United States

Michelle Johnson, Sheetal Kumar and Emily Sanborn
Duff & Phelps LLC

Issue One

Is there official guidance for the treatment of intercompany services in your country (e.g., specific methodologies, safe harbors, etc.)? Are there requirements for documenting intercompany provisions of services in your country?

A. Overview of US Transfer Pricing Regulations for the Provision of Intercompany Services

The US transfer pricing rules are embodied in Internal Revenue Code ("IRC") section 482 and the related Treasury Regulations Section 1.482 ("US Transfer Pricing Regulations").[1] Under these regulations, taxpayers must clearly reflect income attributable to controlled transactions, and support that the pricing of such controlled transactions are in accordance with the arm's length standard. A controlled transaction meets the arm's length standard "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (i.e., the arm's length result)."[2]

Specific guidance for the determination of taxable income in connection with a controlled services transaction is provided for in Section 1.482-9 of the US Transfer Pricing Regulations ("US Services Regulations"). Under the US Services Regulations, the arm's length amount charged in a controlled services transaction must be applied in accordance with the following provisions of Section 1.482-1, including:

- *Section 1.482-1(c): Best Method Rule*. Under the US Transfer Pricing Regulations, there is no strict priority of methods, and no method will invariably be considered to be more reliable than another. Instead, the arm's length result of a controlled transaction will be determined by the method that, given the facts and circumstances of the tested transaction, provides the most reliable measure of an arm's length result. The typical methods applied (and specified under the US Services Regulations) are discussed in the following subsection.
- *Section 1.482-1(d): Comparability*. Typically, the arm's length nature of a transaction is determined by comparing the results of the controlled transaction with results realized by uncontrolled taxpayers performing similar functions and bearing similar risks under similar circumstances. This is achieved by assessing the "comparability" of the uncontrolled transaction to the controlled transaction. While the most important factors of comparability may vary depending on the best method selected, typical factors of comparability that must be evaluated include functions performed, contractual terms of the transaction, risks assumed, economic conditions under which the transaction is carried out, and similarity of property employed or services provided.[3] It is important to note that under the US Transfer Pricing Regulations, the uncontrolled transaction does not need to be identical to the controlled transaction. Instead, it must be determined to be "sufficiently similar." Where material differences may affect the prices and profits reported, adjustments must be made in order to improve the reliability of the results. Typically, such adjustments must be based on commercial practices, economic principles, or statistical analyses. The US Transfer Pricing Regulations do not allow for the unadjusted industry average returns of a controlled transaction to represent the arm's length result.[4]
- *Section 1.482-1(e):Determination of Arm's Length Range*. Under the US Transfer Pricing Regulations, the application of a pricing method will either produce a single result or a range of results that is determined to be the most reliable measure of an arm's length result. A taxpayer will not be subject to adjustments by the Internal Revenue Service ("IRS"), the US taxing authority, if the results of the controlled transaction fall within such range (i.e., the "arm's length range"). The determination of this range (e.g., calculation of interquartile range, selection of comparables, adjustments to increase reliability, etc.) are addressed specifically in Section 1.482-1(e)(2)(i) – (iii) of the US Transfer Pricing Regulations.

Further details concerning the official guidance on the determination of taxable income in connection with a controlled services transaction are provided in the US Transfer Pricing Regulations, under Section 1.482-9.

B. Methods for Evaluating a Controlled Services Transaction

As mentioned above, specific methods for the analysis of the arm's length nature of a controlled services transaction are provided in Section 1.482-9. With the exception of the Services Cost Method (see *Safe Harbor* section below), the application of these meth-

 11/14 Copyright © 2014 by The Bureau of National Affairs, Inc. TP FORUM ISSN 2043-0760

ods is similar to the application of the methods specified for the transfer of tangible goods under Section 1.482-3. We provide a brief overview of the methods specified under the US Services Regulations below:

- *Comparable Uncontrolled Services Price ("CUSP") Method*. The CUSP method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction. In order to apply this method, at least one of the following situations would need to apply.
  - Service Recipient would need to receive services from third parties that are similar to the services received in the controlled services transaction.
  - Service Provider would need to provide services to third parties that are similar to the services provided in the controlled services transaction.
  - Two unrelated parties would have to engage in the provision of services that are similar to those engaged in under the controlled services transaction.

  Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in Section 1.482-1(c). Although all of the factors mentioned under Section 1.482-1(d) should be considered, in general, the similarity of the services rendered and of the intangible property (if any) used in the provision of such services will have the greatest effect on comparability under the CUSP method. Section 1.482-9(c) contains additional details concerning the application of the CUSP method.
- *Gross Services Margin ("GSM") Method*. The GSM evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method is typically applied in instances where a controlled taxpayer provides services to an affiliated entity in connection with a transaction between that affiliated entity and a third-party (e.g., agent services). This method may also be used in cases where a controlled taxpayer contracts to provide services to a third-party and another member of the controlled group actually performs a portion of the services provided (i.e., performs an intermediary service). As with the CUSP method, whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in Section 1.482-1(c). Although all of the factors mentioned under Section 1.482-1(d) should be considered, in general, the similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services, and the contractual terms will have the greatest effect on comparability under the GSM method. Section 1.482-9(d) contains additional details concerning the application of the GSM method.
- *Cost of Services Plus Method*. The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit mark-up realized in comparable uncontrolled transactions. The cost of services plus method is typically used in cases where the controlled service renderer provides the same / similar services to both controlled and uncontrolled parties. Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in Section 1.482-1(c). Although all of the factors mentioned under Section 1.482-1(d) should be considered, in general, the similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services functions, and the contractual terms will have the greatest effect on comparability under the cost of services plus method. Section 1.482-9(e) contains additional details concerning the application of the cost of services plus method.
- *Comparable Profits Method ("CPM")*. The CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (known as "profit level indicators") derived from uncontrolled taxpayers that engaged in similar business activities under similar circumstances. Furthermore, the application of the CPM requires the selection of a tested party (generally the party to the transaction that does not own intangibles and is functionally the least complex entity in the controlled group). In order to apply the CPM, independent, third-party companies would need to be identified that perform similar functions and assume similar risks to those of one of the parties to the tested transaction. The CPM then analyzes the arm's length nature of the tested transaction by benchmarking the returns earned by independent, third-party entities and comparing those returns to the tested party. The comparability criterion for a reliable application of the CPM tends to be less stringent than that of the application of the CUSP, GSM, and cost of services plus methods. Instead, reliability will be most affected by the similarity of the functions performed, risks assumed, and assets employed in the provision of the services. Section 1.482-9(f) contains additional details concerning the application of the CPM.
- *Profit Split Method*. The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed, and resources employed by such controlled taxpayer in the relevant business activity. The application of this method is detailed in Section 1.482-6 of the US Transfer Pricing Regulations. It is also important to note that the US Transfer Pricing Regulations prohibit the use of the Profit Split Method in instances where only one of the controlled taxpayers in the transaction makes significant non-routine contributions.

In addition to the five specified methods described above, the US Transfer Pricing Regulations also allow

for the use of an unspecified method, provided that the unspecified method is determined to provide the most reliable measure of an arm's length price and is in accordance with the provisions of Section 1.482-1 (see Section (i) above). Furthermore, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions. Section 1.482-9(h) provides additional guidance on the application of an unspecified method in the determination of taxable income in connection with a controlled services transaction.

C. Safe Harbor

In addition to the methods provided in Section 1.482-9, the US Transfer Pricing Regulations also provide for safe harbor treatment of services that meet certain criteria. This safe harbor, known as the SCM, is an elective method under Section 1.482-9(b), which allows for services to be charged out at-cost if they meet the following criteria:

- *Service is a Specified Covered Service*.[5] The service is a specified covered service (e.g., controlled services transactions that the Commissioner specifies in Revenue Procedure 2007-13). Specified covered services are determined by the Commissioner to be support services common among taxpayers across industry sectors and that generally do not involve a high median comparable mark-up on total services costs. In January 2007, the US Department of Treasury issued a revised list of over 20 categories of services and 101 activities that would be considered specified covered services, as defined within Rev. Proc. 2007-13 ("White List"). If the service activity does not appear on the White List, the service must instead meet the criteria to be considered a low-margin covered service (discussed below).

