DEPARTMENT OF THE TREASURY

Internal Revenue Service

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Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles; Stewardship Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance regarding the treatment of controlled services transactions under section 482 and the allocation of income from intangibles, in particular with respect to contributions by a controlled party to the value of an intangible owned by another controlled party. This document also contains final and temporary regulations that modify the regulations under section 861 concerning stewardship expenses to be consistent with the changes made to the regulations under section 482. These final and temporary regulations potentially affect controlled taxpayers within the meaning of section 482. They provide updated guidance necessary to reflect economic and legal developments since the issuance of the current guidance.

DATES: *Effective Date:* These regulations are effective on January 1, 2007.

Applicability Dates: These regulations apply to taxable years beginning after December 31, 2006.

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SUPPLEMENTARY INFORMATION:

Background

Section 482 of the Internal Revenue Code generally provides that the Secretary may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or to clearly reflect income of a controlled taxpayer. Regulations under section 482 published in the **Federal Register** (33 FR 5849) on April 16, 1968, provided guidance with respect to a wide range of controlled transactions, including transfers of tangible and intangible property and the provision of services. Revised and updated transfer pricing regulations were published in the **Federal Register** (59 FR 34971, 60 FR 65553 and 61 FR 21955) on July 8, 1994, December 20, 1995, and May 13, 1996. A notice of proposed rulemaking and notice of public hearing were published in the **Federal Register** (68 FR 53448) on September 10, 2003. A correction to the notice of proposed rulemaking and notice of public hearing was published in the **Federal Register** (68 FR 70214) on December 17, 2003. A public hearing was held on January 14, 2004.

The Treasury Department and the IRS received a substantial volume of comments on a wide range of issues addressed in the 2003 proposed regulations. These comments were very helpful and substantial changes have been incorporated in response. In order to achieve the goal of updating the 1968 regulations, while facilitating consideration of further public input in refining final rules, these regulations are issued in temporary form with a delayed effective date for taxable years beginning after December 31, 2006.

These regulations are issued a significant amount of time after proposed revisions to the regulations pertaining to cost sharing arrangements were issued. Commentators suggested that this type of timing sequence was important so that each regulation could be assessed properly. Commentators also suggested, among other things, that the services regulations be reissued in temporary and proposed form. By issuing these regulations in temporary and proposed form, the Treasury Department and the IRS provide taxpayers an opportunity to submit additional comments prior to the time these regulations become effective, allowing commentators to consider the potential interaction between these regulations and the cost sharing regulations.

Explanation of Provisions

A. Controlled Services

1. Services Cost Method—Temp. Treas. Reg. § 1.482–9T(b)

a. The Simplified Cost Based Method and Public Comments

The 2003 proposed regulations set forth a simplified cost based method (SCBM). The SCBM was intended to preserve the salutary aspects of the current § 1.482–2(b) cost safe harbor that provide appropriately reduced administrative and compliance burdens for low margin services. At the same time, the existing rules would be brought more in line with the arm's length standard, and various problematic features of those rules would be eliminated. The goal was to provide certainty concerning the pricing of low margin services, thus allowing the compliance efforts of both taxpayers and the IRS to concentrate on those services for which a robust transfer pricing analysis is particularly appropriate. The preamble to the 2003 proposed regulations also indicated that in certain cases, the allocation or sharing among group members of expenses or charges relating to corporate headquarters or other centralized service activities may be consistent with the proposed regulations, but no further guidance was provided on such service sharing arrangements.

A number of commentators argued that the SCBM was actually counterproductive to its stated goals. These commentators contended that to apply the SCBM, taxpayers would potentially need to expend substantial sums to prepare comparability studies, perhaps separately for each of the numerous categories of back office services. They contended that, although taxpayers have in-depth knowledge concerning their businesses and the relative value added by their back offices, the SCBM called for quantitative judgments that business people are not qualified to make by themselves, especially in the prevailing compliance environment. As a matter of proper accountability, taxpayers would be required as a practical matter to devote significant compliance resources to enlist outside consultants or otherwise to develop support for those judgments.

Commentators suggested a range of proposed alternatives to the SCBM regime. One such proposal was simply to return to the approach in the existing regulations under § 1.482–2(b). The 1968 regulations are fairly rudimentary in nature, particularly, in today's tax compliance environment. In addition, those regulations were open to substantial manipulation by taxpayers (both inbound and outbound). Moreover, there have been extensive and far-reaching developments in the services economy since the existing regulations were published in 1968, with real prospects that many intragroup services have values significantly in excess of their cost. As a result, in the course of considering comments on the 2003 proposed regulations, the Treasury Department and the IRS have concluded that it would not be appropriate simply to readopt the standard in the 1968 regulations. Additional proposals by commentators included development of

a list of activities that would qualify to be priced at cost or detailed provisions regarding cost sharing arrangements for low value services performed on a centralized basis, and other options.

The Treasury Department and the IRS may have decided not to return to the 1968 regulations, but have nonetheless taken the full range of comments on the 2003 proposed regulations seriously. Therefore, in light of the extensive comments on these issues, the Treasury Department and the IRS have substantially redesigned the relevant provisions. The Treasury Department and the IRS recognize that the section 482 services regulations potentially affect a large volume of intragroup back office services that are common across many industries. It is in the interest of good tax administration to minimize the compliance burdens applicable to such services, especially to the extent that the arm's length markups are low and the activities do not significantly contribute to business success or failure.

Accordingly, based on the comments, these temporary regulations eliminate the SCBM and replace it with the services cost method (SCM), as set forth in § 1.482–9T(b). The SCM evaluates whether the price for covered services, as defined, is arm's length by reference to the total services costs with no markup. Where the conditions on application of the method are met, the SCM will be considered the best method for purposes of § 1.482–1(c).

b. Services Cost Method: Identification of Covered Services and Other Eligibility Criteria

Section 1.482–9T(b)(4) provides for two categories of covered services that are eligible for the SCM if the other conditions on application of the method are met. If the conditions are satisfied, covered services in each category may be charged at cost with no markup. The first category consists of specified covered services identified in a revenue procedure published by the IRS. This revenue procedure approach is consistent with taxpayer comments. Services will be identified in such revenue procedure based upon the determination of the Treasury Department and the IRS that they constitute support services of a type common across industry sectors and generally do not involve a significant arm's length markup on total services costs. Because the government performs the analysis necessary to determine the eligibility of specified covered services, the compliance burden that was previously imposed by the SCBM is eliminated for a broad class of commonly provided services.

An initial proposed list of specified covered services is contained in an Announcement being published contemporaneously with these temporary regulations. This Announcement will be published in the Internal Revenue Bulletin. For copies of the Internal Revenue Bulletin, see § 601.601(d)(2)(ii)(*b*). The Treasury Department and the IRS solicit public input on whether the list of services sufficiently covers the full range of back office services typical within multinational groups, on the descriptions provided for these covered services, and on other matters related to the Announcement. It is contemplated that a final revenue procedure, reflecting appropriate comments, will be issued to coincide with the effective date of the temporary regulations for taxable years beginning after December 31, 2006. In the future, particular services may be added to, clarified in, or deleted from the list, depending on ongoing developments.

The second category of covered services is certain low margin covered services. Taxpayers objected to the requirement under the SCBM that all services qualify for that method based on a quantitative analysis, but based on comments the Treasury Department and the IRS believe that controlled taxpayers might nonetheless want the discretion to show that particular services—not otherwise covered by the revenue procedure—qualify for the SCM, using a modified quantitative approach. Low margin covered services consist of services for which the median comparable arm's length markup on total services costs is less than or equal to seven percent. As under the SCBM, the median comparable arm's length markup on total services costs means the excess of the arm's length price of the controlled services transaction over total services costs, expressed as a percentage of total services costs. For this purpose, the arm's length price is determined under the general transfer pricing rules without regard to the SCM, using the interquartile range (including any adjustment to the median in the case of results outside such range). Again, if the markup on costs for eligible services is seven percent or less, this category of services can be charged out at cost with no markup.

Under § 1.482–9T(b)(2), specified covered services or low margin covered services otherwise eligible for the SCM will qualify for the method if the taxpayer reasonably concludes in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both. Unlike the quantitative judgment called for under the SCBM, this is a business judgment preeminently within the business person's own expertise. Exact precision is not needed and it is expected that the taxpayer's judgment will be accepted in most cases. This condition is intended to focus transfer pricing compliance resources of both taxpayers and the IRS principally on significant valuation issues. Thus, it is anticipated that in most cases the examination of relevant services will focus only on verification of total services costs and their appropriate allocation. These are issues even under the 1968 regulations. There will be little need in all but the most unusual cases to challenge the taxpayer's reasonable business judgment in concluding that such typical back office services do not contribute significantly to fundamental risks of success or failure. The condition effectively is reserved to allow the IRS to reject any attempt to claim that a core competency of the taxpayer's business qualifies as a mere back office service. For illustrations of the role performed by this condition, see the contrasting pairs of *Example 1* and *Example 2, Example 3* and *Example 4, Example 5* and *Example 6, Example 8* and *Example 9, Example 10* and *Example 11,* and *Example 12* and *Example 13* in § 1.482–9T(b)(6).

As indicated in this preamble, it is expected that in all but unusual cases, the taxpayer's business judgment will be respected. In evaluating the reasonableness of the taxpayer's conclusion, the Commissioner will consider all the relevant facts and circumstances. This provision avoids the need to exclude from the SCM certain back office services that as a general matter and across a range of industry sectors are low margin, but that in the context of a particular business nonetheless constitute high margin services. That is, it permits the Treasury Department and the IRS to include a greater range of service categories under the SCM, even though in specific circumstances an otherwise covered service of a particular taxpayer will be ineligible.

In addition, under § 1.482–9T(b)(3)(i), a single procedural requirement applies under the SCM. The taxpayer must maintain documentation of covered services costs and their allocation. The documentation must include a statement evidencing the taxpayer's intention to apply the SCM.

In § 1.482–9T(b)(3)(ii), the SCM preserves the same list of categories of

controlled transactions that are not eligible to be priced under the method as under the SCBM. The Treasury Department and the IRS continue to believe that these transactions tend to be high margin transactions, transactions for which total services costs constitute an inappropriate reference point, or other types of transactions that should be subject to a more robust arm's length analysis under the general section 482 rules. Comments are requested in this regard in light of the other substantial changes made in the regulations.

Consistent with the purpose of providing for appropriately reduced compliance burdens for services subject to the SCM, the temporary regulations retain provisions in § 1.6662–6T(d)(2) similar to those associated with the SCBM.

c. Shared Services Arrangements

Section 1.482–9T(b)(5) of the temporary regulations provides explicit guidance on shared services arrangements (SSAs). In general, an SSA must include two or more participants; must include as participants all controlled taxpayers that benefit from one or more covered services subject to the SSA; and must be structured such that each covered service (or group of covered services) confers a benefit on at least one participant. A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to the SSA and that substantially complies with the SSA requirements.

Under an SSA, the arm's length charge to each participant is the portion of the total costs of the services otherwise determined under the SCM that is properly allocated to such participant under the arrangement. For purposes of an SSA, two or more covered services may be aggregated, provided that the aggregation is reasonable based on the facts and circumstances, including whether it reasonably reflects the relative magnitude of the benefits that the participants reasonably anticipate from the services in question. Such aggregation may, but need not, correspond to the aggregation used in applying other provisions of the SCM. If the taxpayer reasonably concludes that the SSA (including any aggregation for purposes of the SSA) results in an allocation of the costs of covered services that provides the most reliable measure of the participants' respective shares of the reasonably anticipated benefits from those services, then the Commissioner may not adjust such allocation basis.

In addition, as a procedural matter, the taxpayer must maintain documentation concerning the SSA, including a statement that it intends to apply the SCM under the SSA and information on the participants, the allocation basis, and grouping of services for purposes of the SSA. Guidance is also provided on the coordination of cost allocations under an SSA and cost allocations under a qualified cost sharing arrangement.

d. Deleted Provisions

The SCM is considerably streamlined as compared to the SCBM. Upon further consideration, and in light of public comments, many of the conditions, contractual requirements, quantitative screens, and other technicalities associated with the SCBM have been eliminated. The Treasury Department and the IRS believe this streamlined approach serves the interests of both the government and taxpayers by reducing complexity and administrative burden.

2. Comparable Uncontrolled Services Price Method—Temp. Treas. Reg. § 1.482–9T(c)

The 2003 proposed regulations set forth the comparable uncontrolled services price (CUSP) method. This method evaluated whether the consideration in a controlled services transaction is arm's length by comparison to the price charged in a comparable uncontrolled services transaction. This method was closely analogous to the comparable uncontrolled price (CUP) method in existing § 1.482–3(b).

One commentator objected to the statement in § 1.482–9(b)(1) of the 2003 proposed regulations that, to be evaluated under the CUSP method, a controlled service ordinarily needed to be ''identical to or have a high degree of similarity'' to the uncontrolled comparable transactions. The commentator viewed the comparability analysis in the examples in proposed § 1.482–9(b)(4) as more consistent with the standard in existing § 1.482–3(b)(2)(ii)(A). The Treasury Department and the IRS agree that the comparability standards under the CUSP method for services should run parallel to those under the CUP method for sales of tangible property. Indeed, the provisions are parallel. The commentator misconstrues the purpose of the quoted provision.

Although the provision contains general guidance on situations in which the method ordinarily applies, it is not intended to and does not alter the substantive comparability standards. Just like the CUP method, the standards under the CUSP method emphasize the relative similarity of the controlled services to the uncontrolled transaction and the presence or absence of nonroutine intangibles. Section 1.482–9T(c)(2)(ii) of the temporary regulations also provides, consistent with the best method rule, that the CUSP method generally provides the most direct and reliable measure of an arm's length result if the uncontrolled transaction either has no differences from the controlled services transaction or has only minor differences that have a definite and reasonably ascertainable effect on price, and appropriate adjustments may be made for such differences. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

The CUSP provisions in these temporary regulations are substantially similar to the corresponding provisions in the 2003 proposed regulations.

3. Gross Services Margin Method—Temp. Treas. Reg. § 1.482–9T(d)

The 2003 proposed regulations provided for a gross services margin method, which evaluated the amount charged in a controlled services transaction by reference to the gross services profit margin in uncontrolled transactions that involve similar services. The method was analogous to the resale price method for transfers of tangible property in existing § 1.482–3(c).

Under the 2003 proposed regulations, this method would ordinarily be used where a controlled taxpayer performs activities in connection with a ''related uncontrolled transaction'' between a member of the controlled group and an uncontrolled taxpayer. For example, the method may be used where a controlled taxpayer renders services to another member of the controlled group in connection with a transaction between that other member and an uncontrolled party (agent services), or where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer and another member of the controlled group actually performs the services (intermediary function).

The 2003 proposed regulations defined the terms ''related uncontrolled transaction,'' ''applicable uncontrolled

price,'' and ''appropriate gross services profit''. A ''related uncontrolled transaction'' is a transaction between a member of the controlled group and an uncontrolled taxpayer for which a controlled taxpayer performs either agent services or an intermediary function. The ''applicable uncontrolled price'' is the sales price paid by the uncontrolled party in the related uncontrolled transaction. The ''appropriate gross services profit'' is the product of the applicable uncontrolled price and the gross services profit margin in comparable uncontrolled services transactions. The gross services profit margin takes into account all functions performed by other members of the controlled group and any other relevant factors.

One commentator mistakenly interpreted the term ''related uncontrolled transaction'' to suggest that the comparable transaction under this method is one that takes place between controlled parties. While this was not intended, the Treasury Department and the IRS agree that the nomenclature is potentially confusing, and as a result, these regulations substitute the term ''relevant uncontrolled transaction'' in lieu of ''related uncontrolled transaction'' wherever that appeared. In other respects, the gross services margin provisions in these temporary regulations are substantially similar to the provisions in the 2003 proposed regulations.

4. Cost of Services Plus Method—Temp. Treas. Reg. § 1.482–9T(e)

The 2003 proposed regulations set forth the cost of services plus method. This method evaluated the amount charged in a controlled services transaction by reference to the gross services profit markup in comparable uncontrolled services transactions. The gross services profit is determined by reference to the markup as a percentage of comparable transactional costs in comparable uncontrolled transactions. This method would ordinarily apply where the renderer of controlled services provides the same or similar services to both controlled and uncontrolled parties. In general, those are the only circumstances in which a controlled taxpayer would likely have the detailed information concerning comparable transactional costs necessary to apply this method reliably.

The cost of services plus method in the 2003 proposed regulations was generally analogous to the cost plus method for transfers of tangible property in existing § 1.482–3(d). The method implicitly recognized that financial accounting standards applicable to services have not developed to the same degree as the standards applicable to other categories of transactions, such as manufacturing or distribution of tangible property. For that reason, the method adopted the concept of ''comparable transactional costs,'' which the 2003 proposed regulations defined as all costs of providing the services taken into account in determining the gross services profit markup in comparable uncontrolled services transactions. In this context, comparable uncontrolled transactions could be either services transactions between the controlled taxpayer and uncontrolled parties (internal comparables), or services transactions between two uncontrolled parties (external comparables).

The 2003 proposed regulations also recognized that comparable transactional costs could be a subset of total services costs. Generally accepted accounting principles (GAAP) or Federal income tax accounting rules (if income tax data for comparable uncontrolled transactions are available) could provide an appropriate platform for analysis under this provision, but neither is necessarily conclusive.

Commentators objected that the concept of comparable transactional costs was imprecise, and they suggested that such costs should in any event include only the direct costs associated with providing a particular service, as determined under GAAP or Federal income tax accounting rules. As noted above, the financial accounting standards for services transactions are not as precise as the standards applicable to other types of transactions. The relative lack of uniformity in turn makes it impractical to derive a single definition of cost that would apply generally to controlled services transactions.

Comparable transactional costs may potentially include direct and indirect costs, if such costs are included in the internal or external uncontrolled transactions that form the basis for comparison. Section 1.482–9T(e)(4) *Example 1* has been modified to clarify this concept.

Several commentators objected to § 1.482–9(d)(3)(ii)(A) of the 2003 proposed regulations. In their view, this provision required the results obtained under the cost of services plus method to be confirmed by means of a separate analysis under the comparable profits method (CPM) for services. If a confirming analysis under the CPM for services were required in all cases, commentators reasoned, the cost of services plus method could not be viewed as a specified method in its own right.

The Treasury Department and the IRS agree and clarify that the intent of the rules is not to require confirmation of the results under the cost of services plus method. In response to public comments, § 1.482–9T(e)(3)(ii)(A) of these temporary regulations incorporates several changes. First, restatement of the price under this method in the form of a markup on total costs of the controlled taxpayer is necessary only if the cost of services plus method utilizes external comparables. If internal comparables are used, this calculation need not be performed. Second, in situations where the price is restated, the sole purpose is to determine whether it is necessary to perform additional evaluation of functional comparability.

