyzing data regarding the operation of subsidiaries for purposes of filing reports required by law and not considered to provide a "benefit" to the subsidiaries. This is consistent with the current regulations.

e. Shareholder Activities. Example 8 discusses "shareholder activities" that are treated as providing a "benefit" to the involved subsidiaries. In Example 8, the U.S. parent analyzes and compiles data concerning its foreign subsidiary for purposes of U.S. reporting requirements, but the data also is used by the foreign subsidiary, with appropriate adjustments to account for local accounting practices, to satisfy the foreign subsidiary's reporting requirements. The example concludes that under such circumstances, the foreign subsidiary received a "benefit" for purposes of the proposed regulations.

f. Qualifying Shareholder Activities. Example 12 relates to a U.S. corporation that retains a law firm and an investment banking firm to determine whether a recent change in the law where its foreign

subsidiary is located might permit a restructuring that would increase the foreign subsidiary's profitability and also increase the foreign subsidiary's ability to introduce new products more quickly in its country of residence. The example concludes that the costs relating to retaining the law firm and investment banking firm confer a "benefit" upon the foreign subsidiary within the meaning of the proposed regulations.

g. Qualifying Shareholder Activities. Example 13 involves a U.S. parent corporation that establishes personnel policies for its subsidiaries, including reviewing and approving performance appraisals, and is involved in hiring and firing senior executives of the foreign subsidiaries. The example concludes that these personnel-related activities confer a "benefit" upon the foreign subsidiaries within the meaning of the proposed regulations.

h. Identifiable Benefit. Example 14 involves a U.S. parent corporation that develops a confidential "strategy statement" relating to the long-term business strategy of the parent corporation and its subsidiaries. The "strategy statement" is made available to a particular foreign subsidiary, which evaluates the strategies to determine whether or not to implement one or more of the strategies. The example concludes that if the foreign subsidiary would have paid an unrelated party for a similar analysis or would have undertaken the analysis on its own, the subsidiary received a "benefit" within the meaning of the proposed regulations.

i. "Passive Association." Example 15 involves a U.S. parent corporation of a large controlled group that has been involved in the information-technology sector for 10 years. The U.S. parent corporation acquires a foreign subsidiary, which several months later obtains a contract to redesign and assemble the information technology networks of a large financial institution where the foreign subsidiary is located. The project is significantly larger and more complex than any previous project undertaken by the foreign subsidiary. The example provides that the U.S. parent corporation "had no involvement in the solicitation, negotiation, or anticipated execution of the contract." The example also states that the foreign subsidiary did not use any of the U.S. parent's marketing intangibles to solicit the contract. The example concludes that the foreign subsidiary did not obtain a benefit even through it may have obtained the contract due to its status as a member of the parent corporation's controlled group.

j. "Passive Association." Example 16 assumes the same facts as the previous example, except that the parent corporation provides a "performance guarantee" that allows the foreign subsidiary to obtain the contract on more favorable terms than otherwise would have been possible. The example concludes that the "performance guarantee" is considered to provide a "benefit" to the foreign subsidiary within the meaning of the proposed regulations.

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