- *Service is a Low-margin Covered Service*.[6] Low margin covered services are defined as controlled services transactions for which the median comparable mark-up on total services costs is less than or equal to seven percent. Example 15 in Section 1.482-9(b)(8) provides clarity on the treatment of low-margin covered services. In this example, the interquartile range of arm's length mark-ups on total services costs for accounting services was found to be between three percent and nine percent, with a median of six percent. As the median comparable mark-up on total services costs is six percent, which is less than seven percent, the accounting services constitute low-margin covered services.

- *Service is not an Excluded Activity*.[7] Under the US Transfer Pricing Regulations, in order to be eligible for treatment under the SCM, the service cannot be an excluded activity as defined in Section 1.482-9(b)(4). These services include: (i) manufacturing, (ii) production / extraction, (iii) exploration, or processing of natural resources, (iv) construction, (v) reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement, (vi) research, development, or experimentation, (vii) engineering or scientific activities, (viii) financial transactions, including guarantees, and / or (ix) insurance or reinsurance.
- *Service meets the Business Judgment Rule*. The business judgment rule refers to the fact that the service is not precluded from constituting a covered service. Specifically, the business judgment rule states that "a service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group."[8]
- *Adequate Books and Records*.[9] In order to apply the SCM, the taxpayer must have permanent books of account and records maintained for as long as the costs with respect to the covered services are incurred by the renderer. Such books and records must include a statement referencing the taxpayer's intention to apply the SCM to evaluate the arm's length charge for such services. Furthermore, such books and records must contain sufficient information that would allow for verification by the Commissioner of the total services costs incurred by the renderer. Adequate records would include a description of the services, identification of the renderer and the recipient of the services, as well as sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services under review.

As mentioned above, the SCM is an elective method under the US Services Regulations for the charge of services at-cost. If the taxpayer either (i) does not meet all of the criteria specified above, or (ii) does not elect to apply the SCM, an analysis using the methodologies specified in Section 1.482-9 will apply in determining the taxable income due in connection with a controlled services transaction.

D. Documentation[10]

With the exception of the specific documentation requirements for the application of the SCM (see *Adequate Books and Records* discussion above), the same US transfer pricing documentation requirements apply to all types of allocation of income and deductions among taxpayers, as defined under Section 1.482 of the US Transfer Pricing Regulations. We provide a brief overview of the US documentation requirements below.

Although transfer pricing documentation is not required by US law, the existence of such documentation may avoid the substantial or gross valuation misstatement penalties specified under Section 1.6662(a), (e), and (h) of the US Treasury Regulations. This "penalty protection" protects the taxpayer against the assessment of additional penalty fees in the event an adjustment is made by the IRS to the taxpayer's reported income. Under Section 1.6662-6(d)(2)(iii)(A), the documentation requirement will be met if the taxpayer maintains sufficient documentation to establish that it reasonably concluded that, given the available data and the applicable transfer pricing methods, the method (and the application of that method) provided the most reliable measure of an arm's length result under the principles of the best

11/14 Copyright © 2014 by The Bureau of National Affairs, Inc.

method rule (as discussed above). Furthermore, the taxpayer must provide that documentation to the IRS within 30 days of such a request in connection with an examination of the taxpayer year to which the documentation relates. Such documentation should also be in place by the time the taxpayer files its annual tax return in order to be considered contemporaneous.

US transfer pricing documentation required under Section 1.6662-6(d)(2)(iii)(B)-(C) is divided into two categories:

- *Principal Documents*. These documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. Section 1.6662-6(d)(2)(iii)(B)(1) – (10) lists specific components to be included in such documentation.
- *Background Documents*. These documents are supporting documents upon which assumptions, conclusions, and positions contained in the principal documents are based. A list of documents that may be used to support the principal documentation is provided for in Section 1.6662-6(d)(2)(iii)(C). In addition, other supporting documents that may be used to support the principal documentation is provided for in Section 1.6038A-3(c).