For example, if the price under the cost of services plus method, when restated, indicates a markup on the renderer's total services costs that is either low or negative, this may indicate differences in functions that have not been accounted for under the traditional comparability factors. A low or negative markup suggests the need for additional inquiry, the outcome of which may suggest that the cost of services plus method is not the most reliable measure of an arm's length result under the best method rule. Conforming changes have been made in § 1.482–9T(e)(4) *Example 3* of these temporary regulations.

5. Comparable Profits Method for Services—Temp. Treas. Reg. § 1.482–9T(f)

The 2003 proposed regulations provided for a Comparable Profits Method (CPM) for services, which was similar to the CPM in existing § 1.482–5. In general, the CPM for services evaluated whether the amount charged in a controlled services transaction is arm's length by reference to objective measures of profitability (profit level indicators or PLIs) derived from financial information regarding uncontrolled taxpayers that engage in similar services transactions under similar circumstances. The CPM for services applied only where the renderer of controlled services is the tested party.

Section 1.482–9(e) of the 2003 proposed regulations provided that the profit level indicators (PLIs) provided for in existing § 1.482–5(b)(4)(ii) may also be used under the CPM for services. The relative lack of uniformity in financial accounting standards for services, combined with potentially incomplete information regarding the cost accounting practices of the

uncontrolled comparables, strongly suggest that PLIs that require accurate segmentation of costs may have limited reliability.

The 2003 proposed regulations stated that the degree of consistency in accounting practices between the controlled services transaction and the uncontrolled services transaction might affect the reliability of the results under the CPM for services. If appropriate adjustments to account for such differences are not possible, the reliability of the results under this method will be reduced.

Section 1.482–9(e)(2)(ii) of the 2003 proposed regulations provided for a new profit level indicator that may be particularly useful for controlled services transactions: the ratio of operating profits to total services costs, or the markup on total costs (also referred to as the ''net cost plus''). Because this profit level indicator evaluates operating profits by reference to the markup on all costs related to the provision of services, it is more likely to use a cost base of the tested party that is comparable to the cost base used by uncontrolled parties in performing similar business activities.

The Treasury Department and the IRS received a number of comments concerning the CPM for services. Commentators questioned whether the definition of ''total services costs,'' which provides the net cost plus cost base under the CPM for services, included stock-based compensation. In response to these comments, the Treasury Department and the IRS clarify their intent that § 1.482–5(c)(2)(iv) of the existing regulations apply to the CPM for services. Accordingly, new *Example 3*, *Example 4*, *Example 5*, and *Example 6* are included in § 1.482–9T(f)(3) of these temporary regulations. These examples show the application of existing § 1.482–5(c)(2)(iv) to fact patterns that involve differences in the utilization of or accounting for stock-based compensation in the context of controlled services transactions.

One commentator expressed reservations concerning a statement in the preamble to the 2003 proposed regulations, which indicated that PLIs based on return on capital or assets might be unreliable for controlled services because the reliability of these PLIs decreases as operating assets play a less prominent role in generating operating profits. This commentator contended that such PLIs are reliable for all firms, including service providers. The Treasury Department and the IRS clarify that, although return on capital PLIs may produce reliable results in the case of certain service providers, in general, such PLIs are subject to the general reservation in existing § 1.482–5(b)(4)(i) to the effect that the reliability of such PLIs increases as operating assets play a greater role in general operating profits.

Aside from the addition of the examples described above, the CPM for services provisions in these temporary regulations are substantially similar to the provisions in the 2003 proposed regulations.

6. Profit Split Method—Temp. Treas. Reg. §§ 1.482–9T(g) and 1.482–6T(c)(3)(i)(B)

The 2003 proposed regulations provided additional guidance concerning application of the comparable profit split and the residual profit split methods to controlled services transactions. Generally, these methods evaluated 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 contributions to the combined operating profit or loss.

The 2003 proposed regulations provided that the guidance regarding the profit split methods in existing § 1.482–6, as amended by proposed § 1.482–6(c)(3)(i)(B) and by other changes, applied to controlled services transactions. Section 1.482–9(g) of the 2003 proposed regulations also provided specific additional guidance concerning application of existing § 1.482–6, as amended, to controlled services transactions.

The Treasury Department and the IRS received numerous comments on the profit split method. Commentators objected in particular to references in the 2003 proposed regulations to ''interrelated'' transactions in § 1.482–6(c)(3)(i)(B)(*1*), and to ''high-value services'' and ''highly integrated transactions'' in § 1.482–9(g)(1). Commentators viewed these terms as vague and subjective. Commentators also sought more specific guidance concerning the circumstances in which the residual profit split method would constitute the best method under the principles of existing § 1.482–1(c). In addition, some commentators suggested that one hallmark of a nonroutine contribution in the context of controlled services is that the renderer bears substantial risks. Another commentator suggested that the arm's length compensation for a function performed by an employee or group of employees should not in any event be evaluated under a profit split method. In this commentator's view, such an activity should be classified as routine because the market return for the function is equivalent to the total compensation paid to the employees. Commentators also raised several objections to the factual assumptions in the proposed analysis concerning § 1.482–9(g)(2) *Example 2* of the 2003 proposed regulations.

The Treasury Department and the IRS agreed with a number of comments and, as a result, have made substantial changes to these provisions. Under these temporary regulations, all references to ''interrelated'' transactions in § 1.482–6(c)(3)(i)(B)(*1*), as well as references to ''high-value services'' and ''highly integrated transactions'' in § 1.482–9(g)(1) have been eliminated. Section 1.482–9T(g)(1) now states that the profit split method is ''ordinarily used in controlled services transactions involving a combination of nonroutine contributions by multiple controlled taxpayers.'' This change from the 2003 proposed regulations (which referred to ''high-value'' or ''highly-integrated'' transactions), conforms to the changes to § 1.482–6T(c)(3)(i)(B)(*1*), as described below.

Section 1.482–6T(c)(3)(i)(B)(*1*) of these temporary regulations defines a nonroutine contribution as ''a contribution that is not accounted for as a routine contribution.'' In other words, a nonroutine contribution is one for which the return cannot be determined by reference to market benchmarks. Importantly, in this context, the term ''routine'' does not necessarily signify that a contribution is low value. In fact, comparable uncontrolled transactions may indicate that the returns to a routine contribution are very significant.

In response to the comments and in accordance with the revised definition of nonroutine contribution in these temporary regulations, the following references were eliminated as unnecessary: (1) Contributions not fully accounted for by market returns; and (2) contributions so interrelated with other transactions that they cannot be reliably evaluated on a separate basis. These changes will bring added clarity to the temporary regulations.

The Treasury Department and the IRS believe that these revised provisions respond to the public comments and offer more specific guidance concerning the circumstances in which the profit split method would likely constitute the best method under existing § 1.482–1(c). In particular, the term ''high-value'' is not included in temporary § 1.482–9T(g)(1), thus eliminating any implication that the profit split method is a ''default'' method for controlled services that have value significantly in excess of cost. This shift in emphasis is

also reflected in section B.2 of this preamble, which describes the deletion of language from several examples that some believed suggested that the residual profit split is a default method. The clear intent is that no method, including the profit split, is a default method for purposes of the best method rule. Rather, the profit split method applies if a controlled services transaction has one or more material elements for which it is not possible to determine a market-based return. The Treasury Department and the IRS believe that the above changes address the comments made and so do not believe that it is necessary for the regulations to adopt alternative definitions of nonroutine contribution put forward by commentators, such as definitions based on the degree of risk borne by the renderer of services or the extent to which an activity is performed solely by employees of the taxpayer.

Finally, based on the public comments, and in light of the changes described in this preamble, § 1.482–9(g)(2) *Example 2* of the 2003 proposed regulations has been withdrawn and replaced by a new example that more effectively illustrates application of the profit split method to nonroutine contributions by multiple controlled parties.

7. Unspecified Methods—§ 1.482–9T(h)

The 2003 proposed regulations provided that an unspecified method may provide the most reliable measure of an arm's length result under the best method rule. Such an unspecified method must take into account that uncontrolled taxpayers compare the terms of a particular transaction to the realistic alternatives to that transaction.

No significant comments were received concerning the unspecified method provisions. Consistent with the general aim to coordinate the analyses under the various sections of the regulations under section 482 so that economically similar transactions will be evaluated similarly, however, § 1.482–9T(h) has been modified to provide that in applying an unspecified method to services, the realistic alternatives to be considered include ''economically similar transactions structured as other than services transactions.'' This provision allows flexibility to consider non-services alternatives to a services transaction, for example, a transfer or license of intangible property, if such an approach provides the most reliable measure of an arm's length result. The Treasury Department and the IRS are considering similar changes to §§ 1.482–3(e)(1) and 1.482–4(d)(1) of the existing regulations. Public comments are requested regarding the advisability of such changes and the form they should take. Aside from this change, the unspecified method provisions in these temporary regulations are substantially similar to the provisions in the 2003 proposed regulations.

8. Contingent-Payment Contractual Terms—Temp. Treas. Reg. § 1.482–9T(i)

The contingent-payment contractual term provisions in the 2003 proposed regulations built on the fundamental principle that, in structuring controlled transactions, taxpayers are free to choose from among a wide range of risk allocations. This provision in the 2003 proposed regulations also acknowledged that contingent-payment terms—terms requiring compensation to be paid only if specified results are obtained—may be particularly relevant in the context of controlled services transactions. The 2003 proposed regulations provided detailed guidance concerning contingent-payment contractual terms, including economic substance considerations as well as documentation requirements.

Under § 1.482–9(i)(2) of the 2003 proposed regulations, a contingent-payment arrangement was given effect if it met three basic requirements: (1) The arrangement is contained in a written contract executed prior to the start of the activity; (2) the contract makes payment contingent on a future benefit directly related to the outcome of the controlled services transaction; and (3) the contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.

Commentators generally supported the contingent-payment terms provision as providing guidance concerning a contractual structure with particular relevance to controlled services transactions. However, they also raised three fundamental concerns regarding the scope and operation of this provision. First, the commentators questioned whether controlled taxpayers would need to identify uncontrolled comparables for any contingent-payment terms that they seek to adopt. Second, they pointed out that certain references to economic substance provisions and documentation requirements were either unclear or duplicative of provisions in existing § 1.482–1(d)(3). Third, commentators expressed concern that the IRS might improperly impute contingent-payment terms as a means of addressing erroneous transfer pricing in situations that do not involve lack of economic substance, for example, non-arm's length pricing of activities such as marketing or research and development.

The temporary regulations respond to each of these concerns. First, under § 1.482–9(i)(1) of the 2003 proposed regulations, one factor that needed to be considered was whether an uncontrolled taxpayer would have paid a contingent fee if it engaged in a similar transaction under comparable circumstances. In response to comments, the temporary regulations eliminate this requirement and instead emphasize the importance of the economic substance principles under § 1.482–1(d)(3) of the existing regulations. That is, whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference to whether it corresponds to arrangements adopted by uncontrolled parties.

Second, in response to comments, the temporary regulations eliminate duplicative or unnecessary references to the economic substance rules. For example, § 1.482–9T(i)(2)(ii) has been modified to provide that the contingent-payment arrangement as a whole, including both the contingency and the basis of payment, must be consistent with economic substance, as evaluated under existing § 1.482–1(d)(3)(ii)(B). This section eliminates the additional requirement under the 2003 proposed regulations, that the arm's length charge under a contingent-payment arrangement must be evaluated by reference to economic substance principles.

Third, the temporary regulations respond to the concern identified by commentators that the IRS might apply the contingent-payment provisions in an inappropriate manner, for example, to correct erroneous transfer pricing in prior taxable years that are not under examination. As discussed in more detail in section C of this preamble, the temporary regulations include an example to illustrate factual circumstances in which contractual terms pertaining to risk allocations (provided they are otherwise consistent with taxpayers' conduct and arrangements) are fully respected, notwithstanding that on examination the activities were determined to have been priced on a non-arm's length basis. Other concerns, relating to interaction of the contingent-payment terms provision with the commensurate with income standard, are also addressed in section C of this preamble.

New § 1.482–9T(i)(5) *Example 3* illustrates the application of these rules to a situation in which the contingency identified in a contingent-payment

provision is not satisfied. The example responds to a request by commentators for additional guidance to address such a factual scenario.

9. Total Services Costs—Temp. Treas. Reg. § 1.482–9T(j)

Section 1.482–9(j) of the 2003 proposed regulations defined ''total services costs'' for purposes of the SCBM, the CPM for services, and the cost of services plus method where the gross services profit was restated in the form of a markup on total services costs.

Under the 2003 proposed regulations, total services costs included all costs directly identified with provision of the controlled services, as well as all other costs reasonably allocable to such services under § 1.482–9(k). The Treasury Department and the IRS intended that, in this context, ''costs'' must comprise provision for all resources expended, used, or made available to render the service. Generally accepted accounting principles (GAAP) or Federal income tax accounting rules may provide an appropriate analytic platform, but neither would necessarily be conclusive in evaluating whether an item must be included in total services costs. The issue of determining total services costs is not a new one; it is relevant under the current 1968 regulations as well.

Commentators objected that § 1.482–9(j) of the 2003 proposed regulations failed to list the specific items that were included in total services costs. Some commentators suggested that, absent more precise guidance in this regard, controlled taxpayers should be permitted to rely on the definition of costs applicable under GAAP or Federal income tax principles. Commentators also requested clarification whether total services costs included stock-based compensation.

The Treasury Department and the IRS view the definition of total services costs in the 2003 proposed regulations as having struck the correct balance between specificity and flexibility. In general, the accounting standards applicable to services do not provide a uniform means of determining all costs that relate to the provision of services. Consequently, the Treasury Department and the IRS conclude that total services costs for purposes of section 482 cannot be determined solely by reference to GAAP or other accounting standards or practices.

In response to comments, however, § 1.482–9T(j) of the temporary regulations clarifies that all contributions in cash or in kind (including stock-based compensation) are included in total services costs. In addition, the third sentence of § 1.482–9T(j) states that ''costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered.'' To better reflect, for example, the inclusion of stock-based compensation in total services costs, the term ''provision'' is adopted in place of the term ''consideration'' as used in the 2003 proposed regulations.

Commentators also observed that the definition of total services costs in the 2003 proposed regulations did not address situations in which the costs of a controlled service provider include significant charges from uncontrolled parties. Commentators posited that such third-party costs should be permitted to ''pass through,'' rather than being subject to a markup under the transfer pricing method used to analyze the controlled services transaction. The Treasury Department and the IRS agree that these comments raised an issue that needs to be addressed, but decided to do so in a manner different from that suggested by the commentators. In response to this comment, the temporary regulations add § 1.482–9T(l)(4), which under certain circumstances allows a controlled services transaction that involves third-party costs to be evaluated on a disaggregated basis. See section A.11.e of this preamble.

10. Allocation of Costs—Temp. Treas. Reg. § 1.482–9T(k)

Section 1.482–9(k) of the 2003 proposed regulations retained the flexible approach of existing § 1.482–2(b)(3) through (6), which permitted taxpayers to use any reasonable allocation and apportionment of costs in determining an arm's length charge for services. In evaluating whether the allocation used by the taxpayer is appropriate, the 2003 proposed regulations required that consideration be given to all bases and factors, including practices used by the taxpayer to apportion costs for other (non-tax) purposes. Such practices, although relevant, need not be given conclusive weight by the Commissioner in evaluating the arms length charge for controlled services.

Commentators urged that any technique that a taxpayer uses to allocate costs should be entitled to deference, provided it is consistent with GAAP. For the reasons expressed above concerning § 1.482–9T(j), GAAP may provide an appropriate analytic platform but is not necessarily controlling in evaluating the arm's length charge for controlled services.

In the case of administrative or support services, commentators suggested that the Commissioner should accept any reasonable allocation used by the taxpayer, for example, revenue, sales, or employee headcount. In general, the cost of a service that provides benefits to multiple parties must be allocated in a manner that reliably reflects the proportional benefit received by each of those parties. This standard is intended to be substantially equivalent to the standard in § 1.482–2(b)(2)(i) and 1.482–2(b)(6) of the existing regulations. In response to comments, § 1.482–9T(b)(5)(i)(B) of these temporary regulations also provides rules whereby the costs of covered services subject to a shared services arrangement are allocated to participants in a manner that the taxpayer reasonably concludes will most reliably reflect each participant's reasonably anticipated benefits from the services. See section A.1.c of this preamble.

11. Controlled Services Transactions—Temp. Treas. Reg. § 1.482–9T(l)

a. Definition of Activity—Temp. Treas. Reg. § 1.482–9T(l)(2)

Section 1.482–9(l) of the 2003 proposed regulations set forth a threshold test for determining whether an activity constituted a controlled services transaction subject to the general framework of § 1.482–9. The 2003 proposed regulations broadly defined a controlled services transaction as any activity by a controlled taxpayer that resulted in a benefit to one or more other controlled taxpayers. An ''activity'' was in turn defined as the use by the renderer, or the making available to the recipient, of any property or other resources of the renderer.

One commentator interpreted this provision as indicating that any activity properly analyzed under one or more other provisions of the transfer pricing regulations should not be subject to §1.482–9 of the 2003 proposed regulations. Other commentators suggested that the ''predominant character'' of a transaction should control whether it is analyzed as a controlled service under §1.482–9 of the 2003 proposed regulations or under other provisions of the section 482 regulations.

Controlled taxpayers have a great deal of flexibility to structure transactions in various ways that are economically equivalent. In some cases, an overall transaction may include separate elements of differing characters, for example, a transfer of tangible property bundled together with the provision of

a service. The structure adopted may sometimes be more reliably analyzed on either a disaggregated or an aggregated basis under the relevant section of the section 482 regulations, for example, either as a separate transfer of tangible property under the existing section 482 regulations in § 1.482–3 and a separate controlled services transaction under these temporary regulations in § 1.482–9T, or as an overall controlled services transaction under these temporary regulations. To the extent that a controlled transaction is structured so that it is most reliably evaluated as a controlled services transaction, it will be analyzed as such. To the extent that multiple elements of a single overall transaction potentially create an overlap between the section 482 regulations applicable to other types of transactions and these temporary regulations concerning controlled services transactions, the Treasury Department and the IRS believe that the appropriate coordination is achieved by applying the rules in § 1.482–9T(m). See section A.12.a of this preamble.

b. Benefit Test—Temp. Treas. Reg. § 1.482–9T(l)(3)

Section 1.482–9(l)(3) of the 2003 proposed regulations provided rules for determining whether an activity provides a benefit. Under § 1.482–9(l)(3)(i), a benefit is present if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or is reasonably anticipated to do so. Another requirement is that an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or a similar activity, or be willing to perform for itself the same or similar activity. The 2003 proposed regulations thus made significant changes to the benefit test under the existing regulations, which is based on whether an uncontrolled party in the position of the renderer would expect payment for a particular activity. The 2003 proposed regulations adopted the so-called ''specific benefit'' approach, which mandates an arm's length charge only if a particular activity provides an identifiable benefit to a particular taxpayer. In addition, § 1.482–9(l)(3)(ii) of the 2003 proposed regulations provided that no benefit is present if an activity has only indirect or remote effects.