As mentioned above, the documentation guidance provided above is applicable to both the determination of income in connection with a controlled services transaction and other types of intercompany transactions (e.g., tangible, intangible, etc.) covered under Section 1.482 of the US Transfer Pricing Regulations.

Issue Two

If a taxpayer relies on a methodology that refers to services costs, what support is required to substantiate the cost base?

A. Substantiating the cost base using a methodology that refers to services costs

As mentioned above, the US Transfer Pricing Regulations specify methods for the determination of taxable income in connection with a controlled services transaction in Section 1.482-9. In the case where services costs are relied upon in applying a method, any reasonable method may be used to allocate and apportion the costs. However, in establishing the appropriate method of allocation and apportionment, all bases and factors (e.g., total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent) must be considered.

When a taxpayer relies on a methodology that refers to the allocation of services costs, there are several factors to consider in order to sufficiently substantiate the cost base. The key factors are outlined in more detail below:

- *Activities must be deemed beneficial to the recipients:* The primary factor in substantiating the cost base is to show that activities performed by the Service Provider are beneficial to the recipients of the charge (i.e., the Service Recipient). In general, 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. An activity is generally considered to provide a benefit if an uncontrolled taxpayer in similar circumstances would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed the same activity or a similar activity on its own.
- *The activity is not deemed indirect or remote*: If an activity is deemed to provide an indirect or remote benefit, this should not be included in the allocation. An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose.
- *The activity is not duplicative*: If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.
- *The activity is not a shareholder activity*: An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers.

In addition to the factors presented above, it is also important to consider the role of passive association in the identification of beneficial services to be charged out as part of the total services costs. Passive association refers to benefits that are received solely as a result of being a member of a controlled group. Such benefits that are derived from passive association will not be considered to be "beneficial" under Section 1.482-9(l)(3)(i), and thus will not be eligible for allocation under the US Transfer Pricing Regulations.

A second important step to substantiating the cost base is to understand how services costs are defined. To this end, guidance may be taken from Section 1.482-9(j), which refers to total services costs as including all costs of rendering those services for which total services costs are being determined. In general, services costs can be any cost that relates to the expense for all resources expended, used, or made available to achieve the specific objective for which the

service is rendered. Under the US Transfer Pricing Regulations, such costs include all costs in cash or in kind that, based on the analysis of the facts and circumstances, are directly identified with the provision of the controlled services, as provided for under Section 1.482-9(j). It is important to note that stock-based compensation, in particular, is listed as an expense that must be included in total services costs under Section 1.482-9(j) despite the fact that third parties do not typically share stock option expenses in services agreements.[11]

Total services costs do not include interest expense, foreign income taxes (as defined in Section 1.901-2(a)) or domestic income taxes.[12] Generally accepted accounting principles ("GAAP") or federal income tax accounting rules may provide an appropriate starting point, but neither would necessarily be conclusive in evaluating whether an item must be included in total services costs.

Item Three

For audits concerning the transfer of intercompany services, what types of information are typically requested from the tax authorities in your jurisdiction? What level of detail for support of services is typically requested to support intercompany services charges when under audit?

A. Information Requested and Level of Detail Expected During an Audit

On February 14, 2014, the IRS released its "Transfer Pricing Audit Roadmap"[13] in which it outlines a typical audit timeline in the United States, and provides advice and links to helpful reference material for navigating a transfer pricing audit. One of the key takeaways from the Audit Roadmap is the fact that most cases are usually won and lost on the facts, highlighting the importance of presenting an effective story that explains the taxpayer's value chain, competitive position in its industry, and financial results, in a clear and compelling fashion. If indications are that the tax result claimed by the taxpayer is at odds with common sense and economic reality (i.e., "too good to be true"), it will be more vulnerable for additional scrutiny from the IRS. Conversely, if indications are that the taxpayer's financial results are reasonable, and the taxpayer's selection of method fits its fact profile, the IRS may determine that it is not worth pursuing the issue.

A clear and compelling story often includes (but is not limited to) the following.