Commentators viewed the 2003 proposed regulations as providing insufficient guidance concerning methods that controlled taxpayers might use to allocate or share expenses or charges, in particular with respect to centralized services performed on a centralized basis for multiple affiliates.

In response to these comments, the temporary regulations authorize the use of shared services arrangements for centralized services that qualify for the SCM in § 1.482–9T(b). By entering into such arrangements, taxpayers can, among other things, reduce the burden associated with analysis of centralized services, which would presumably include activities that provide benefits on only an occasional or intermittent basis. See section A.1.c of this preamble, concerning shared services arrangements.

One commentator suggested that, because the benefit test in the 2003 proposed regulations focused on the recipient, the arm's length charge should also be analyzed from the perspective of the recipient and economic conditions in the recipient's geographic market. The commentator misunderstands the application of the benefit test. Although the benefit test focuses on the recipient, evaluation of the arm's length charge under the best method rule in a particular case (for example, under a profit split method) may require analysis of the recipient, the renderer, or both (depending, for example, on which party performs the simplest, most easily measurable functions).

c. Specific Applications of the Benefit Test—Temp Treas. Reg. § 1.482–9T(l)(3)(ii) through (v)

The 2003 proposed regulations provided additional rules concerning application of the benefit test to particular circumstances, such as application to activities with indirect or remote effects, duplicative activities, shareholder activities, and passive association. These rules in the 2003 proposed regulations were substantially similar to the rules in existing § 1.482–2(b)(2). For example, § 1.482–9(l)(3)(ii) and (l)(3)(iii) provided that no benefit is present if an activity has only indirect or remote effects or merely duplicates an activity that the recipient has already performed on its own behalf. Section 1.482–9(l)(3)(iv) provided that shareholder activities do not confer a benefit on controlled parties and therefore do not give rise to an arm's length charge. Shareholder activities were defined as activities that primarily benefit the owner-member of a controlled group in its capacity as owner, rather than other controlled parties.

In addition, § 1.482–9(l)(3)(v) of the 2003 proposed regulations provided that certain ''passive association'' effects do not give rise to a benefit within the meaning of the regulations concerning controlled services. Passive association was defined as an increment of value that a controlled party obtains on account of its membership in the controlled group. Section 1.482–9(l)(3)(v) of the 2003 proposed regulations provided, however, that membership in a controlled group may be considered in evaluating comparability between controlled and uncontrolled transactions.

Concerning indirect or remote effects, one commentator suggested that if a centralized activity by a parent confers only occasional or intermittent benefits on a subsidiary, such benefits should be classified as indirect or remote. As to the shareholder provisions, commentators noted that the 2003 proposed regulations failed to address the potential that an activity that confers a reasonably identifiable increment of value on a controlled party might also be appropriately classified as a shareholder activity. As to the passive association provisions, commentators questioned whether membership in a controlled group is relevant to evaluation of comparability. Commentators raised the concern that virtually any uncontrolled transaction could potentially be considered unreliable, because it generally would not reflect the same efficiencies and synergies as the controlled services transaction.

Regarding the comments concerning indirect or remote effects, the Treasury Department and the IRS believe that to equate occasional or intermittent benefits in all cases with indirect or remote effects would conflict with the specific-benefit rule. That rule requires that any service that produces an identifiable and direct benefit warrants an arm's length charge, even if the service is provided only occasionally or intermittently. Accordingly, the temporary regulations retain this provision without change.

In response to comments relating to shareholder activities, § 1.482–9T(l)(3)(iv) of the temporary regulations refers to the ''sole effect'' rather than the ''primary effect'' of an activity. This change clarifies that a shareholder activity is one of which the sole effect is either to protect the renderer's capital investment in one or more members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements specifically applicable to the renderer, or both. As modified, the definition in temporary § 1.482–9T(l)(3)(iv) now conforms to the general

definition of benefit in § 1.482–9T(l)(3)(i).

In response to commentators' request for clarification regarding the passive association rules, new § 1.482–9T(l)(5) *Example 19* illustrates a situation in which group membership would be taken into account in evaluating comparability.

The Treasury Department and the IRS have inserted the word ''generally'' in the description of duplicative activities in § 1.482–9T(l)(3)(iii). This change clarifies that although a duplicative activity does not generally give rise to a benefit, under certain circumstances, such an activity may provide an increment of value to the recipient by reference to the general rule in § 1.482–9T(l)(3)(i). In such cases, the activity would be appropriately classified as a controlled services transaction.

d. Guarantees, Including Financial Guarantees

The proposed regulations appear to have created confusion on the part of some taxpayers regarding the appropriate characterization of financial guarantees for tax purposes. The provision of a financial guarantee does not constitute a service for purposes of determining the source of the guarantee fees. See *Centel Communications, Inc.* v. *Commissioner*, 920 F.2d 1335 (7th Cir. 1990); *Bank of America* v. *United States,* 680 F.2d 142 (Ct. Cl. 1980). Nevertheless, some taxpayers have suggested that guarantees are services that could qualify for the cost safe harbor and that the provision of a guarantee has no cost. This position would mean that in effect guarantees are uniformly non-compensatory. The Treasury Department and the IRS do not agree with this uniform no charge rule for guarantees. As a result, financial transactions, including guarantees, are explicitly excluded from eligibility for the SCM by § 1.482–9T(b)(3)(ii)(H). However, no inference is intended by this exclusion that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes. The Treasury Department and the IRS subsequently intend to issue transfer pricing guidance regarding financial guarantees, in particular, along with other guidance concerning the treatment of global dealing operations. See Section A.12.e of this preamble for a discussion of coordination with global dealing operations. Such guidance will also include rules to determine the source of income from financial guarantees.

e. Third-Party Costs—Temp. Treas. Reg. § 1.482–9T(l)(4)

Commentators observed that the definition of ''total services costs'' in § 1.482–9(j) of the 2003 proposed regulations did not address situations in which the costs of a controlled service provider included significant charges from uncontrolled parties. Commentators claimed that such third-party costs should be treated as ''pass through'' items that, in most cases, should not be subject to the markup (if any) applicable to costs incurred by the renderer in its capacity as service provider. This comment was potentially relevant to all cost-based methods in § 1.482–9 of the 2003 proposed regulations. The Treasury Department and the IRS agreed that these comments raised an issue that needed to be addressed, but decided to do so in a manner different from that suggested by the commentators.

In response to this comment, these temporary regulations include a new § 1.482–9T(l)(4). Under this provision, if total services costs include material third-party costs, the controlled services transaction may be analyzed either as a single transaction or as two separate transactions, depending on which approach provides the most reliable measure of the arm's length result under the best method rule in existing § 1.482–1(c). Consistent with the best method rule, in determining which approach provides the most reliable indication of the arm's length result, the primary factors are the degree of comparability between the controlled services transaction and the uncontrolled comparables and the quality of the data and assumptions used. New § 1.482–9T(l)(5) *Example 20* and *Example 21* provide illustrations of this rule.

The rule in § 1.482–9T(l)(4) of the temporary regulations applies to all specified methods that use cost to evaluate the arm's length charge for controlled services, including the SCM in § 1.482–9T(b). A determination that a controlled services transaction is more reliably evaluated on a disaggregated basis may have an effect on the analysis of that transaction under other provisions of these regulations.

f. Examples, Temp. Treas. Reg. § 1.482–9T(l)(5)

Section 1.482–9T(l)(5) of the temporary regulations provides numerous examples that illustrate applications of the rules in § 1.482–9T(l). Changes have been made to certain of these examples to conform to the modifications described under the previous headings in this section.

12. Coordination With Other Transfer Pricing Rules—Temp. Treas. Reg. § 1.482–9T(m)

Section 1.482–9(m) of the 2003 proposed regulations provided coordination rules applicable to a controlled services transaction that is combined with, or includes elements of, a non-services transaction. These coordination rules relied on the best method rule in existing § 1.482–1(c)(1) to determine which method or methods would provide the most reliable measure of an arm's length result for a particular controlled transaction.

a. Services Transactions That Include Other Types of Transactions—Temp. Treas. Reg. § 1.482–9T(m)(1)

A transaction structured as a controlled services transaction may include material elements that do not constitute controlled services. Section 1.482–9(m)(1) of the 2003 proposed regulations provided that, the decision whether to evaluate such a transaction in an integrated manner under the transfer pricing methods in § 1.482–9 or to evaluate one or more elements separately under services and non-services methods depends on which of these approaches would provide the most reliable measure of an arm's length result. If the non-services component(s) of an integrated transaction could be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables, then the transaction could generally be evaluated solely as a controlled service under § 1.482–9.

One commentator criticized this coordination rule as inherently subjective and proposed that a ''predominant character'' test be adopted instead. Another commentator interpreted certain statements in the preamble as indicating that any controlled transaction that was reliably analyzed under one of the transfer pricing methods applicable to tangible or intangible property would necessarily be outside the scope of the regulations regarding controlled services.

Upon further consideration, the Treasury Department and the IRS believe that no changes are necessary to the coordination rule in § 1.482–9T(m)(1) because these commentators have misconstrued the application of this rule to integrated transactions. The coordination rule in § 1.482–9T(m)(1) focuses on the underlying economics of such transactions and the most reliable means of evaluating those economics under the best method rule. The Treasury Department and the IRS recognize that controlled taxpayers have

substantial flexibility to structure transactions in a variety of economically equivalent ways. Provided that the structure adopted has economic substance, the coordination rule is designed to respect that structure and to seek the most reliable means of evaluating the arm's length price. Consequently, if a taxpayer structures a transaction so that it constitutes a controlled service, the transaction will generally be analyzed under the principles of § 1.482–9T, without regard to other provisions of the section 482 regulations.

b. Services Transactions That Effect a Transfer of Intangible Property—Temp. Treas. Reg. § 1.482–9T(m)(2)

Section 1.482–9(m)(2) of the 2003 proposed regulations provided that a transaction structured as a controlled service may result in the transfer of intangible property, may include an element that constitutes the transfer of intangible property, or may have an effect similar to the transfer of intangible property. In such cases, if the element of the transaction that related to intangible property was material, the arm's length result for that element would be determined or corroborated under a method provided for in the regulations applicable to transfers of intangible property. See existing § 1.482–4.

Commentators viewed this rule as potentially authorizing the Commissioner to recharacterize a controlled services transaction as a transaction that involved a transfer of intangible property. Such authority, commentators claimed, was inconsistent with existing § 1.482–4(b), which defines an intangible as an item that has ''substantial value independent of the services of any individual.'' Commentators also contended that the coordination rules impermissibly extended the commensurate with income standard to controlled services transactions. Commentators suggested that, assuming each component of a controlled services transaction may be reliably accounted for under a specified transfer pricing method, no additional analysis is necessary concerning elements that arguably pertain to intangible property.

The Treasury Department and the IRS agree with the commentators that the phrase ''may have an effect similar to the transfer of intangible property'' could be interpreted as improperly expanding § 1.482–4 of the existing regulations to non-intangible transactions. This is not the intent of this provision. Consequently, to make this clear, the temporary regulations omit this phrase.

Other concerns raised by commentators misinterpret the interaction between this coordination rule and the definition of intangibles in § 1.482–4(b). Section 1.482–4(b) of the existing regulations contains a list of specified intangibles and a residual category of other similar items, all of which must have ''substantial value independent of the services of any individual.'' In contrast, the coordination rule in § 1.482–9T(m)(2) applies after it is determined that an integrated transaction includes an intangible component that is material. Because the coordination rule in § 1.482–9T(m)(2) applies only to transactions that incorporate a material intangible component, it is not inconsistent with existing § 1.482–4(b), nor does it apply the commensurate with income standard of existing § 1.482–4(f)(2) to transactions that do not have a material element that constitutes an intangible transfer.

Section 1.482–9(m)(6) *Example 4* of the 2003 proposed regulations illustrated the application of this rule to a controlled services transaction that included an element constituting the transfer of an intangible. Several commentators questioned the factual assumptions in *Example 4*. Commentators contended that a controlled party performing R&D for another controlled party generally would not have rights in any know-how or technical data arising out of the R&D activity; instead the contract would specify that the party that paid for the research would obtain such rights.

The Treasury Department and the IRS agree with these comments and have concluded that the factual assumptions in this example are unclear. Consequently, *Example 4* has been redrafted to illustrate a situation in which the controlled party performing the R&D is the owner of know-how or technical data that resulted from that R&D activity. The controlled party then transfers its rights to another controlled party. As revised, this example more clearly illustrates application of the rule in § 1.482–9T(m)(2).

c. Services Subject to a Qualified Cost Sharing Arrangement—Temp. Treas. Reg. § 1.482–9T(m)(3)

Section 1.482–9(m)(3) of the 2003 proposed regulations provided that services provided by a controlled participant under a qualified cost sharing arrangement are subject to existing § 1.482–7. The Treasury Department and the IRS are in the process of comprehensively revising the regulations applicable to cost sharing. In the interim, and pending issuance of final regulations that coordinate these two provisions, the rule § 1.482–9T(m)(3) retains this coordination rule.

d. Other Types of Transaction That Include a Services Transaction—Temp. Treas. Reg. § 1.482–9T(m)(4)

Section 1.482–9T(m)(4) is adopted in substantially the same form as in the 2003 proposed regulations. A transaction structured other than as a controlled services transaction may include material elements that constitute controlled services. Section 1.482–9T(m)(4) of these temporary regulations provides rules for evaluating such integrated transactions. As with the corresponding rules in the 2003 proposed regulations, these rules complement the more general rule in § 1.482–9(m)(1), which relates to integrated transactions structured as controlled services transactions.

e. Global Dealing Operations

In § 1.482–9(m)(5) of the 2003 proposed regulations, the section for coordination with the global dealing regulations was ''reserved.'' In response to comments, this provision is omitted in these temporary regulations, based on the view that reserved treatment is not appropriate. The Treasury Department and the IRS are presently working on new global dealing regulations. The intent of the Treasury Department and the IRS is that when final regulations are issued, those regulations, not § 1.482–9T, will govern the evaluation of the activities performed by a global dealing operation within the scope of those regulations. Pending finalization of the global dealing regulations, taxpayers may rely on the proposed global dealing regulations, not the temporary services regulations, to govern financial transactions entered into in connection with a global dealing operation as defined in proposed § 1.482–8. Therefore, proposed regulations under § 1.482–9(m)(5) issued elsewhere in the **Federal Register** clarify that a controlled services transaction does not include a financial transaction entered into in connection with a global dealing operation.

B. Income Attributable to Intangibles—Temp. Treas. Reg. § 1.482–4T(f)(3) and (4)

The 2003 proposed regulations substantially replaced § 1.482–4(f)(3) of the existing regulations, which dealt with issues relating to the allocation of income from intangibles. The 2003 proposed regulations adopted new § 1.482–4(f)(3) and (f)(4), which

provided modified rules for determining the owner of an intangible for purposes of section 482 and also provided rules for determining the arm's length compensation in situations where a controlled party other than the owner makes contributions to the value of an intangible.

1. Ownership of Intangible Property—Temp. Treas. Reg. § 1.482–4T(f)(3)

Section 1.482–4(f)(3)(i)(A) of the 2003 proposed regulations contained modified rules for determining the owner of intangible property for purposes of section 482. In general, under these rules, the controlled party that was identified as the owner of a legally protected intangible under the intellectual property laws of the relevant jurisdiction or other legal provision was treated as the owner of that intangible for purposes of section 482.

The 2003 proposed regulations also clarified that a license or other right to use an intangible may constitute an item of intangible property for purposes of section 482. This provision, which contemplated the identification of a single owner for each discrete set of rights that constitutes an intangible, replaced provisions in the existing regulations that could be interpreted as providing for multiple owners of an intangible. See Proposed § 1.482–4(f)(3)(i) and (f)(3)(iv), *Example 4.*

The 2003 proposed regulations also adopted a provision that parallels the requirement in the existing regulations, to the effect that ownership for purposes of section 482 must be consistent with the economic substance of the controlled transaction. Intellectual property law generally places relatively few limitations on the ability of members of a controlled group to assign or transfer legal ownership among themselves. As a result, this rule is a safeguard against purely formal assignments of ownership that, if given effect for purposes of section 482, could produce results that are inconsistent with the arm's length standard.

Under § 1.482–4(f)(3)(i)(A) of the 2003 proposed regulations, in situations where it was not possible to identify the owner of an intangible under the intellectual property law of the relevant jurisdiction, contractual term, or other legal provision, the controlled taxpayer with practical control over the intangible would be treated as the owner for purposes of section 482. This provision replaced the so-called ''developer-assister'' rule in existing § 1.482–4(f)(3)(ii)(B). In the case of non-legally protected intangibles, the developer-assister rule assigned ownership of an intangible to the controlled taxpayer that bore the largest portion of the costs of development.

The 2003 proposed regulations did not adopt the developer-assister rule, so they also eliminated related provisions pertaining to assistance to the owner of intangible property. In place of those rules, the 2003 proposed regulations contained new provisions relating to contributions to the value of intangible property owned by another controlled party. See Proposed § 1.482–4(f)(4)(i). These rules are discussed in greater detail in section B.2 of this preamble.

Section 1.482–4(f)(3)(i)(B) of the 2003 proposed regulations excluded certain intangibles that are subject to the cost sharing provisions of § 1.482–7. The Treasury Department and the IRS are currently revising the existing regulations related to cost sharing. When final cost sharing regulations are issued, § 1.482–4(f)(3) and (4) will take into account the changes made to the cost sharing provisions.

Extensive comments were received concerning the revised approach to determining ownership of intangibles under section 482. To varying degrees, many commentators supported the new ownership standard, noting that it should be easier to apply and should produce more certainty of results in this area. Other commentators, however, took issue with the proposed rules. Some of these commentators took the position that legal ownership does not provide an appropriate basis for determining ownership under section 482, while others believed that the determination of ownership under section 482 should include a full-scale application of substantive intellectual property law, including relevant statutory provisions as well as judicial doctrines and common law principles that may bear on the issue of ownership.

After considering the public comments, the Treasury Department and the IRS conclude that legal ownership provides the appropriate framework for determining ownership of intangibles under section 482. In this specific context, the Treasury Department and the IRS intend that the ''legal owner'' under these rules will be the controlled party that possesses title to the intangible, based on consideration of the facts and circumstances. This analysis would take into account applications filed with a central government registry (such as the U.S. Patent and Trademark Office or the Copyright Office in the United States), any contractual provisions in effect between the controlled parties, and other legal provisions. Legal ownership, understood in this manner, provides a practical and administrable framework for determining ownership of intangibles for purposes of section 482.