- Taxpayer's background and the history of the intercompany transactions under review.
- Discussion of all intercompany transactions in the year(s) under examination. Details to include:
  - taxpayer's rationale for entering into the transactions;
  - taxpayer's value chain(s) associated with the intangible, services and/or tangible goods; and,
  - whether the intercompany transaction is associated with the transfer of an income stream, or contribution to the value, of any intangible.
- Discussion of the functions performed, assets employed, and risks assumed by each controlled party of the respective intercompany transaction.
- Description detailing how the preparer of the transfer pricing study gained knowledge of each controlled party's functions performed, assets employed, and risks assumed (and availability upon request of supporting documents such as interview notes).
- Identification of persons responsible for structuring the transaction from the tax planning perspective.
- Transfer pricing methods selected by the taxpayer for the analysis of material transactions.

Providing a clear and compelling picture of the company's overall business, value chain, and support for the pricing of its intercompany transactions may help to reduce the potential for an audit. However, if the IRS selects the company for an audit, the taxpayer may expect to be asked for the following types of information for the transfer of services between related entities: (i) any and all transfer pricing reports and documentation, (ii) interview notes from which the functional analysis was derived, (iii) intercompany agreements, (iv) financial allocation models, and (v) cost center data including cost center numbers, names and details of functions performed. In order to reduce the burden of information gathering during an audit, it is recommended that taxpayers have contemporaneous documentation ready to provide to tax authorities upon request, including reference and location to the ten principal documents referred to in Section (iv) of this response. In addition, the taxpayer may expect to be asked for background documents that support the principle documents, as discussed in Section (iv) of this response.

While every audit is different, it has been our experience that transfer pricing audits in the United States concerning the intercompany transfer of services go more smoothly if the taxpayer is able to present the following.

- A clear and logical build-up of the "Total Services Costs" used as the fully-loaded cost pool. This initial step is important in proving that the right costs are being captured in order to begin allocating potential charges.
- A listing of all the cost centers housed in the entity providing the service (i.e., not just those that were eventually allocated out), as well as an indication as to which cost centers were analyzed and which were not. This helps substantiate the cost base by being transparent up-front.
- A listing of all guarantee charges either administered (or not) by the company.

In addition, it is also important to check the 861 calculations (and amounts allocated to stewardship) to ensure that they do not tell a conflicting story (compared to that told by the intercompany amounts categorized as stewardship). Thus, in practice, transparency up-front, as well as the presentation of a clear and consistent story concerning the costs of services allocated and why, will help smooth the audit process considerably for both the taxpayer and the IRS.

Michelle Johnson is Managing Director and Sheetal Kumar and Emily Sanborn are Vice Presidents at Duff & Phelps, LLC. They

can be contacted at:
Michelle.Johnson@DuffandPhelps.com;
Sheetal.Kumar@DuffandPhelps.com; and,
Emily.Sanborn@DuffandPhelps.com

NOTES

[1] Many US companies are also subject to domestic transfer pricing rules that address intercompany transactions that occur across state or city borders. Most US states address transfer pricing in some manner in their state tax regulations and, in many cases, state law points taxpayers to Section 482 for guidance.

[2] Treas. Reg. § 1.482-1(b)(1).

[3] Treas. Reg. § 1.482-1(d)(1)(i) – (v).

[4] Treas. Reg. § 1.482-1(d)(2).

[5] Treas. Reg. § 1.482-9(b)(3)(i).

[6] Treas. Reg. § 1.482-9(b)(3)(ii).

[7] Treas. Reg. § 1.482-9(b)(4).

[8] Treas. Reg. § 1.482-9(b)(5).

[9] Treas. Reg. § 1.482-9(b)(6).

[10] The documentation requirements, and related penalties, under the US Transfer Pricing Regulations are covered in more detail in the September 2013 *Transfer Pricing Forum* publication, US response, by Mark Schuette, Patrick McColgan, and Emily Sanborn (Duff & Phelps, LLC).

[11] Xilinx, Inc. V. Commissioner, 125 T.C. 37 (2005).

[12] Treas. Reg. § 1.482-9(j).