The suggestions that the ownership rules under section 482 should in effect incorporate by reference the substantive intellectual property rules have not been adopted. In the view of the Treasury Department and the IRS, it would be counterproductive to require an in-depth application of intellectual property law in determining which controlled party is treated as the owner under section 482. The primary function of intellectual property law is to define the rights of a legal entity, which in some cases might be a controlled group, as compared with one or more uncontrolled parties that have competing claims to the same item of intangible property. For this reason, application of the substantive provisions of intellectual property law would not be useful, and might in fact produce inappropriate results, given that under section 482 the relevant determination is which of several controlled parties should be classified as the owner of an intangible.

The Treasury Department and the IRS anticipate that ownership of an intangible as determined under the legal owner standard will not conflict with the simultaneous requirement that ownership under section 482 be determined in accordance with the economic substance. For example, if the economic substance of the controlled parties' dealings conflicts with treatment of the legal owner as the owner under section 482, the Commissioner may determine ownership by reference to the economic substance of the transaction. In other cases, ownership for purposes of section 482 should be consistent with the ownership determined by reference to either legal ownership or practical control.

The Treasury Department and the IRS also believe that the 2003 proposed regulations properly adopted a practical control standard for ''non-legally protected'' intangibles. The control standard should not displace valid contractual terms intended to specify that a particular controlled party is the owner of an existing intangible or an intangible under development. Because a contractual term constitutes a ''legal provision,'' the intangible would be analyzed as a legally protected intangible, as opposed to a non-legally protected intangible subject to the practical control rule.

Commentators suggested that certain statements in the 2003 proposed regulations incorrectly equated a licensee of intangible property with a

distributor of tangible property. In response to these comments, the Treasury Department and the IRS have revised the examples in § 1.482–4T(f)(4)(ii) to avoid any implication that these regulations equate or distinguish these business relationships.

2. Contributions to the Value of an Intangible—Temp. Treas. Reg. § 1.482–4T(f)(4)

Under § 1.482–4(f)(4)(i) of the 2003 proposed regulations, the rules of section 482 were applied to determine the arm's length compensation for any activity that was reasonably anticipated to increase the value of an intangible owned by another controlled party. Such an activity was defined as a ''contribution'' under this provision. This provision replaced certain rules in the existing regulations that required arm's length compensation to be provided for any assistance by a controlled party to the owner of the intangible.

This new guidance concerning contributions to the value of an intangible was intended to provide a more refined framework than the rules in existing § 1.482–4(f)(3), in particular by reducing the potential for inappropriate, all-or-nothing results. Moreover, because the revised rules afforded heightened deference to contractual arrangements, they were intended to give controlled taxpayers incentives to document transactions on a contemporaneous basis and to adhere to the contractual terms agreed upon at the outset of the arrangement.

Section 1.482–4(f)(4)(i) of the 2003 proposed regulations provided that compensation for a contribution may be embedded within the terms of another transaction, may be stated separately as a fee for services, or may be provided for as a reduction in the royalty or the transfer price of tangible property. The regulations also recognized that if a controlled party's activities are reasonably anticipated to enhance only the value of its own rights under a license or exclusive distribution arrangement, no compensation is due under the arm's length standard. The rules addressed the most commonly encountered factual scenarios that potentially give rise to contributions on the part of a controlled party.

Section 1.482–4(f)(4)(i) of the 2003 proposed regulations provided that in general a separate allocation is not appropriate if the compensation for a contribution was embedded within the terms of a related controlled transaction. In such cases, the contribution is taken into account in evaluating the comparability of the controlled transaction to the uncontrolled comparables and in determining the arm's length consideration for the controlled transaction that includes the embedded contribution.

This rule potentially interacted with § 1.482–3(f) of the existing regulations, concerning transfers of tangible property together with an embedded intangible. For example, assume that a reseller of trademarked goods performs activities that are classified as contributions within the meaning of § 1.482–4(f)(4). If no separate compensation for these activities is provided for by a contractual term, then ordinarily no allocation would be appropriate either for the embedded trademark or for the underlying activities. Both elements would, however, be taken into account in evaluating the comparability of the controlled transfer to the uncontrolled comparables and in determining the arm's length consideration for the controlled transfer of the trademarked goods. See § 1.482–4T(f)(4)(ii) *Example 2.*

Commentators objected to certain aspects of *Example 2, Example 3, Example 5,* and *Example 6* in § 1.482–4(f)(4)(ii) of the 2003 proposed regulations. Those examples stated that, if it is not possible to identify uncontrolled transactions that incorporated a similar range of interrelated elements as the nonroutine contributions by the controlled parties, it may be appropriate to apply a residual profit split analysis. In the opinion of commentators, these statements implied that profit split methods were preferred methods in any case that involved a contribution to the value of an intangible.

The Treasury Department and the IRS agree with these comments. There was no intention to imply any such treatment of the residual profit split method. As a result, these statements in the examples have been eliminated. In addition, the examples in the temporary regulations specifically refer to the best method rule and cross-reference new *Example 10, Example 11,* and *Example 12* in § 1.482–8, which show application of the best method rule to intangible development activities. See also section A.6 of this preamble, concerning definition of nonroutine contribution for purposes of the profit split methods.

In addition, and in response to comments, a new *Example 5* in § 1.482–1T(d)(3)(ii)(C) illustrates factual circumstances in which contractual terms pertaining to intangible development activities are respected, although on examination the activities are found to be priced on a non-arm's length basis. Together, these changes clarify that, subject to the best method rule and satisfaction of economic substance requirements, controlled parties may adopt contractual terms that provide for marketing, research and development, or other intangible development activities to be compensated based on reimbursement of specified costs plus a profit element. The underlying contractual compensation terms will be given effect for purposes of section 482 as long as they have economic substance.

Commentators sought clarification regarding the term ''incremental marketing activities,'' which was used in several examples in § 1.482–4(f)(4)(ii) of the 2003 proposed regulations.

In the examples, the term ''incremental marketing activities'' referred to activities by a controlled party that are quantitatively greater (in terms of volume, expense, etc.) than the activities undertaken by comparable uncontrolled parties in the transactions used to analyze the controlled transaction. Such activities must be taken into account by either evaluating a separate transaction that accounts for such incremental activities or analyzing the underlying transaction and making necessary adjustments to the uncontrolled transactions to incorporate such activities into the comparability analysis. Discrete changes were made to the examples to clarify these principles. As a result, apart from this additional clarification, these comments are not adopted.

Commentators proposed that the Treasury Department and the IRS adopt discounted cash-flow analysis (DCF) as a specified method for analysis of contributions. The Treasury Department and the IRS find it unnecessary to do so because they already recognize DCF as one of several approaches that may be reliably applied to evaluate intangible property. This method may be particularly useful, either as an unspecified method or in conjunction with one of the specified methods, in evaluating contributions within the meaning of § 1.482–4T(f)(4)(i). Further consideration is being given to the suggestion to adopt DCF as a specified method in its own right.

C. Contractual Terms Imputed From Economic Substance—§ 1.482–1(d)(3)(ii)(C), Examples 3, 4, 5, and 6

Central to the approach taken in the 2003 proposed regulations were the concepts that controlled taxpayers have substantial freedom to adopt contractual terms, and that such contractual terms are given effect under section 482, provided they are in accord with the economic substance of the controlled

parties' dealings. An important corollary of these principles, however, applies where controlled parties fail to specify contractual terms, or specify terms that are not consistent with economic substance. In such cases, the Commissioner may impute contractual terms to accord with the economic substance of the controlled parties' activities. See § 1.482–1(d)(3) of the existing regulations.

Commentators raised several concerns regarding the potential interaction between the economic substance rules in existing § 1.482–1(d)(3) and certain provisions in the 2003 proposed regulations, including those relating to contributions to the value of intangibles and contingent-payment contractual terms. Some commentators suggested that application of these provisions together with the existing economic substance rules could create incentives for the Commissioner to make inappropriate adjustments, e.g., to impute contingent-payment terms or transfers of intangibles in any situation in which non-arm's length pricing was identified.

It bears emphasis that the Commissioner may invoke his authority under § 1.482–1(d)(3)(ii) in only two situations: (1) Controlled taxpayers fail to specify contractual terms for the transaction; or (2) controlled taxpayers specify contractual terms that are not in accordance with economic substance. Clearly, if contributions within the meaning of § 1.482–4T(f)(4)(i) are present, the contractual terms of the controlled transaction should address those contributions in a manner that accords with economic substance. If this is not the case, the Commissioner must impute an arrangement that best conforms to the economic substance of the transaction. In given facts and circumstances, it may be possible to rely on evidence that the taxpayer brings forward. In other circumstances, the Commissioner will impute an arrangement based on economic substance, taking into account the facts and circumstances, the parties' conduct, and other relevant evidence, including any that the taxpayer brings forward on examination. See *Example 3*, *Example 4*, and *Example 6* in § 1.482–1T(d)(3)(ii)(C).

In response to comments, § 1.482–1T(d)(3)(ii)(C) includes a new *Example 5*, which illustrates the interaction of the economic substance rule with general transfer pricing rules in the context of intangible development activities. In the example, the contractual terms specify that intangible development activities are priced by reference to reimbursement of specified costs plus a markup or profit component. On examination, the Commissioner determines that the specified compensation falls outside the arm's length range, as determined by comparison to uncontrolled transactions. The example illustrates that this determination, without more, does not support a conclusion that the contractual terms lacked economic substance. If, however, the compensation paid is outside the arm's length range by a substantial amount, the Commissioner may take that fact into account in determining whether the contractual arrangement as a whole possessed economic substance.

The examples in § 1.482–1(d)(3)(ii)(C) of the 2003 proposed regulations described alternative constructions that the Commissioner might adopt if the contractual terms for the controlled transaction were not in accordance with economic substance: These alternatives included: (1) Imputation of a separate services arrangement, with contingent-payment terms; (2) imputation of a long-term, exclusive distribution arrangement; or (3) requiring compensation for termination of an imputed long-term license arrangement. The Treasury Department and the IRS believe that one or more of these arrangements may be appropriate, depending on the facts of the specific case.

Commentators expressed concerns regarding the scope of the Commissioner's authority to impute arrangements based on economic substance. Some commentators suggested that a single set of contractual terms should apply in any situation where the Commissioner determines that the controlled parties' contractual terms lack economic substance. Another commentator recommended that the Commissioner should impute only contractual terms similar to those observed in comparable uncontrolled transactions. After much consideration, the Treasury Department and the IRS have not adopted these comments. The determination of the economic substance of a transaction between related parties necessarily turns on an examination of all the facts and circumstances. Under the regulations, the taxpayer is in control of this issue in the first instance to the extent it expressly sets forth the economic substance in contractual terms and its conduct and arrangements are consistent with these terms. Otherwise, the IRS is forced to try and impute the economic substance based on whatever facts and circumstances are available, including any information the taxpayer brings forward on examination.

Commentators also suggested that under the 2003 proposed regulations, the Commissioner's authority to impute contingent-payment contractual terms was unnecessarily broad. In the commentators' view, this authority would lead the Commissioner to apply commensurate with income principles to controlled transactions that have no significant intangible property component. The Commissioner's authority to impute contingent-payment contractual terms was appropriately tailored to result in application of economic substance principles in those situations where it was warranted. The Treasury Department and the IRS believe that the commensurate with income principle of the statute is consistent with the arm's length principle and fundamentally relates to the underlying economic substance and true risk allocations inherent in the relevant controlled transactions. Related parties may, with economic substance, agree to compensate one another for services with compensation payable only in future periods contingent on the success or failure of the services to produce the contemplated results. Related parties may expressly enter into those contractual terms and, in the absence of express terms or where the related parties' conduct and arrangements are inconsistent with their contractual terms, the IRS may in appropriate facts and circumstances impute contingent-payment contractual terms.

D. Stewardship Expenses—§ 1.861–8T

The temporary regulations would modify the present regulations under § 1.861–8(e)(4) to conform to, and to be consistent with, the revised language relating to controlled services transactions as set forth in § 1.482–9T(l).

E. Effective Date—§ 1.482–9T(n)

In order to achieve the goal of updating the 1968 regulations, while facilitating consideration of further public input in refining final rules, these regulations are issued in temporary form with a delayed effective date for taxable years beginning after December 31, 2006. Controlled taxpayers may also elect to apply these temporary regulations to any taxable year beginning after September 10, 2003, the date of publication of the 2003 proposed regulations. Where such an election is made, the temporary regulations will apply in full to such taxable year and all subsequent taxable years of the taxpayer making the election. Such an election must be made by attaching a statement to the taxpayer's timely filed U.S. tax return

(including extensions) for its first taxable year after December 31, 2006.

These regulations are issued after proposed revisions to the regulations pertaining to cost sharing arrangements. By issuing regulations in temporary and proposed form concerning controlled services and the allocation of income from intangibles, the Treasury Department and the IRS also provide taxpayers an opportunity to submit comments that take into account the potential interaction between these two sets of regulations.

The initial list of specified covered services for purposes of the SCM is being issued for public input in the form of an Announcement in tandem with these temporary regulations. This Announcement will be published in the Internal Revenue Bulletin. For copies of the Internal Revenue Bulletin, see § 601.601(d)(2)(ii)(b). The Treasury Department and the IRS intend to take all public comments into account and issue a final revenue procedure that will be effective coincident with the delayed effective date of these temporary regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Thomas A. Vidano and Carol B. Tan, Office of Associate Chief Counsel (International) for matters relating to section 482, and David Bergkuist, Office of Associate Chief Counsel (International) for matters relating to stewardship.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social Security and Unemployment compensation.

Amendment to the Regulations

■ Accordingly, 26 CFR parts 1 and 31 are amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.482–9 also issued under 26 U.S.C. 482. * * *

■ **Par. 2.** Section 1.482–0 is amended as follows:

■ 1. The section heading is revised.

■ 2. The entries for 1.482–1(a)(1), (b)(2)(i), (d)(3)(ii)(C), (d)(3)(v), (f)(2)(ii)(A), (f)(2)(ii)(B), (g)(4)(iii), (i) and (j) are revised.

■ 3. The entries for § 1.482–2(b) are revised.

■ 4. The entries for § 1.482–4(f)(3), (f)(4) and (f)(5) are revised and new entries for § 1.482–4(f)(6) and (f)(7) are added.

■ 5. The entries for 1.482–6(c)(2)(ii)(B)(*1*), (c)(2)(ii)(D), (c)(3)(i)(A), (c)(3)(i)(B) and (c)(3)(ii)(D) are revised and the entry for 1.482–6(d) is added.

■ 6. The entry for 1.482–8(a) is revised.

■ 7. The entries for 1.482–9 are added.

The additions and revisions read as follows:

§ 1.482–0 Outline of regulations under section 482.

* * * * *

§ 1.482–1 Allocation of income and deductions among taxpayers.

(a)(1) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(a)(1).

* * * * *

(b) * * *

(2) * * *

(i) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(b)(2)(i).

* * * * *

(d) * * *

(3) * * *

(ii) * * *

(C) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(d)(3)(ii)(C).

(v) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(d)(3)(v).

* * * * *

(f) * * *

(2) * * *

(ii) * * *

(A) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(f)(2)(ii)(A).

(iii) * * *

(B) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(f)(2)(iii)(B).

* * * * *

(g) * * *

(4) * * *

(iii) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(g)(4)(iii).

* * * * *

(i) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(i).

* * * * *

(j) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–1T(j).

§ 1.482–2 Determination of taxable income in specific situations.

* * * * *

(b) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–2T(b).

* * * * *

§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

* * * * *

(f) * * *

(3) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–4T(f)(3).

(4) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–4T(f)(4).

(5) Consideration not artificially limited.

(6) Lump sum payments

(i) In general.

(ii) Exceptions.

(iii) Example.

(7) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–4T(f)(7).

§ 1.482–6 Profit split method.

* * * * *

(c) * * *

(2) * * *

(ii) * * *

(B) * * *

(*1*) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(c)(2)(ii)(B)(*1*).

* * * * *

(D) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(c)(2)(ii)(D).

(3) * * *

(i) * * *

(A) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(c)(3)(i)(A).

(B) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(c)(3)(i)(B).

(ii) * * *

(D) [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(c)(3)(ii)(D).

* * * * *

(d) Effective date. [Reserved]. For further guidance, see § 1.482–0T, the entry for § 1.482–6T(d).

§ 1.482–8 Examples of the best method rule.

(a) Introduction.

* * * * *

§ 1.482–9 Methods to determine taxable income in connection with a controlled services transaction. [Reserved].

For further guidance, see § 1.482–0T, the entries for § 1.482–9T.

■ **Par. 3.** Section 1.482–0T is added to read as follows:

§ 1.482–0T Outline of regulations under section 482.

This section contains major captions for §§ 1.482–1T, 1.482–2T, 1.482–4T, 1.482–6T, 1.482–8T, and § 1.482–9T.

§ 1.482–1T Allocation of income and deductions among taxpayers.

(a) In general.
(1) Purpose and scope.
(2) through (b)(1) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(a)(2) through (b)(1).
(b)(2) Arm's length methods.
(i) Methods.
(b)(2)(ii) through (d)(3)(ii)(B) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(b)(2)(ii) through (c)(3)(ii)(B).
(C) Examples.
(d)(3)(iii) and (iv) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(d)(3)(iii) and (iv).
(v) Property or services.
(d)(4) through (f)(2)(i) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(d)(4) through (f)(2)(i).
(ii) Allocation based on taxpayer's actual transactions.
(A) In general.
(f)(2)(ii)(B) through (f)(2)(iii)(A) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(f)(2)(ii)(B) through (f)(2)(iii)(A).
(B) Circumstances warranting consideration of multiple year data.
(f)(2)(iii)(C) through (g)(3) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(f)(2)(iii)(C) through (g)(3).
(4) Setoffs.
(i) In general.
(g)(4)(ii) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(g)(4)(ii).
(iii) Examples.
(g)(4)(iii) Example 2 through (h) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(g)(4)(iii) Example 2 through (h).
(i) Definitions.
(i)(1) through (10) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–1(i)(1) through (10).
(j) Effective date.
(1) In general.
(2) Election to apply regulation to earlier years.
(3) Expiration date.

§ 1.482–2T Determination of taxable income in specific situations.

(a) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–2(a).
(b) Rendering of services.
(c) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–2(c).
(d) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–2(d).
(e) Effective date.
(1) In general.
(2) Election to apply regulation to earlier years.
(3) Expiration date.

§ 1.482–4T Methods to determine taxable income in connection with a transfer of intangible property.

(a) through (f)(2) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–4(a) through (f)(2).
(3) Ownership of intangible property.
(i) Identification of owner.
(A) In general.
(B) Cost sharing arrangements.
(ii) Examples.
(4) Contribution to the value of an intangible owned by another.
(i) In general.
(ii) Examples.
(f)(5) and (f)(6) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–4(f)(5) and (f)(6).
(7) Effective date.
(i) In general.
(ii) Election to apply regulation to earlier years.
(iii) Expiration date.

§ 1.482–6T Profit split method.

(a) through (c)(2)(ii)(A) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–6(a) through (c)(2)(ii)(A).
(B) Comparability.
(*1*) In general.
(c)(2)(ii)(B)(*2*) through (C) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–6(c)(2)(ii)(B)(*2*) through (C).
(D) Other factors affecting reliability.
(c)(3)(i) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–6(c)(3)(i).
(A) Allocate income to routine contributions.
(B) Allocate residual profit.
(*1*) Nonroutine contributions generally.
(*2*) Nonroutine contributions of intangible property.
(c)(3)(ii)(A) through (C) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–6(c)(3)(ii)(A) through (C).
(D) Other factors affecting reliability.
(c)(3)(iii) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–6(c)(3)(iii).
(d) Effective date.
(1) In general.
(2) Election to apply regulation to earlier taxable years.
(3) Expiration date.

§ 1.482–8T Examples of the best method rule.

(a) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–8(a).
(b) [Reserved]. For further guidance, see § 1.482–0, the entry for § 1.482–8(b)
(c) Effective date.
(1) In general.
(2) Election to apply regulation to earlier taxable years.
(3) Expiration date.

§ 1.482–9T Methods to determine taxable income in connection with a controlled services transaction.

(a) In general.
(b) Services cost method
(1) In general.
(2) Not services that contribute significantly to fundamental risks of business success or failure.
(3) Other conditions on application of services cost method.
(i) Adequate books and records.
(ii) Excluded transactions.
(4) Covered services.
(i) Specified covered services.
(ii) Low margin covered services.
(5) Shared services arrangement.
(i) In general.
(ii) Requirements for shared services arrangement.
(A) Eligibility.
(B) Allocation.
(C) Documentation.
(iii) Definition and special rules.
(A) Participant.
(B) Aggregation.
(C) Coordination with cost sharing arrangements.
(6) Examples.
(c) Comparable uncontrolled services price method.
(1) In general.
(2) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) In general.
(B) Adjustments for differences between controlled and uncontrolled transactions.
(iii) Data and assumptions.
(3) Arm's length range.
(4) Examples.
(5) Indirect evidence of the price of a comparable uncontrolled services transaction.
(i) In general.
(ii) Example.
(d) Gross services margin method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Relevant uncontrolled transaction.
(iii) Applicable uncontrolled price.
(iv) Appropriate gross services profit.
(v) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between controlled and uncontrolled transactions.
(D) Buy-sell distributor.
(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(e) Cost of services plus method.
(1) In general.
(2) Determination of arm's length price.
(i) In general.
(ii) Appropriate gross services profit.
(iii) Comparable transactional costs.
(iv) Arm's length range.
(3) Comparability and reliability considerations.
(i) In general.
(ii) Comparability.
(A) Functional comparability.
(B) Other comparability factors.
(C) Adjustments for differences between the controlled and uncontrolled transactions.

(iii) Data and assumptions.
(A) In general.
(B) Consistency in accounting.
(4) Examples.
(f) Comparable profits method.
(1) In general.
(2) Determination of arm's length result.
(i) Tested party.
(ii) Profit level indicators.
(iii) Comparability and reliability considerations—Data and assumptions—Consistency in accounting.
(3) Examples.
(g) Profit split method.
(1) In general.
(2) Examples.
(h) Unspecified methods.
(i) Contingent-payment contractual terms for services.
(1) Contingent-payment contractual terms recognized in general.
(2) Contingent-payment arrangement.
(i) General Requirements
(A) Written contract.
(B) Specified contingency.
(C) Basis for payment.
(ii) Economic Substance and Conduct
(3) Commissioner's authority to impute contingent-payment terms.
(4) Evaluation of arm's length charge.
(5) Examples.
(j) Total services costs.
(k) Allocation of costs.
(1) In general.
(2) Appropriate method of allocation and apportionment.
(i) Reasonable method standard.
(ii) Use of general practices.
(3) Examples.
(l) Controlled services transaction.
(1) In general.
(2) Activity.
(3) Benefit.
(i) In general.
(ii) Indirect or remote benefit.
(iii) Duplicative activities.
(iv) Shareholder activities.
(v) Passive association.
(4) Disaggregation of Transactions
(5) Examples.
(m) Coordination with transfer pricing rules for other transactions.
(1) Services transactions that include other types of transactions.
(2) Services transactions that effect a transfer of intangible property.
(3) Services subject to a qualified cost sharing arrangement.
(4) Other types of transactions that include controlled services transactions.
(5) Examples.
(n) Effective date.
(1) In general.
(2) Election to apply regulations to earlier taxable years.
(3) Expiration date.

■ **Par. 4.** Section 1.482–1 is amended as follows:
■ 1. Paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3,* (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii) and paragraph (i) are revised.
■ 2. Paragraph (d)(3)(ii)(C) *Examples 4* through *6* are added.
■ 3. Paragraph (j)(6) is added.

The addition and revisions read as follows:

§ 1.482–1 Allocation of income and deductions among taxpayers.

(a)(1) [Reserved]. For further guidance, see § 1.482–1T(a)(1).
* * * * *
(b) * * * (1) * * *
(b)(2)(i) [Reserved]. For further guidance, see § 1.482–1T(b)(2)(i).
* * * * *
(d) * * *
(3) * * *
(ii) * * *
(C) * * *
Example 3. [Reserved]. For further guidance, see § 1.482–1T(d)(3)(ii)(C), Example 3.
Examples 4 through *6.* [Reserved]. For further guidance, see 1.482–1T(d)(3)(ii)(C) *Examples 4* through *6.*
* * * * *
(v) [Reserved]. For further guidance, see § 1.482–1T(d)(3)(v).
* * * * *
(f) * * *
(2) * * *
(ii)(A) [Reserved]. For further guidance, see § 1.482–1T(f)(2)(ii)(A).
* * * * *
(iii) * * *
(B) [Reserved]. For further guidance, see § 1.482–1T(f)(3)(iii)(B).
* * * * *
(g) * * *
(4) * * * (i) * * * [Reserved]. For further guidance, see § 1.482–1T(g)(4)(i).
(iii) * * *
Example 1. [Reserved]. For further guidance, see § 1.482–1T(g)(4)(iii), *Example 1.*
* * * * *
(i) [Reserved]. For further guidance, see § 1.482–1T(i).
(j) * * *
(6) [Reserved]. For further guidance, see § 1.482–1T(j)(6).

Par. 5. Section 1.482–1T is added to read as follows:

§ 1.482–1T Allocation of income and deductions among taxpayers (temporary).

(a) *In general*—(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482. Section 1.482–2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482–3 through 1.482–6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482–7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482–7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. Section 1.482–8 provides examples illustrating the application of the best method rule. Finally, § 1.482–9T provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

(a)(2) through (b)(1) [Reserved]. For further guidance, see § 1.482–1(a)(2) through (b)(1).

(b)(2) *Arm's length methods*—(i) *Methods.* Sections 1.482–2 through 1.482–6 and § 1.482–9T provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard and, if they do not, to determine the arm's length result. Section 1.482–7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

(b)(2)(ii) through (d)(3)(ii)(C), *Examples 1,* and *2* [Reserved]. For further guidance, see § 1.482–1(b)(2)(ii) through (d)(3)(ii)(C), *Examples 1* and *2.*

Example 3. Contractual terms imputed from economic substance. (i) FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. In year 1, FP enters the United States market by selling YY wristwatches to its newly organized United States subsidiary, USSub, for distribution in the United States market. USSub pays FP a fixed price per wristwatch. USSub and FP undertake, without separate compensation, marketing activities to establish the YY trademark in the United States market. Unrelated foreign producers of trademarked wristwatches and their authorized United States distributors respectively undertake similar marketing activities in independent arrangements involving distribution of trademarked wristwatches in the United States market. In years 1 through 6, USSub markets and sells YY wristwatches in the United States. Further, in years 1 through 6, USSub undertakes incremental marketing activities in addition to the activities similar to those observed in the independent distribution transactions in the United States market. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. Assume

that, aside from these incremental activities, and after any adjustments are made to improve the reliability of the comparison, the price paid per wristwatch by the independent, authorized distributors of wristwatches would provide the most reliable measure of the arm's length price paid per YY wristwatch by USSub.

(ii) By year 7, the wristwatches with the YY trademark generate a premium return in the United States market, as compared to wristwatches marketed by the independent distributors. In year 7, substantially all the premium return from the YY trademark in the United States market is attributed to FP, for example through an increase in the price paid per watch by USSub, or by some other means.

(iii) In determining whether an allocation of income is appropriate in year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, ex ante, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, USSub's undertaking the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' attribution to FP in year 7 of substantially all the premium return from the enhanced YY trademark in the United States market. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the YY trademark wristwatches. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive agreement to exploit the YY trademark in the United States that allows USSub to benefit from the incremental marketing activities it performed. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term, exclusive agreement to exploit the YY trademark in the United States, an agreement that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

Example 4. Contractual terms imputed from economic substance. (i) FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries worldwide. In year 1, FP enters into a licensing agreement that affords its newly organized United States subsidiary, USSub, exclusive rights to certain manufacturing and marketing intangibles (including the AA trademark) for purposes of manufacturing and marketing athletic gear in the United States under the AA trademark. The contractual terms of this agreement obligate USSub to pay FP a royalty based on sales, and also obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities. Unrelated foreign businesses license independent United States businesses to manufacture and market athletic gear in the United States, using trademarks owned by the unrelated foreign businesses. The contractual terms of these uncontrolled transactions require the licensees to pay royalties based on sales of the merchandise, and obligate the licensors and licensees to undertake without separate compensation specified types and levels of marketing activities. In years 1 through 6, USSub manufactures and sells athletic gear under the AA trademark in the United States. Assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangibles, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts in paragraph (ii) of this example.

(ii) In years 1 through 6, USSub performs incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the license agreement with FP, that are also incremental as compared to those observed in the comparables. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. By year 7, AA trademark athletic gear generates a premium return in the United States, as compared to similar athletic gear marketed by independent licensees. In year 7, USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during years 1 through 6, and to compensate USSub on a cost basis for any incremental marketing activities it may perform in year 7 and subsequent years. In addition, the parties revise the license agreement executed in year 1, and increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States.

(iii) In determining whether an allocation of income is appropriate in year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, ex ante, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit. In this case, USSub's undertaking the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' adoption in year 7 of contractual terms by which FP compensates USSub on a cost basis for the incremental marketing activities that it performed. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the AA trademark athletic gear. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for the incremental activities it performed during years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive United States license agreement that allows USSub to benefit from the incremental activities. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term United States license agreement, a license that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in this particular case.

Example 5. Non-arm's length compensation. (i) The facts are the same as in paragraph (i) of *Example 4.* As in *Example 4,* assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangibles, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts described in paragraph (ii) of this example.

(ii) In years 1 through 4, USSub performs certain incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the basic license agreement, that are also incremental as compared with those activities observed in the comparables. At the start of year 1, FP enters into a separate services agreement with USSub, which states that FP will compensate USSub quarterly, in an amount equal to specified costs plus X%, for these incremental marketing functions. Further, these written agreements reflect the intent of the parties that USSub receive such compensation from FP throughout the term of the agreement, without regard to the success or failure of the promotional activities. During years 1 though 4, USSub performs marketing activities pursuant to the separate services agreement and in each year USSub receives the specified compensation from FP on a cost of services plus basis.

(iii) In evaluating year 4, the Commissioner performs an analysis of independent parties that perform promotional activities comparable to those performed by USSub

and that receive separately-stated compensation on a current basis without contingency. The Commissioner determines that the magnitude of the specified cost plus X% is outside the arm's length range in each of years 1 through 4. Based on an evaluation of all the facts and circumstances, the Commissioner makes an allocation to require payment of compensation to USSub for the promotional activities performed in year 4, based on the median of the interquartile range of the arm's length markups charged by the uncontrolled comparables described in § 1.482–1(e)(3).

(iv) Given that based on facts and circumstances, the terms agreed by the controlled parties were that FP would bear all risks associated with the promotional activities performed by USSub to promote the AA trademark product in the United States market, and given that the parties' conduct during the years examined was consistent with this allocation of risk, the fact that the cost of services plus markup on USSub's services was outside the arm's length range does not, without more, support imputation of additional contractual terms based on alternative views of the economic substance of the transaction, such as terms indicating that USSub, rather than FP, bore the risk associated with these activities. In other facts and circumstances, had the compensation paid to USSub been significantly outside the arm's length range, that might lead the Commissioner to examine further whether, despite the contractual terms that require cost-plus reimbursement of USSub, the economic substance of the transaction was not consistent with FP's bearing the risk associated with promotional activities in the United States market.

Example 6. Contractual terms imputed from economic substance. (i) Company X is a member of a controlled group that has been in operation in the pharmaceutical sector for many years. In years 1 through 4, Company X undertakes research and development activities. As a result of those activities, Company X developed a compound that may be more effective than existing medications in the treatment of certain conditions.

(ii) Company Y is acquired in year 4 by the controlled group that includes Company X. Once Company Y is acquired, Company X makes available to Company Y a large amount of technical data concerning the new compound, which Company Y uses to register patent rights with respect to the compound in several jurisdictions, making Company Y the legal owner of such patents. Company Y then enters into licensing agreements with group members that afford Company Y 100% of the premium return attributable to use of the intangible by its subsidiaries.

(iii) In determining whether an allocation is appropriate in year 4, the Commissioner may consider the economic substance of the arrangements between Company X and Company Y, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that an uncontrolled taxpayer operating at arm's length would make available the results of its research and development or perform services that resulted in transfer of valuable know how to another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, Company X's undertaking the research and development activities and then providing technical data and know-how to Company Y in year 4 is inconsistent with the registration and subsequent exploitation of the patent by Company Y. Therefore, the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights. For example, the Commissioner may impute a separate services agreement that affords Company X contingent-payment compensation for its services in year 4 for the benefit of Company Y, consisting of making available to Company Y technical data, know-how, and other fruits of research and development conducted in previous years. These services benefited Company Y by giving rise to and contributing to the value of the patent rights that were ultimately registered by Company Y. In the alternative, the Commissioner may impute a transfer of patentable intangible rights from Company X to Company Y immediately preceding the registration of patent rights by Company Y. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

(d)(3)(iii) and (iv) [Reserved]. For further guidance, see § 1.482–1(d)(3)(iii) and (d)(3)(iv).

(d)(3)(v) *Property or services.* Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangibles that are embedded in tangible property or services being transferred. The comparability of the embedded intangibles will be analyzed using the factors listed in § 1.482–4(c)(2)(iii)(B)(*1*) (comparable intangible property). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied. For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property and performance of services, see §§ 1.482–3 through 1.482–6 and § 1.482–9T; see also § 1.482–3(f), § 1.482–4T(f)(4), and § 1.482–9T(m), dealing with the coordination of the intangible and tangible property and performance of services rules.

(d)(4) through (f)(2)(i) [Reserved]. For further guidance, see § 1.482–1(d)(4) through (f)(2)(i).

(f)(2)(ii) *Allocation based on taxpayer's actual transactions*—(A) *In general.* The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. See § 1.482–1(d)(3) (factors for determining comparability; contractual terms and risk); §§ 1.482–3(e), 1.482–4(d), and 1.482–9T(h) (unspecified methods).

(f)(2)(ii)(B) through (f)(2)(iii)(A) [Reserved]. For further guidance, see § 1.482–1(f)(2)(ii)(B) through (f)(2)(iii)(A).

(f)(2)(iii)(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data are available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of paragraph (d)(3)(iii) of this section (risk), paragraph (d)(4)(i) of this section (market share strategy), § 1.482–4(f)(2) (periodic adjustments), § 1.482–5 (comparable profits method), § 1.482–9T(f) (comparable profits method for services), and § 1.482–9T(i) (contingent-payment contractual terms for services). On the other hand, multiple year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method of § 1.482–3(b) or the comparable uncontrolled services price method of § 1.482–9T(c) (except to the extent that risk or market share strategy issues are present).

(f)(2)(iii)(C) through (g)(3) [Reserved]. For further guidance, see § 1.482–1(f)(2)(iii)(C) through (g)(3).

(g)(4) *Setoffs*—(i) *In general.* If an allocation is made under section 482 with respect to a transaction between

controlled taxpayers, the Commissioner will take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation. Such setoff, however, will be taken into account only if the requirements of paragraph (g)(4)(ii) of this section are satisfied. If the effect of the setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions. For purposes of this setoff provision, the term arm's length refers to the amount defined in paragraph (b) of this section (Arm's length standard), without regard to the rules in § 1.482–2(a) that treat certain interest rates as arm's length rates of interest.

(g)(4)(ii) [Reserved]. For further guidance, see § 1.482–1(g)(4)(ii).

(g)(4)(iii) *Examples.* The following examples illustrate this paragraph (g)(4):

Example 1. P, a U.S. corporation, renders construction services to S, its foreign subsidiary in Country Y, in connection with the construction of S's factory. An arm's length charge for such services determined under § 1.482–9T would be $100,000. During the same taxable year P makes available to S the use of a machine to be used in the construction of the factory, and the arm's length rental value of the machine is $25,000. P bills S $125,000 for the services, but does not charge S for the use of the machine. No allocation will be made with respect to the undercharge for the machine if P notifies the district director of the basis of the claimed setoff within 30 days after the date of the letter from the district director transmitting the examination report notifying P of the proposed adjustment, establishes that the excess amount charged for services was equal to an arm's length charge for the use of the machine and that the taxable income and income tax liabilities of P are not distorted, and documents the correlative allocations resulting from the proposed setoff.

(g)(4)(iii) *Example 2* through (h) [Reserved]. For further guidance, see § 1.482–1(g)(4)(iii) *Example 2* through (h).

(i) *Definitions.* The definitions set forth in paragraphs (i)(1) through (i)(10) of this section apply to this section and §§ 1.482–2T through 1.482–9T.

(j)(1) through (j)(5) [Reserved]. For further guidance, see 1.482–1(j)(1) through (j)(5).

(j)(6)(i) The provisions of paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3, Example 4, Example 5,* and *Example 6,* (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section are generally applicable for taxable years beginning after December 31, 2006.

(ii) A person may elect to apply the provisions of paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3, Example 4, Example 5,* and *Example 6,* (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(iii) The applicability of § 1.482–1T expires on or before July 31, 2009.

■ **Par. 6.** Section 1.482–2 is amended as follows:

■ 1. Paragraph (b) is revised.

■ 2. Paragraph (e) is added.

The addition and revision read as follows:

§ 1.482–2 Determination of taxable income in specific situations.