[13] http://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf

United States

Michelle Johnson, Rod Koborsi, Sheetal Kumar, and Emily Sanborn
Duff & Phelps LLC

Issue Four

Comment on the frequency of transfer pricing audits involving services, or on any other trends in this area. Have you noticed an increase in attention geared toward the transfer of intercompany services in your jurisdiction?

The Internal Revenue Service ("IRS") has not published statistics on the level of transfer pricing audits, including those that involve services transactions. The IRS did report that 36 percent of Advanced Pricing Agreements ("APAs") executed in 2013 involved the provision of services. In addition, the clear majority of APAs involving services transactions applied the Services Cost Method ("SCM") or Comparable Profits Method ("CPM").[1] The SCM is effectively a safe harbor that allows certain services to be charged at-cost, whereas the CPM evaluates whether the amount charged for a certain service is arm's-length by reference to a measure of the profitability of unrelated companies that engaged in similar activities under similar circumstances.

In the authors' experience, the IRS has seemed to focus on two areas during transfer pricing audits of inbound or outbound service charges: 1) The appropriate cost base or "total services costs" used; and, 2) The reasonableness and accuracy of the allocation methodology used to charge each service activity or "service cost center" to its related beneficiaries.

A. Audit Trend #1: Correct Total Services Costs Used

The IRS defines total services costs as "all costs in cash or in kind (including stock-based compensation) that are directly identified with, or reasonably allocated to, the services. In general, costs for this purpose should comprise the provision for all resources expended, used, or made available to render the service."[2] Multinational corporations with headquarters in the United States must not only determine the direct costs associated with each activity being performed (e.g., research & development, marketing, finance, and accounting), but should also allocate indirect costs that fully load each service cost center. This area has been a major focus of the IRS in determining whether the taxpayer's starting point prior to allocating costs to beneficiaries is agreeable.

Costs that must be considered include overhead (e.g., office rent/lease, supplies, telecommunications, computers, and building security) and stock-based compensation. The IRS has explicitly addressed stock-based (or stock-option) compensation in the Internal Revenue Code ("IRC") section 482 and the related Treasury Regulations Section 1.482 ("US Transfer Pricing Regulations"), but does not provide guidance on how to value stock-based compensation. One potential approach would be to value the employee stock option plan provided by the parent on the basis of the total amount of costs of providing stock options. Doing so would determine the costs that would have been incurred by the beneficiary to obtain its parent companies' stock options if it were a third party. Nevertheless, a consistent methodology of allocating this cost is recommended to reduce audit risk.

Additionally, taxpayers should be conscious that service charges do not include costs associated with the following.

- Stewardship: The US Transfer Pricing Regulations define stewardship as "expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both."[3]
- Duplicative activities: These activities are defined as "an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account. . .the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient."[4]
- Passive association: A controlled taxpayer generally will not be considered to obtain a benefit where the benefit results from the controlled taxpayer's status as a member of a controlled group.
- Indirect/Remote benefit: This relates to activities for which benefit is so indirect or remote that the recipient would not be willing to pay an uncontrolled party to perform a similar activity, and would not be willing to perform such an activity for itself for the same purpose.

Foreign corporations that charge U.S. related parties should especially be aware of these exclusions.

B. Audit Trend #2: Reasonableness and Accuracy of Allocation Methodology

The IRS will evaluate whether the services costs are appropriately allocated when a renderer's activity re-

12/14 Copyright © 2014 by The Bureau of National Affairs, Inc.

ISSN 2043-0760

sults in a benefit for multiple legal entities and when the charge is determined under a method that makes references to costs. In what is referred to as the "Reasonable Method Standard", the US Transfer Pricing Regulations state that any reasonable method may be used to apportion costs, such as time spent, assets, sales, and compensation.[5] The allocation methodology for each service cost center should be supported through functional interviews or service questionnaires.

In determining whether costs for a service activity are appropriately allocated and charged, taxpayers should deliberate whether a third party would pay for the service being charged under similar circumstances. If the answer is uncertain, an allocation may not be defensible.

Common audit triggers related to allocation methodologies of services transactions include:

- a broad-based allocation metric used for all service cost centers, such as a percentage of revenue by entity, may give rise to more scrutiny; and,
- a lack of support for the allocation methodology used may weaken a taxpayer's position under audit. A best practice is to rely on the input provided (through functional interviews or questionnaires) by managers closest to the service activity being performed.

C. Focus areas for U.S. Inbound and Outbound Service Charges

U.S. taxpayers who perform global or regional headquarter services should consider the following when assessing services transactions:

- confirm that the cost-base meets the requirements of the US Transfer Pricing Regulations. This involves fully-loading the service cost centers with overhead costs, including stock-based compensation. Once the costs for each service cost center are fully-loaded, consider reconciling the list to the general ledger to ensure expenses have not been overlooked;
- perform a check to ensure that the process for determining whether service activities are beneficial is reasonable and consistent. Methodologies that are applied consistently regionally or globally provide a better audit defense for the U.S. taxpayer. A best practice would be to prepare a transfer pricing model that reconciles costs to the general ledger, demonstrates consistent allocations across locations, and reconciles the service charges to actual invoices paid; and
- prepare contemporaneous documentation related to services transactions, especially if the charges meet the companies' materiality thresholds. Doing so will allow for penalty protection in the event the IRS is successful in making an adjustment.

Foreign companies who charge U.S. taxpayers should consider the following when assessing service transactions:

- confirm that the service charges received have adequate support through transfer pricing documentation and intercompany service agreements. This type of support will include detail on the total services costs, transfer pricing method, and allocation method used. As mentioned above, among its many benefits, contemporaneous documentation will allow for penalty protection for the US taxpayer;
- determine if duplicate activities are being performed locally, which may give rise to a service charge that does not directly benefit the U.S. taxpayer;
- if applicable, confirm that costs associated with the service charge and royalty payments to a foreign parent are not double counted. The costs associated with intangible generating activities (such as technology development and brand marketing) should be borne by the intangible owner and may be already embedded within a royalty charge; and
- ensure that service charges involving executive employees have a direct benefit to the U.S. taxpayer being charged and are not considered stewardship in nature.

Issue Five

What are the expectations of tax authorities in your jurisdiction with respect to applying allocation metrics? What type of support and justification is typically needed for applying allocation metrics?

As mentioned in our response to question four, the US Transfer Pricing Regulations do not explicitly state the allowable metrics to be used, but instead expect the taxpayer to apply the Reasonable Method Standard. Furthermore, the US Transfer Pricing Regulations explicitly state that "In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate."[6]

To ensure that the allocation metrics used are reasonable and appropriate, it is highly recommended that the metrics be vetted by the individual responsible for the service cost center being analyzed. The metric used for each service cost center should be revisited on an annual basis and especially when business changes occur.

For example, companies typically utilize enterprise resource planning ("ERP") systems across their entire global supply chain. These systems are costly and are usually considered beneficial to subsidiaries. Management may decide to allocate its ERP costs by the percentage of revenue of each beneficiary. However, a more accurate metric would be to locate the number of active licenses (or users) being utilized at each beneficiary and allocate the costs by the percentage of licenses in a specific subsidiary as a proportion of total licenses. Doing so would provide a more accurate representation of the beneficiaries of the service activity in this example.

While the IRS does not provide guidance on the metrics to be used for each service activity, we list overleaf metrics commonly used when charging foreign related beneficiaries. It should be noted, however, that metrics should be tailored to the taxpayer's specific facts and circumstances.

Service Activity	Commonly Used Allocation Metrics
Human Resources	Headcount
Information Technology	Licenses or Users
Finance and Accounting	Turnover or Operating Expenses
General Marketing	Revenue
Account Management	Revenue
Legal	Headcount, Time Spent, or by Case/Issue
Executive Management	Time Spent
Recruiting	Headcount or Time Spent

Finally, taxpayers cannot ignore the transfer pricing rules and guidance of the recipient of the service charge. For example, Mexican tax authorities are extremely wary of pro-rata allocation metrics and require substantive support for the reasonability of the metric. Taxpayers should therefore aim to select an allocation metric that most closely aligns with the benefits of the recipient to ensure that their transfer pricing risks are mitigated globally.