* * * * *

(b) *Rendering of services.* [Reserved]. For further guidance, see § 1.482–2T(b).

* * * * *

(e) *Effective date.* [Reserved]. For further guidance, see § 1.482–2T(e).

■ **Par. 7.** Section 1.482–2T is added to read as follows:

§ 1.482–2T Determination of taxable income in specific situations (temporary).

(a) [Reserved]. For further guidance, see § 1.482–2(a).

(b) *Rendering of services.* For rules governing allocations under section 482 to reflect an arm's length charge for controlled transactions involving the rendering of services, see § 1.482–9T.

(c) [Reserved]. For further guidance, see § 1.482–2(c).

(d) [Reserved]. For further guidance, see § 1.482–2(d).

(e) *Effective date*—(1) *In general.* The provision of paragraph (b) of this section is generally applicable for taxable years beginning after December 31, 2006.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of § 1.482–2T expires on or before July 31, 2009.

■ **Par. 8.** Section 1.482–4 is amended as follows:

■ 1. Paragraph (f)(3) is revised.

■ 2. Paragraphs (f)(4) and (f)(5) are redesignated as paragraphs (f)(5) and (f)(6), respectively.

■ 3. New paragraphs (f)(4) and (f)(7) are added.

The revision and additions read as follows:

§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

* * * * *

(f) * * *

(3) [Reserved]. For further guidance, see § 1.482–4T(f)(3).

(4) [Reserved]. For further guidance, see § 1.482–4T(f)(4).

* * * * *

(7) [Reserved]. For further guidance, see § 1.482–4T(f)(7).

■ **Par. 9.** Section 1.482–4T is added to read as follows:

§ 1.482–4T Methods to determine taxable income in connection with a transfer of intangible property (temporary).

(a) through (f)(2) [Reserved]. For further guidance, see § 1.482–4(a) through (f)(2).

(f)(3) *Ownership of intangible property*—(i) *Identification of owner*—(A) *In general.* 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. See § 1.482–1(d)(3)(ii)(B) (identifying contractual terms). If no owner of the respective intangible is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms (including terms imputed pursuant to § 1.482–1(d)(3)(ii)(B)) or other legal provision, then the controlled taxpayer who has control of the intangible, based on all the facts and circumstances, will be considered the sole owner of the intangible for purposes of this section.

(B) *Cost sharing arrangements.* The rule in paragraph (f)(3)(i)(A) of this section will apply to interests in covered intangibles, as defined in § 1.482–7(b)(4)(iv), only as provided in § 1.482–7 (sharing of costs).

(ii) *Examples.* The principles of this paragraph (f)(3) are illustrated by the following examples:

Example 1. FP, a foreign corporation, is the registered holder of the AA trademark in the United States. FP licenses to its U.S. subsidiary, USSub, the exclusive rights to manufacture and market products in the United States under the AA trademark. FP is the owner of the trademark pursuant to intellectual property law. USSub is the owner of the license pursuant to the terms of the license, but is not the owner of the trademark. See paragraphs (b)(3) and (4) of this section (defining an intangible as, among other things, a trademark or a license).

Example 2. The facts are the same as in *Example 1.* As a result of its sales and marketing activities, USSub develops a list of several hundred creditworthy customers that regularly purchase AA trademarked products. Neither the terms of the contract between FP and USSub nor the relevant intellectual property law specify which party owns the customer list. Because USSub has knowledge of the contents of the list, and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for purposes of this paragraph (f)(3).

(4) *Contribution to the value of an intangible owned by another*—(i) *In general.* The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of an intangible owned by another controlled taxpayer will be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to § 1.482–1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

(ii) *Examples.* The principles of this paragraph (f)(4) are illustrated by the following examples:

Example 1. A, a member of a controlled group, allows B, another member of the controlled group, to use tangible property, such as laboratory equipment, in connection with B's development of an intangible that B owns. By furnishing tangible property, A makes a contribution to the development of an intangible owned by another controlled taxpayer, B. Pursuant to paragraph (f)(4)(i) of this section, the arm's length charge for A's furnishing of tangible property will be determined under the rules for use of tangible property in § 1.482–2(c).

Example 2. (i) *Facts.* FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. FP enters into an exclusive, five-year, renewable agreement with its newly organized U.S. subsidiary, USSub. The contractual terms of the agreement grant USSub the exclusive right to re-sell trademark YY wristwatches in the United States, obligate USSub to pay a fixed price per wristwatch throughout the entire term of the contract, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities.

(ii) The consideration for FP's and USSub's marketing activities, as well as the consideration for the exclusive right to re-sell YY trademarked merchandise in the United States, are embedded in the transfer price paid for the wristwatches. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to these embedded contributions.

(iii) Whether an allocation is warranted with respect to the transfer price for the wristwatches is determined under §§ 1.482–1, 1.482–3, and this section through § 1.482–6. The comparability analysis would include consideration of all relevant factors, including the nature of the intangible embedded in the wristwatches and the nature of the marketing activities required under the agreement. This analysis would also take into account that the compensation for the activities performed by USSub and FP, as well as the consideration for USSub's use of the YY trademark, is embedded in the transfer price for the wristwatches, rather than provided for in separate agreements. See §§ 1.482–3(f) and 1.482–9T(m)(4).

Example 3. (i) *Facts.* FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries. In year 1, FP licenses to a newly organized U.S. subsidiary, USSub, the exclusive rights to use certain manufacturing and marketing intangibles to manufacture and market athletic gear in the United States under the AA trademark. The license agreement obligates USSub to pay a royalty based on sales of trademarked merchandise. The license agreement also obligates FP and USSub to perform without separate compensation specified types and levels of marketing activities. In year 1, USSub manufactures and sells athletic gear under the AA trademark in the United States.

(ii) The consideration for FP's and USSub's respective marketing activities is embedded in the contractual terms of the license for the AA trademark. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to the embedded contributions in year 1. See § 1.482–9T(m)(4).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement would be analyzed under § 1.482–1 and this section through § 1.482–6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangibles subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. Pursuant to paragraph (f)(4)(i) of this section, the analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty paid for use of the AA trademark, rather than provided for in a separate services agreement. For illustrations of application of the best method rule, see § 1.482–8T *Example 10*, *Example 11*, and *Example 12*.

Example 4. (i) *Facts.* The year 1 facts are the same as in *Example 3*, with the following exceptions. In year 2, USSub undertakes certain incremental marketing activities, in addition to those required by the contractual terms of the license for the AA trademark executed in year 1. The parties do not execute a separate agreement with respect to these incremental marketing activities performed by USSub The license agreement executed in year 1 is of sufficient duration that it is reasonable to anticipate that USSub will obtain the benefit of its incremental activities, in the form of increased sales or revenues of trademarked products in the U.S. market.

(ii) To the extent that it was reasonable to anticipate that USSub's incremental marketing activities would increase the value only of USSub's intangible (that is, USSub's license to use the AA trademark for a specified term), and not the value of the AA trademark owned by FP, USSub's incremental activities do not constitute a contribution for which an allocation is warranted under paragraph (f)(4)(i) of this section.

Example 5. (i) *Facts.* The year 1 facts are the same as in *Example 3.* In year 2, FP and USSub enter into a separate services agreement that obligates USSub to perform certain incremental marketing activities to promote AA trademark athletic gear in the United States, above and beyond the activities specified in the license agreement executed in year 1. In year 2, USSub begins to perform these incremental activities, pursuant to the separate services agreement with FP.

(ii) Whether an allocation is warranted with respect to USSub's incremental marketing activities covered by the separate services agreement would be evaluated under §§ 1.482–1 and 1.482–9T, including a comparison of the compensation provided for the services with the results obtained under a method pursuant to § 1.482–9T, selected and applied in accordance with the best method rule of § 1.482–1(c).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement is determined under § 1.482–1 and this section through § 1.482–6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangibles subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. The comparability analysis would take into account that the compensation for the incremental activities by USSub is provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see § 1.482–8T *Example 10*, *Example 11*, and *Example 12.*

Example 6. (i) *Facts.* The year 1 facts are the same as in *Example 3.* In year 2, FP and USSub enter into a separate services agreement that obligates FP to perform incremental marketing activities, not specified in the year 1 license, by advertising AA trademarked athletic gear in selected international sporting events, such as the Olympics and the soccer World Cup. FP's corporate advertising department develops and coordinates these special promotions. The separate services agreement obligates USSub to pay an amount to FP for the benefit

to USSub that may reasonably be anticipated as the result of FP's incremental activities. The separate services agreement is not a qualified cost sharing arrangement under § 1.482–7. FP begins to perform the incremental activities in year 2 pursuant to the separate services agreement.

(ii) Whether an allocation is warranted with respect to the incremental marketing activities performed by FP under the separate services agreement would be evaluated under § 1.482–9T. Under the circumstances, it is reasonable to anticipate that FP's activities would increase the value of USSub's license as well as the value of FP's trademark. Accordingly, the incremental activities by FP may constitute in part a controlled services transaction for which USSub must compensate FP. The analysis of whether an allocation is warranted would include a comparison of the compensation provided for the services with the results obtained under a method pursuant to § 1.482–9T, selected and applied in accordance with the best method rule of § 1.482–1(c).

(iii) Whether an allocation is appropriate with respect to the royalty under the license agreement would be evaluated under § 1.482–1 through § 1.482–6 of this section. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of USSub's license, the nature of the intangibles subject to the license, and the marketing activities required to be undertaken by both FP and USSub pursuant to the license. This comparability analysis would take into account that the compensation for the incremental activities performed by FP was provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see § 1.482–8T, *Example 10*, *Example 11*, and *Example 12*.

(f)(5) and (f)(6) [Reserved]. For further guidance, see § 1.482–4(f)(5) and (f)(6).

(f)(7) *Effective date.* (i) *In general.* The provisions of paragraphs (f)(3) and (f)(4) are generally applicable for taxable years beginning after December 31, 2006.

(ii) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (f)(3) and (f)(4) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(iii) *Expiration date.* The applicability of § 1.482–4T expires on or before July 31, 2009.

■ **Par. 10.** Section 1.482–6 is amended by revising paragraphs (c)(2)(ii)(B)(*1*), (c)(2)(ii)(D), (c)(3)(i)(A), (c)(3)(i)(B), and (c)(3)(ii)(D) to read as follows:

The revisions and addition read as follows:

§ 1.482–6 Profit split method.

* * * * *

(c) * * *

(2) * * *

(ii) * * *

(B) * * * (*1*) * * * [Reserved]. For further guidance, see § 1.482–6T(c)(2)(ii)(B)(*1*).

* * * * *

(D) [Reserved]. For further guidance, see § 1.482–6T(c)(2)(ii)(D).

* * * * *

(3) * * *

(i) * * *

(A) [Reserved]. For further guidance, see § 1.482–6T(c)(3)(i)(A).

(B) [Reserved]. For further guidance, see § 1.482–6T(c)(3)(i)(B).

(ii) * * *

(D) [Reserved]. For further guidance, see § 1.482–6T(c)(3)(ii)(D).

* * * * *

■ **Par. 11.** Section 1.482–6T is added to read as follows:

§ 1.482–6T Profit split method (temporary).

(a) through (c)(2)(ii)(A) [Reserved]. For further guidance, see § 1.482–6(a) through (c)(2)(ii)(A).

(c)(2)(ii)(B) *Comparability*—(*1*) *In general.* The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability provisions of § 1.482–1(d). The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in § 1.482–5(c)(2) or § 1.482–9T(f)(2)(iii) because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(c)(2)(ii)(B)(*2*) through (C) [Reserved]. For further guidance, see § 1.482–6(c)(2)(ii)(B)(*2*) through (C).

(c)(2)(ii)(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, 1.482–5 and 1.482–9T, the comparable profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(c)(3)(i) [Reserved]. For further guidance, see § 1.482–6(c)(3)(i).

(c)(3)(i)(A) *Allocate income to routine contributions.* The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§ 1.482–3, 1.482–4, 1.482–5 and 1.482–9T.

(B) *Allocate residual profit*—(*1*) *Nonroutine contributions generally.* The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that is not accounted for as a routine contribution. 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. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the nonroutine contribution must be made among all the business activities in which it is used.

(*2*) *Nonroutine contributions of intangible property.* In many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property. For purposes of paragraph (c)(3)(i)(B)(*1*) of this section, the relative value of nonroutine intangible property contributed by taxpayers may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of nonroutine intangible property contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property contributed by all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions.

(c)(3)(ii)(A) through (C) [Reserved]. For further guidance, see § 1.482–6(c)(3)(ii)(A) through (C).

(c)(3)(ii)(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, 1.482–5 and 1.482–9T, the first step of the residual profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(c)(3)(iii) [Reserved]. For further guidance, see § 1.482–6(c)(3)(iii).

(d) *Effective date*—(1) *In general.* The provisions of paragraphs (c)(2)(ii)(B)(*1*) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section are generally applicable for taxable years beginning after December 31, 2006.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (c)(2)(ii)(B)(*1*) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of § 1.482–6T expires on or before July 31, 2009.

■ **Par. 12.** Section 1.482–8 is amended as follows:

■ 1. Designating the undesignated introductory text as paragraph (a) and adding a paragraph heading.

■ 2. Adding paragraph (b) designation, heading, and *Examples 10* through *12*.

The additions read as follows:

§ 1.482–8 Examples of the best method rule.

(a) *Introduction.* * * *

(b) *Examples.* * * *

Examples 10 through *12*. [Reserved]. For further guidance, see 1.482–8T(b) *Examples 10* through *12*.

■ **Par. 13.** Section 1.482–8T is added to read as follows:

§ 1.482–8T Examples of the best method rule (temporary).

(a) [Reserved]. For further guidance, see § 1.482–8(a).

(b) [Reserved]. For further guidance, see § 1.482–8(b), *Examples 1* through *9*.

Example 10. Cost of services plus method preferred to other methods. (i) FP designs and manufactures consumer electronic devices that incorporate advanced technology. In year 1, FP introduces Product X, an entertainment device targeted primarily at the youth market. FP's wholly-owned, exclusive U.S. distributor, USSub, sells Product X in the U.S. market. USSub hires an independent marketing firm, Agency A, to promote Product X in the U.S. market. Agency A has successfully promoted other electronic products on behalf of other uncontrolled parties. USSub executes a one-year, renewable contract with Agency A that requires it to develop the market for Product X, within an annual budget set by USSub. In years 1 through 3, Agency A develops advertising, buys media, and sponsors events featuring Product X. Agency A receives a markup of 25% on all expenses of promoting Product X, with the exception of media buys, which are reimbursed at cost. During year 3, sales of Product X decrease sharply, as Product X is displaced by competitors' products. At the end of year 3, sales of Product X are discontinued.

(ii) Prior to the start of year 4, FP develops a new entertainment device, Product Y. Like Product X, Product Y is intended for sale to the youth market, but it is marketed under a new trademark distinct from that used for Product X. USSub decides to perform all U.S. market promotion for Product Y. USSub hires key Agency A staff members who handled the successful Product X campaign. To promote Product Y, USSub intends to use methods similar to those used successfully by Agency A to promote Product X (print advertising, media, event sponsorship, etc.). FP and USSub enter into a one-year, renewable agreement concerning promotion of Product Y in the U.S. market. Under the agreement, FP compensates USSub for promoting Product Y, based on a cost of services plus markup of A%. Third-party media buys by USSub in connection with Product Y are reimbursed at cost.

(iii) Assume that under the contractual arrangements between FP and USSub, the arm's length consideration for Product Y and the trademark or other intangibles may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the year 4 promotional activities performed by USSub pursuant to its contract with FP.

(iv) USSub's accounting records contain reliable data that separately state the costs incurred to promote Product Y. A functional analysis indicates that USSub's activities to promote Product Y in year 4 are similar to activities performed by Agency A during years 1 through 3 under the contract with FP. In other respects, no material differences exist in the market conditions or the promotional activities performed in year 4, as compared to those in years 1 through 3.

(v) It is possible to identify uncontrolled distributors or licensees of electronic products that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities perform, as one component of business

activities. If that were possible, the comparable profits method for services might provide a reliable measure of an arm's length result. The functional analysis of the marketing activities performed by USSub in year 4 indicates that they are similar to the activities performed by Agency A in years 1 through 3 for Product X. Because reliable information is available concerning the markup on costs charged in a comparable uncontrolled transaction, the most reliable measure of an arm's length price is the cost of services plus method in § 1.482–9T(e).

Example 11. CPM for services preferred to other methods. (i) FP manufactures furniture and accessories for residential use. FP sells its products to retailers in Europe under the trademark, ''Moda.'' FP holds all worldwide rights to the trademark, including in the United States. USSub is FP's wholly-owned subsidiary in the U.S. market and the exclusive U.S. distributor of FP's merchandise. Historically, USSub dealt only with specialized designers in the U.S. market and advertised in trade publications targeted to this market. Although items sold in the U.S. and Europe are physically identical, USSub's U.S. customers generally resell the merchandise as non-branded merchandise.

(ii) FP retains an independent firm to evaluate the feasibility of selling FP's trademarked merchandise in the general wholesale and retail market in the United States. The study concludes that this segment of the U.S. market, which is not exploited by USSub, may generate substantial profits. Based on this study, FP enters into a separate agreement with USSub, which provides that USSub will develop this market in the United States for the benefit of FP. USSub separately accounts for personnel expenses, overhead, and out-of-pocket costs attributable to the initial stage of the marketing campaign (Phase I). USSub receives as compensation its costs, plus a markup of X%, for activities in Phase I. At the end of Phase I, FP will evaluate the program. If success appears likely, USSub will begin full-scale distribution of trademarked merchandise in the new market segment, pursuant to agreements negotiated with FP at that time.

(iii) Assume that under the contractual arrangements in effect between FP and USSub, the arm's length consideration for the merchandise and the trademark or other intangibles may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the marketing activities conducted by USSub in years 1 and following.

(iv) A functional analysis reveals that USSub's activities consist primarily of modifying the promotional materials created by FP, negotiating media buys, and arranging promotional events. FP separately compensates USSub for all Phase I activities, and detailed accounting information is available regarding the costs of these activities. The Phase I activities of USSub are similar to those of uncontrolled companies that perform, as their primary business activity, a range of advertising and media relations activities on a contract basis for uncontrolled parties.

(v) No information is available concerning the comparable uncontrolled prices for services in transactions similar to those engaged in by FP and USSub. Nor is any information available concerning uncontrolled transactions that would allow application of the cost of services plus method. It is possible to identify uncontrolled distributors or licensees of home furnishings that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities performed, as one component of their business activities. On the other hand, it is possible to identify uncontrolled advertising and media relations companies, the principal business activities of which are similar to the Phase I activities of USSub. Under these circumstances, the most reliable measure of an arm's length price is the comparable profits method of § 1.482–9T(f). The uncontrolled advertising comparables' treatment of material items, such as classification of items as cost of goods sold or selling, general, and administrative expenses, may differ from that of USSub. Such inconsistencies in accounting treatment between the uncontrolled comparables and the tested party, or among the comparables, are less important when using the ratio of operating profit to total services costs under the comparable profits method for services in § 1.482–9T(f). Under this method, the operating profit of USSub from the Phase I activities is compared to the operating profit of uncontrolled parties that perform general advertising and media relations as their primary business activity.