Issue Six

Concerning your country's view of the provision of R&D services, are contract R&D services permissible? When will the provision of intercompany services be assumed to be a transfer of intangible property requiring compensation?

Contract Research and Development ("R&D") services are permissible under the US Transfer Pricing Regulations, and are subject to the same arm's-length standard as other controlled transactions.

A critical part of an intercompany analysis is determining the characterization of a transaction as either a service or the transfer of an intangible, as this delineation results in different tax treatments. While the US Transfer Pricing Regulations do not provide specific guidance to determine when the provision of intercompany services can be assumed to be a transfer of intangible property, various definitions and examples provide some assistance in making this distinction.

Under the US Transfer Pricing Regulations, an intangible asset is defined as:

> . . .an asset that comprises any of the following items and has substantial value independent of the services of any individual: patents, inventions, formulae, processes, designs, patterns, or know-how; copyrights and literary, musical, or artistic compositions; trademarks, trade names, or brand names; franchises, licenses, or contracts; methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and other similar items.[7]

Section 1482-9(m)(1) discusses the fact that certain controlled services transactions may include other elements for which a separate category of methods are provided, including the transfer of intangible property. Whether such an integrated transaction is evaluated as a controlled services transaction under Section 1.482-9, or under the intangible property discussion in Section 1.482-4 is dependent on which approach will provide the most reliable measure of an arm's-length result. The US Transfer Pricing Regulations also provide an example in which a US company and its foreign affiliate enter into a technical assistance agreement. One entity shares the results of R&D it has conducted, and as a result, the affiliate gains some useful knowledge through which it applies for a patent. The US Transfer Pricing Regulations conclude that in this example, the US entity provided more than technical assistance. It has, in fact, transferred intangible property in the form of know-how. As a result, this part of the analysis must be analyzed under Section 1.482-4.[8]

Given that the US Transfer Pricing Regulations do not provide concrete guidance as to when the provision of services rise to the level of intangible property, certain facts of the transaction must be analyzed to make this determination. Considerations include whether the price paid and benefits received as a result of services provided are consistent with those that would be achieved under comparable circumstances with uncontrolled third parties.

Another aspect is to determine whether such services are available from other parties in the industry (with a similar repayment structure). Per the Service Regulations, both the comparable uncontrolled transaction ("CUT") method and the comparable uncontrolled services price ("CUSP") method "will generally be the most direct and reliable measure of the arm's-length result" under the "the same, or substantially the same, circumstances as the controlled transaction." If the taxpayer has characterized the controlled transaction as an intangible property transfer, and can find a comparable uncontrolled transaction to support its claim, it may face fewer challenges by the tax authorities. Similarly, if a taxpayer believes the controlled transaction is an intercompany service (and not a transfer of intangible property), and it can demonstrate the arm's-length nature of the transaction using the CUSP method, this may decrease the chances of challenges by tax authorities—assuming the IRS is agreement with the comparability of the CUSP.

However, if a CUT or CUSP cannot be found, then a taxpayer must consider its specific facts and circumstances to determine if an intangible asset has substantial value independent of the services of any individual.

Michelle Johnson is Managing Director, Rod Koborsi, Sheetal Kumar and Emily Sanborn are Vice Presidents at Duff & Phelps, LLC. They can be contacted at:
Michelle.Johnson@DuffandPhelps.com;
Rod.Koborsi@DuffandPhelps.com
Sheetal.Kumar@DuffandPhelps.com; and,
Emily.Sanborn@DuffandPhelps.com

NOTES

[1] Internal Revenue Services, Announcement 2014-14: *Announcement and Reporting Advance Pricing Agreements*, April 14, 2014, http://www.irs.gov/irb/2014-16_IRB/ar17.html.

[2] Treas. Reg. § 1.482-9(j)

[3] Treas. Reg. § 1.482-9(l)(3)(iv)

[4] Treas. Reg. § 1.482-9(l)(3)(iii).

[5] Treas. Reg. § 1.482-9(k)(2)(i).

[6] Treas. Reg. § 1.482-9(k)(1).

[7] Treas. Reg. § 1.482-4(b).

[8] Treas. Reg. § 1.482-9(m)(5), Example 4.