Example 12. Residual profit split preferred to other methods. (i) USP is a manufacturer of athletic apparel sold under the AA trademark, to which FP owns the worldwide rights. USP sells AA trademark apparel in countries throughout the world, but prior to year 1, USP did not sell its merchandise in Country X. In year 1, USP acquires an uncontrolled Country X company which becomes its wholly-owned subsidiary, XSub. USP enters into an exclusive distribution arrangement with XSub in Country X. Before being acquired by USP in year 1, XSub distributed athletic apparel purchased from uncontrolled suppliers and resold that merchandise to retailers. After being acquired by USP in year 1, XSub continues to distribute merchandise from uncontrolled suppliers and also begins to distribute AA trademark apparel. Under a separate agreement with USP, XSub uses its best efforts to promote the AA trademark in Country X, with the goal of maximizing sales volume and revenues from AA merchandise.

(ii) Prior to year 1, USP executed long-term endorsement contracts with several prominent professional athletes. These contracts give USP the right to use the names and likenesses of the athletes in any country in which AA merchandise is sold during the term of the contract. These contracts remain in effect for five years, starting in year 1. Before being acquired by USP, XSub renewed a long-term agreement with SportMart, an uncontrolled company that owns a nationwide chain of sporting goods retailers in Country X. XSub has been SportMart's primary supplier from the time that SportMart began operations. Under the agreement, SportMart will provide AA merchandise preferred shelf-space and will feature AA merchandise at no charge in its print ads and seasonal promotions. In consideration for these commitments, USP and XSub grant SportMart advance access to new products and the right to use the professional athletes under contract with USP in SportMart advertisements featuring AA merchandise (subject to approval of content by USP).

(iii) Assume that it is possible to segregate all transactions by XSub that involve distribution of merchandise acquired from uncontrolled distributors (non-controlled transactions). In addition, assume that, apart from the activities undertaken by USP and XSub to promote AA apparel in Country X, the arm's length compensation for other functions performed by USP and XSub in the Country X market in years 1 and following can be reliably determined. At issue in this *Example 12* is the application of the residual profit split analysis to determine the appropriate division between USP and XSub of the balance of the operating profits from the Country X market, that is the portion attributable to nonroutine contributions to the marketing and promotional activities.

(iv) A functional analysis of the marketing and promotional activities conducted in the Country X market, as described in this example, indicates that both USP and XSub made nonroutine contributions to the business activity. FP contributed the long-term endorsement contracts with professional athletes. XSub contributed its long-term contractual rights with SportMart, which were made more valuable by its successful, long-term relationship with SportMart.

(v) Because both USP and XSub made valuable, nonroutine contributions to the marketing and promotional activities in Country X, neither the comparable uncontrolled services price method, the cost of services plus method, nor the comparable profits method for services will provide a reliable measure of an arm's length result. On account of the valuable, nonroutine contributions made by both parties, the most reliable measure of an arm's length result is the residual profit split method in § 1.482–9T(g). The residual profit split analysis would take into account both routine and nonroutine contributions by USP and XSub, in order to determine an appropriate allocation of the combined operating profits in the Country X market from the sale of AA merchandise and from related promotional and marketing activities.

(c) *Effective date*—(1) *In general.* The provisions of § 1.482–8T *Example 10*, *Example 11*, and *Example 12* are generally applicable for taxable years beginning after December 31, 2006.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of § 1.482–8T *Example 10*, *Example 11*, and *Example*

12 to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of § 1.482–8T expires on or before July 31, 2009.

■ **Par. 14.** Section 1.482–9T is added to read as follows:

§ 1.482–9T Methods to determine taxable income in connection with a controlled services transaction (temporary).

(a) *In general.* The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in this section. Each method must be applied in accordance with the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e), except as those provisions are modified in this section. The methods are—

(1) The services cost method, described in paragraph (b) of this section;

(2) The comparable uncontrolled services price method, described in paragraph (c) of this section;

(3) The gross services margin method, described in paragraph (d) of this section;

(4) The cost of services plus method, described in paragraph (e) of this section;

(5) The comparable profits method, described in § 1.482–5 and in paragraph (f) of this section;

(6) The profit split method, described in § 1.482–6 and in paragraph (g) of this section; and

(7) Unspecified methods, described in paragraph (h) of this section.

(b) *Services cost method*—(1) *In general.* The services cost method evaluates whether the amount charged for covered services meeting the requirements of paragraphs (b)(2) and (b)(3) of this section is arm's length by reference to the total services costs (as defined in paragraph (j) of this section) with no markup. If covered services meet the conditions of this paragraph (b), then the services cost method will be considered the best method for purposes of § 1.482–1(c), and the Commissioner's allocations will be limited to adjusting the amount charged for such services to the properly determined amount of such total services costs.

(2) *Not services that contribute significantly to fundamental risks of business success or failure.* Services are not covered services unless the taxpayer reasonably concludes in its business judgment that the covered services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both. In evaluating the reasonableness of the conclusion required by this paragraph (b)(2), consideration will be given to all the facts and circumstances.

(3) *Other conditions on application of services cost method.* The arm's length amount charged in a controlled services transaction may be evaluated under the services cost method if it meets the requirements of paragraph (b)(3)(i) of this section and is not described in paragraph (b)(3)(ii) of this section.

(i) *Adequate books and records.* Permanent books of account and records are 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 evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for such services. Such books and records must be adequate to permit verification by the Commissioner of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question in accordance with paragraph (k) of this section.

(ii) *Excluded transactions.* The following categories of transactions, in whole or part, are not covered services:

(A) Manufacturing;

(B) Production;

(C) Extraction, exploration or processing of natural resources;

(D) Construction;

(E) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement;

(F) Research, development, or experimentation;

(G) Engineering or scientific;

(H) Financial transactions, including guarantees; and

(I) Insurance or reinsurance.

(4) *Covered services.* For purposes of this paragraph (b), covered services consist of a controlled transaction or a group of controlled service transactions (see § 1.482–1(f)(2)(i) (aggregation of transactions)) that meets the definition of specified covered services or low margin covered services.

(i) *Specified covered services.* Specified covered services are controlled services transactions that the Commissioner specifies by revenue procedure. Services will be included in such revenue procedure based upon the Commissioner's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable markup on total services costs. For the definition of the median comparable markup on total services costs, see paragraph (b)(4)(ii) of this section. The Commissioner may add to, subtract from, or otherwise revise the specified covered services described in the revenue procedure by subsequent revenue procedure, which amendments will ordinarily be prospective only in effect.

(ii) *Low margin covered services.* Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the median comparable markup on total services costs means the excess of the arm's length price of the controlled services transaction determined under the general section 482 regulations without regard to this paragraph (b), using the interquartile range described in § 1.482–1(e)(2)(iii)(C) and as necessary adjusting to the median of such interquartile range, over total services costs, expressed as a percentage of total services costs.

(5) *Shared services arrangement*—(i) *In general.* If covered services are the subject of a shared services arrangement, then the arm's length charge to each participant for such services will be the portion of the total costs of the services otherwise determined under the services cost method of this paragraph (b) that is properly allocated to such participant pursuant to the arrangement.

(ii) *Requirements for shared services arrangement.* A shared services arrangement must meet the requirements described in this paragraph (b)(5).

(A) *Eligibility.* To be eligible for treatment under this paragraph (b)(5), a shared services arrangement must—

(*1*) Include two or more participants;

(*2*) Include as participants all controlled taxpayers that reasonably anticipate a benefit (as defined under paragraph (l)(3)(i) of this section) from one or more covered services specified in the shared services arrangement; and

(*3*) Be structured such that each covered service (or each reasonable aggregation of services within the meaning of paragraph (b)(5)(iii)(B) of this section) confers a benefit on at least one participant in the shared services arrangement.

(B) *Allocation.* The costs for covered services must be allocated among the participants based on their respective shares of the reasonably anticipated benefits from those services, without regard to whether the anticipated benefits are in fact realized. Reasonably anticipated benefits are benefits as defined in paragraph (l)(3)(i) of this section. The allocation of costs must provide the most reliable measure of the participants' respective shares of the reasonably anticipated benefits under the principles of the best method rule. See § 1.482–1(c). The allocation must be applied on a consistent basis for all participants and services. The allocation to each participant in each taxable year must reasonably reflect that participant's respective share of reasonably anticipated benefits for such taxable year. If the taxpayer reasonably concluded that the shared services arrangement (including any aggregation pursuant to paragraph (b)(5)(iii)(B) of this section) allocated costs for covered services on a basis that most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to such services, as provided for in this paragraph (b)(5), then the Commissioner may not adjust such allocation basis.

(C) *Documentation.* The taxpayer must maintain sufficient documentation to establish that the requirements of this paragraph (b)(5) are satisfied, and include—

(*1*) A statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for covered services pursuant to a shared services arrangement;

(*2*) A list of the participants and the renderer or renderers of covered services under the shared services arrangement;

(*3*) A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and

(*4*) A description of any aggregation of covered services for purposes of the shared services arrangement, and an indication whether this aggregation (if any) differs from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(4)(ii) of this section.

(iii) *Definitions and special rules*—(A) *Participant.* A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to a shared services arrangement that substantially complies with the requirements described in this paragraph (b)(5).

(B) *Aggregation.* Two or more covered services may be aggregated in a reasonable manner taking into account all the facts and circumstances, including whether the relative magnitude of reasonably anticipated benefits of the participants sharing the costs of such aggregated services may be reasonably reflected by the allocation basis employed pursuant to paragraph (b)(5)(ii)(B) of this section. The aggregation of services under a shared services arrangement may differ from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(4)(ii) of this section, provided that such alternative aggregation can be implemented on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary.

(C) *Coordination with cost sharing arrangements.* To the extent that an allocation is made to a participant in a shared services arrangement that is also a participant in a cost sharing arrangement subject to § 1.482–7, such amount with respect to covered services is first allocated pursuant to the shared services arrangement under this paragraph (b)(5). Costs allocated pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible development activity under § 1.482–7 and other activities of the participant.

(6) *Examples.* The application of this section is illustrated by the following examples. No inference is intended whether the presence or absence of one or more facts is determinative of the conclusion in any example. For purposes of *Examples 1* through *14,* assume that Company P and its subsidiaries, Company Q and Company R, are corporations and members of the same group of controlled entities (PQR Controlled Group). For purposes of *Examples 15* through *17,* assume that Company P and its subsidiary, Company S, are corporations and members of the same group of controlled entities (PS Controlled Group). For purposes of *Examples 18* through *26,* assume that Company P and its subsidiaries, Company X, Company Y, and Company Z, are corporations and members of the same group of controlled entities (PXYZ Group) and that Company P and its subsidiaries satisfy all of the requirements for a shared services arrangement specified in paragraphs (b)(5)(ii) and (iii) of this section.

Example 1. Data entry services. (i) Company P, Company Q and Company R own and operate hospitals. Company P also owns and operates a computer system for maintaining medical information gathered by doctors and nurses during interviews and treatment of patients. Company P uses a scanning device to convert medical information from various paper records into a digital format. Company Q and Company R do not have a computer system that allows them to input or maintain this information, but they have access to this information through their computer systems. Since Company Q and Company R do not have the requisite computer infrastructure, Company P maintains this medical information for itself as well as for Company Q and Company R.

(ii) Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of paragraph (b) of this section, Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 2. Data entry services. (i) Company P owns and operates several gambling establishments. Company Q and Company R own and operate travel agencies. Company P provides its customers with a ''player's card,'' which is a smart card device used in Company P's gambling establishments to track a player's bets, winnings, losses, hotel accommodations, and food and drink purchases. Using their customer lists, Company Q and Company R request marketing information about their customers that Company P has gathered from these player's cards. Company Q and Company R use the smart card data to sell customized vacation packages to their customers, taking into account their individual preferences and spending patterns. Annual reports for the PQR Controlled Group state that these smart card data constitute an important element of the group's overall strategic business planning, including advertising and accommodations.

(ii) Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 3. Recruiting services. (i) Company P, Company Q and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P's human resources department recruits mid-level managers and engineers for itself as well as for Company Q and Company R by attending job fairs and other recruitment events. For recruiting higher-level managers and engineers, each of these companies uses

recruiters from unrelated executive search firms.

(ii) Assume that these services relating to recruiting are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of paragraph (b) of this section, Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 4. Recruiting services. (i) Company P, Company Q and Company R are agencies that represent celebrities in the entertainment industry. Among the most important resources of these companies are the highly compensated agents who have close personal relationships with celebrities in the entertainment industry. Company P implements a recruiting plan to hire highly compensated agents for itself, and other highly compensated agents for each of its wholly-owned subsidiaries in foreign countries, Company Q and Company R.

(ii) Assume that these services relating to recruiting are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 5. Credit analysis services. (i) Company P is a manufacturer and distributor of clothing for retail stores. Company Q and Company R are distributors of clothing for retail stores. As part of its operations, personnel in Company P perform credit analysis on its customers. Most of the customers have a history of purchases from Company P, and the credit analysis involves a review of the recent payment history of the customer's account. For new customers, the personnel in Company P perform a basic credit check of the customer, using reports from a business credit reporting agency. On behalf of Company Q and Company R, Company P performs credit analysis on customers who order clothing from Company Q and Company R, using the same method as Company P uses for itself.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 6. Credit analysis services. (i) Company P, Company Q and Company R lease furniture to retail customers who present a significant credit risk and are generally unable to lease furniture from other providers. As part of its leasing operations, personnel in Company P perform credit analysis on each of the potential lessees. The personnel have developed special expertise in determining whether a particular customer who presents a significant credit risk (as indicated by credit reporting agencies) will be likely to make the requisite lease payments on a timely basis. In order to compensate for the specialized analysis of a customer's default risk, as well as the default risk itself, Company P charges more than the market lease rate charged to customers with average credit ratings. Also, as part of its operations, Company P performs similar credit analysis services for Company Q and Company R, which charge correspondingly high monthly lease payments.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 7. Credit analysis services. (i) Company P is a large full-service bank, which provides products and services to corporate and consumer markets, including unsecured loans, secured loans, lines of credit, letters of credit, conversion of foreign currency, consumer loans, trust services, and sales of certificates of deposit. Company Q makes routine consumer loans to individuals, such as auto loans and home equity loans. Company R makes only business loans to small businesses.

(ii) Company P performs credit analysis and prepares credit reports for itself, as well as for Company Q and Company R. Company P, Company Q and Company R regularly employ these credit reports in the ordinary course of business in making decisions regarding extensions of credit to potential customers (including whether to lend, rate of interest, and loan terms).

(iii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the credit analysis services constitute part of a ''financial transaction'' described in paragraph (b)(3)(ii)(H) of this section. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 8. Data verification services. (i) Company P, Company Q and Company R are manufacturers of industrial supplies. Company P's accounting department performs periodic reviews of the accounts payable information of Company P, Company Q and Company R, and identifies any inaccuracies in the records, such as double-payments and double-charges.

(ii) Assume that these services relating to verification of data are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 9. Data verification services. (i) Company P gathers from unrelated customers information regarding accounts payable and accounts receivable and utilizes its own computer system to analyze that information for purposes of identifying errors in payment and receipts (data mining). Company P is compensated for these services based on a fee that reflects a percentage of amounts collected by customers as a result of the data mining services. These activities constitute a significant portion of Company P's business. Company P performs similar activities for Company Q and Company R by analyzing their accounts payable and accounts receivable records.

(ii) Assume that these services relating to data mining are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 10. Legal services. (i) Company P is a domestic corporation with two wholly-owned foreign subsidiaries, Company Q and Company R. Company P and its subsidiaries manufacture and distribute equipment used by industrial customers. Company P maintains an in-house legal department consisting of attorneys experienced in a wide range of business and commercial matters. Company Q and Company R maintain small legal departments, consisting of attorneys experienced in matters that most frequently arise in the normal course of business of Company Q and Company R in their respective jurisdictions.

(ii) Company P seeks to maintain in-house legal staff with the ability to address the majority of legal matters that arise in the United States with respect to the operations of Company P, as well as any U.S. reporting or compliance obligations of Company Q or Company R. The in-house legal staffs of Company Q and Company R are much more limited. It is necessary for Company P to retain several local law firms to handle litigation and business disputes arising from the activities of Company Q and Company R.

Although Company Q and Company R pay the fees of these law firms, the hiring authority and general oversight of the firms' representation is in the legal department of Company P.

(iii) In determining what portion of the legal expenses of Company P may be allocated to Company Q and Company R, Company P first excludes any expenses relating to legal services that constitute shareholder activities and other items that are not properly analyzed as controlled services. Assume that the remaining services relating to general legal functions performed by in-house legal counsel are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these latter services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 11. Legal services. (i) Company P is a domestic holding company whose operating companies generate electric power for consumers by operating nuclear plants. Company P has several domestic operating companies, including Companies Q and R. Assume that, although Company P owns 100% of the stock of Companies Q and R, the companies do not elect to file a consolidated Federal income tax return with Company P.

(ii) Company P maintains an in-house legal department consisting of experienced attorneys in the areas of Federal utilities regulation, Federal labor and environmental law, securities law, and general commercial law. Companies Q and R maintain their own, smaller in-house legal staffs comprised of experienced attorneys in the areas of state and local utilities regulation, state labor and employment law, and general commercial law. The legal department of Company P performs general oversight of the legal affairs of the company and determines whether a particular matter would be more efficiently handled by the Company P legal department, by the legal staffs in the operating companies, or in rare cases, by retained outside counsel. In general, Company P has succeeded in minimizing duplication and overlap of functions between the legal staffs of the various companies or by retained outside counsel.

(iii) The domestic nuclear power plant operations of Companies Q and R are subject to extensive regulation by the U.S. Nuclear Regulatory Commission (NRC). Operators are required to obtain pre-construction approval, operating licenses, and, at the end of the operational life of the nuclear reactor, nuclear decommissioning certificates. Company P files consolidated financial statements on behalf of itself, as well as Companies Q and R, with the United States Securities and Exchange Commission (SEC). In these SEC filings, Company P discloses that failure to obtain any of these licenses (and the related periodic renewals) or agreeing to licenses on terms less favorable than those granted to competitors would have a material adverse impact on the operations of Company Q or Company R. Company P maintains a group of experienced attorneys that exclusively represents Company Q and Company R before the NRC. Although Company P occasionally hires an outside law firm or industry expert to assist on particular NRC matters, the majority of the work is performed by the specialized legal staff of Company P.

(iv) Certain of the legal services performed by Company P constitute duplicative or shareholder activities that do not confer a benefit on the other companies and therefore do not need to be allocated to the other companies, while certain other legal services are eligible to be charged to Company Q and Company R in accordance with the services cost method.

(v) Assume that the specialized legal services relating to nuclear licenses performed by in-house legal counsel of Company P are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 12. Group of services. (i) Company P, Company Q and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P has an enterprise resource planning (ERP) system that maintains data relating to accounts payable and accounts receivable information for all three companies. Company P's personnel perform the daily operations on this ERP system such as inputting data relating to accounts payable and accounts receivable into the system and extracting data relating to accounts receivable and accounts payable in the form of reports or electronic media and providing those data to all three companies. Periodically, Company P's computer specialists also modify the ERP system to adapt to changing business functions in all three companies. Company P's computer specialists make these changes by either modifying the underlying software program or by purchasing additional software or hardware from unrelated third party vendors.

(ii) Assume that these services relating to accounts payable and accounts receivable are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

(iii) Assume that the services performed by Company P's computer specialists that relate to modifying the ERP system are specifically excluded from the services described in a revenue procedure referenced in paragraph (b)(4) of this section as developing hardware or software solutions (such as systems integration, Web site design, writing computer programs, modifying general applications software, or recommending the purchase of commercially available hardware or software). Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 13. Group of services. (i) Company P manufactures and sells widgets under an exclusive contract to Customer 1. Company Q and Company R sell widgets under exclusive contracts to Customer 2 and Customer 3, respectively. At least one year in advance, each of these customers can accurately forecast its need for widgets. Using these forecasts, each customer over the course of the year places orders for widgets with the appropriate company, Company P, Company Q or Company R. A customer's actual need for widgets seldom deviates from that customer's forecasted need.

(ii) It is most efficient for the PQR Controlled Group companies to manufacture and store an inventory of widgets in advance of delivery. Although all three companies sell widgets, only Company P maintains a centralized warehouse for widgets. Pursuant to a contract, Company P provides storage of these widgets to Company Q and Company R at an arm's length price.

(iii) Company P's personnel also obtain orders from all three companies customers to draw up purchase orders for widgets as well as make payment to suppliers for widget replacement parts. In addition, Company P's personnel use data entry to input information regarding orders and sales of widgets and replacement parts for all three companies into a centralized computer system. Company P's personnel also maintain the centralized computer system and extract data for all three companies when necessary.

(iv) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 14. Group of services. (i) Company P, Company Q and Company R assemble and sell gadgets to unrelated customers. Each of these companies purchases the components necessary for assembly of the gadgets from unrelated suppliers. As a service to its subsidiaries, Company P's personnel obtain orders for components from all three companies, prepare purchase orders, and make payment

to unrelated suppliers for the components. In addition, Company P's personnel use data entry to input information regarding orders and sales of gadgets for all three companies into a centralized computer. Company P's personnel also maintain the centralized computer system and extract data for all three companies on an as-needed basis. The services provided by Company P personnel, in conjunction with the centralized computer system, constitute a state-of-the-art inventory management system that allows Company P to order components necessary for assembly of the gadgets on a ''just-in-time'' basis.

(ii) Unrelated suppliers deliver the components directly to Company P, Company Q and Company R. Each of the companies stores the components in its own facilities for use in filling specific customer orders. The companies do not maintain any inventory that is not identified in specific customer orders. Because of the efficiencies associated with services provided by personnel of Company P, all three companies are able to significantly reduce their inventory-related costs. Company P's Chief Executive Officer makes a statement in one of its press conferences with industry analysts that its inventory management system is critical to the company's success.

(iii) Assume that these services that relate to tracking purchase and sales of inventory are specified covered services within the meaning of paragraph (b)(4)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 15. Low margin covered services. Company P renders certain accounting services to Company S. Company P uses the services cost method for the accounting services, and determines the amount charged as Company P's total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm's length markups on total services costs is between 3% and 6%, and the median is 4%. Because the median comparable markup on total services costs is 4%, which is less than 7%, the accounting services constitute low margin covered services within the meaning of paragraph (b)(4)(ii) of this section.

Example 16. Low margin covered services. Company P performs logistics-coordination services for its subsidiaries, including Company S. Company P uses the services cost method for the logistics services, and determines the amount charged as Company P's total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm's length markups on total services costs is between 6% and 13%, and the median is 9%. Because the median comparable markup on total services costs is 9%, which exceeds 7%, the logistics-coordination services do not constitute low margin covered services within the meaning of paragraph (b)(4)(ii) of this section. With respect to the determination and application of the interquartile range, see § 1.482–1(e)(2)(iii)(C).

Example 17. Low margin covered services. Company P performs certain custodial and maintenance services for certain office properties owned by Company S. Company P uses the services cost method for the services, and determines the amount charged as Company P's total cost of providing the services plus no markup. Uncontrolled comparables perform a similar range of custodial and maintenance services for uncontrolled parties and charge those parties an annual fee based on the total square footage of the property. These transactions meet the criteria for application of the comparable uncontrolled services price method of paragraph (c) of this section. The arm's length price for the custodial and maintenance services is determined under the general section 482 regulations without regard to this paragraph (b), using the interquartile range described in § 1.482–1(e)(2)(iii)(C) and as necessary adjusting to the median of such interquartile range. Based on reliable accounting information, the total services costs (as defined in paragraph (j) of this section) attributable to the custodial and maintenance services are subtracted from such price. The resulting excess of such price of the controlled services transaction over total services costs, as expressed as a percentage of total services costs, is determined to be 4%. Because the median comparable markup on total services costs as determined by an application of the section 482 regulations without regard to this paragraph (b) is 4%, which is less than 7%, the custodial and maintenance services constitute low margin covered services within the meaning of paragraph (b)(4)(ii) of this section.

Example 18. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized data processing facility that performs automated invoice processing and order generation for all of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from the centralized data processing services, the total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefits shares, because value of merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.

(iii) The total volume of orders and invoices processed may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the data processing services. Alternatively, depending on the facts and circumstances, total central processing unit time attributable to the transactions of each subsidiary may provide a more reliable basis on which to evaluate the shares of reasonably anticipated benefits.

Example 19. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized center that performs human resources functions, such as administration of pension, retirement, and health insurance plans that are made available to employees of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from these centralized services, the total revenues of each subsidiary may not provide the most reliable measure of reasonably anticipated benefit shares, because total revenues do not bear a relationship to the shares of reasonably anticipated benefits from the underlying services.

(iii) Employee headcount or total compensation paid to employees may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the covered services.

Example 20. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Under that method, Company P determines the amount charged for these services pursuant to a shared services arrangement based on an application of paragraph (b)(5) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(4)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Companies X, Y and Z reasonably anticipate benefits from service A. Company P does not reasonably anticipate benefits from service A. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to § 1.482–9T(k) to Company X, Y and Z for service A is as follows:

SERVICE A

[Total cost 300]

Company	
X	150
Y	75
Z	75

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600 employees.
Company Y—250 employees.
Company Z—250 employees.

(iv) Company P allocates the 300 total services costs of service A based on employee headcount as follows:

SERVICE A

[Total cost 300]

Allocation key	Company	
	Headcount	Amount
X	600	164
Y	250	68

SERVICE A—Continued

[Total cost 300]

Allocation key	Company	
	Headcount	Amount
Z	250	68

(v) Based on these facts, Company P may reasonably conclude that the employee headcount allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service A.

Example 21. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs accounts payable services (service B) on behalf of the PXYZ Group and determines the amount charged for the services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(5) of this section. Service B is a specified covered service described in a revenue procedure pursuant to paragraph (b)(4)(i) of this section. The total services costs for service B otherwise determined under the services cost method is 500.

(ii) Companies X, Y and Z reasonably anticipate benefits from service B. Company P does not reasonably anticipate benefits from service B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to § 1.482–9T(k) to Companies X, Y and Z for service B is as follows:

SERVICE B

[Total cost 500]

Company	
X	125
Y	205
Z	170

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600.
Company Y—200.
Company Z—200.

(iv) The total number of transactions (transaction volume) with uncontrolled customers by each company is as follows:

Company X—2,000.
Company Y—4,000.
Company Z—3,500.

(v) If Company P allocated the 500 total services costs of service B based on employee headcount, the resulting allocation would be as follows:

SERVICE B

[Total cost 500]

Allocation key	Company	
	Headcount	Amount
X	600	300
Y	200	100
Z	200	100

(vi) In contrast, if Company P used volume of transactions with uncontrolled customers as the allocation basis under the shared services arrangement, the allocation would be as follows:

SERVICE B

[Total cost 500]

Allocation key	Company	
	Transaction volume	Amount
X	2,000	105
Y	4,000	211
Z	3,500	184

(vi) Based on these facts, Company P may reasonably conclude that the transaction volume, but not the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service B.

Example 22. Shared services arrangement and aggregation. (i) Company P performs human resource services (service A) and accounts payable services (service B) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(5) of this section. Service A and service B are specified covered services described in a revenue procedure pursuant to paragraph (b)(4)(i) of this section. The total services costs otherwise determined under the services cost method for service A is 300 and for service B is 500; total services costs for services A and B are 800. Company P determines that aggregation of services A and B for purposes of the arrangement is appropriate.

(ii) Companies X, Y and Z reasonably anticipate benefits from services A and B. Company P does not reasonably anticipate benefits from services A and B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to § 1.482–9T(k) to Companies X, Y and Z for services A and B is as follows:

SERVICES A AND B

[Total cost 800]

Company	
X	350
Y	100
Z	350

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.
Company Y—4,000.
Company Z—4,000.

(iv) The total number of employees in each company is as follows:

Company X—600.
Company Y—200.
Company Z—200.

(v) If Company P allocated the 800 total services costs of services A and B based on transaction volume or employee headcount, the resulting allocation would be as follows:

AGGREGATED SERVICES AB

[Total cost 800]

Company	Allocation key		Allocation key	
	Transaction volume	Amount	Headcount	Amount
X	2,000	160	600	480
Y	4,000	320	200	160
Z	4,000	320	200	160

(vi) In contrast, if aggregated services AB were allocated reference to the total U.S. dollar value of sales to uncontrolled parties (trade sales) by each company, the following results would obtain:

AGGREGATED SERVICES AB

[Total costs 800]

Company	Allocation key	
	Trade sales (millions)	Amount
X	$400	314
Y	120	94
Z	500	392

(vii) Based on these facts, Company P may reasonably conclude that the trade sales, but not the transaction volume or the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services AB.

Example 23. Shared services arrangement and aggregation. (i) Company P performs services A through P on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(5) of this section. All of these services A through Z constitute either specified covered services or low margin covered services described in paragraph (b)(4) of this section. The total services costs for services A through Z otherwise determined under the services cost method is 500. Company P determines that aggregation of services A through Z for purposes of the arrangement is appropriate.

(ii) Companies X and Y reasonably anticipate benefits from services A through Z and Company Z reasonably anticipates benefits from services A through X but not from services Y or Z (Company Z performs services similar to services Y and Z on its own behalf). Company P does not reasonably anticipate benefits from services A through Z. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to § 1.482–9T(k) to Company X, Y and Z for services A through Z is as follows:

Company	Services A–M (cost 490)	Services N–P (cost 10)	Services A–P (total cost 500)
X	90	5	95
Y	240	5	245
Z	160	.....	160

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.

Company Y—4,500.

Company Z—3,500.

(iv) Company P allocates the 500 total services costs of services A through Z based on transaction volume as follows:

AGGREGATED SERVICES A–Z

[Total costs 500]

Company	Allocation key	
	Transaction volume	Amount
X	2,000	100
Y	4,500	225
Z	3,500	175

(v) Based on these facts, Company P may reasonably conclude that the transaction volume allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services A through Z.

Example 24. Renderer reasonably anticipates benefits. (i) Company P renders services on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method. Company P's share of reasonably anticipated benefits from services A, B, C, and D is 20% of the total reasonably anticipated benefits of all participants. Company P's total services cost for services A, B, C, and D charged within the Group is 100.

(ii) Based on an application of paragraph (b)(5) of this section, Company P charges 80 which is allocated among Companies X, Y and Z. No charge is made to Company P under the shared services arrangement for activities that it performs on its own behalf.

Example 25. Coordination with cost sharing arrangement. (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(5) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(4)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Company X, Y, Z and P reasonably anticipate benefits from service A. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the total charge of 300 is allocated as follows:

X—100.

Y—50.

Z—25.

P—125.

(iii) In addition to performing services, P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000.

(iv) Companies P and X enter into a cost sharing arrangement in accordance with § 1.482–7. Under the arrangement, Company P will undertake all intangible development activities. All of Company P's research and development (R&D) activity is devoted to the intangible development activity under the cost sharing arrangement. Company P will manufacture, market, and otherwise exploit the product in its defined territory. Companies P and X will share intangible development costs in accordance with their reasonably anticipated benefits from the intangibles, and Company X will make payments to Company P as required under § 1.482–7. Company X will manufacture, market, and otherwise exploit the product in the rest of the world.

(v) A portion of the charge under the shared services arrangement is in turn allocable to the intangible development activity undertaken by Company P. The most reliable estimate of the proportion allocable to the intangible development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (Company P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's charge of 125, or 42, is allocated to the intangible development activity. Companies P and X must share the intangible development costs of the cost shared intangibles (including the charge of 42 that is allocated under the shared services arrangement) in proportion to their respective shares of reasonably anticipated benefits under the cost sharing arrangement. That is, the reasonably anticipated benefit shares under the cost sharing arrangement are determined separately from reasonably anticipated benefit shares under the shared services arrangement.

Example 26. Coordination with cost sharing arrangement. (i) The facts and analysis are the same as in *Example 25*, except that Company X also performs intangible development activities related to the cost sharing arrangement. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the 300 of service costs is allocated as follows:

X—100.

Y—50.

Z—25.

P—125.

(ii) In addition to performing services, Company P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000. Company X undertakes 400 of R&D and incurs manufacturing and other costs of 600.

(iii) Companies P and X enter into a cost sharing arrangement in accordance with § 1.482–7. Under the arrangement, both

Companies P and X will undertake intangible development activities. All of the research and development activity conducted by Companies P and X is devoted to the intangible development activity under the cost sharing arrangement. Both Companies P and X will manufacture, market, and otherwise exploit the product in their respective territories and will share intangible development costs in accordance with their reasonably anticipated benefits from the intangibles, and both will make payments as required under § 1.482–7.

(iv) A portion of the charge under the shared services arrangement is in turn allocable to the intangible development activities undertaken by Companies P and X. The most reliable estimate of the portion allocable to Company P's intangible development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's allocated services cost method charge of 125, or 42, is allocated to its intangible development activity.

(v) In addition, it is necessary to determine the portion of the charge under the shared services arrangement to Company X that should be further allocated to Company X's intangible development activities under the cost sharing arrangement. The most reliable estimate of the portion allocable to Company X's intangible development activity is 400 (Company X's R&D expenses) divided by 1,000 (Company X's costs), or 40%. Accordingly, 40% of the 100 that was allocated to Company X, or 40, is allocated in turn to Company X's intangible development activities. Company X makes a payment to Company P of 100 under the shared services arrangement and includes 40 of services cost method charges in the pool of intangible development costs.

(vi) The parties' respective contributions to intangible development costs under the cost sharing arrangement are as follows:
P: 500 + (0.333 * 125) = 542
X: 400 + (0.40 * 100) = 440

(c) *Comparable uncontrolled services price method*—(1) *In general.* The comparable uncontrolled services price 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. The comparable uncontrolled services price method is ordinarily used where the controlled services either are identical to or have a high degree of similarity to the services in the uncontrolled transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from 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 § 1.482–1(c). The application of these factors under the comparable uncontrolled services price method is discussed in paragraphs (c)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of § 1.482–1(d). Although all of the factors described in § 1.482–1(d)(3) must be considered, similarity of the services rendered, and of the intangibles (if any) used in performing the services, generally will have the greatest effects on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of § 1.482–1(d)(2). Specific examples of factors that may be particularly relevant to application of this method include—

(*1*) Quality of the services rendered;

(*2*) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and whether costs were incurred without a provision for current reimbursement);

(*3*) Intangibles (if any) used in rendering the services;

(*4*) Geographic market in which the services are rendered or received;

(*5*) Risks borne (for example, costs incurred to render the services, without provision for current reimbursement);

(*6*) Duration or quantitative measure of services rendered;

(*7*) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and

(*8*) Alternatives realistically available to the renderer and the recipient.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled services price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482–1(c) (best method rule).

(3) *Arm's length range.* See § 1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Internal comparable uncontrolled services price. Company A, a United States corporation, performs shipping, stevedoring, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of $60 per container to place loaded cargo containers in Country X on oceangoing vessels for marine transportation. Company A also performs identical services in Country X for its wholly-owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled transactions. In evaluating the appropriate measure of the arm's length price for the container-loading services performed for Company B, because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the comparable uncontrolled services price constitutes the best method for determining the arm's length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in comparable uncontrolled transactions, a loading charge of $60 per cargo container will be considered the most reliable measure of the arm's length price for the services rendered to Company B. See paragraph (c)(2)(ii)(A) of this section.

Example 2. External comparable uncontrolled services price. (i) The facts are the same as in *Example 1*, except that Company A performs services for Company B, but not for uncontrolled parties. Based on information obtained from unrelated parties (which is determined to be reliable under the comparability standards set forth in paragraph (c)(2) of this section), it is determined that uncontrolled parties in Country X perform services comparable to those rendered by Company A to Company

B, and that such parties charge $60 per cargo container.

(ii) In evaluating the appropriate measure of an arm's length price for the loading services that Company A renders to Company B, the $60 per cargo container charge is considered evidence of a comparable uncontrolled services price. See paragraph (c)(2)(ii)(A) of this section.

Example 3. External comparable uncontrolled services price. The facts are the same as in *Example 2*, except that uncontrolled parties in Country X render similar loading and stevedoring services, but only under contracts that have a minimum term of one year. If the difference in the duration of the services has a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of § 1.482–1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Use of valuable intangibles. (i) Company A, a United States corporation in the biotechnology sector, renders research and development services exclusively to its affiliates. Company B is Company A's wholly-owned subsidiary in Country X. Company A renders research and development services to Company B.

(ii) In performing its research and development services function, Company A uses proprietary software that it developed internally. Company A uses the software to evaluate certain genetically engineered compounds developed by Company B. Company A owns the copyright on this software and does not license it to uncontrolled parties.

(iii) No uncontrolled parties can be identified that perform services identical or with a high degree of similarity to those performed by Company A. Because there are material differences for which reliable adjustments cannot be made, the comparable uncontrolled services price method is unlikely to provide a reliable measure of the arm's length price. See paragraph (c)(2)(ii)(A) of this section.

Example 5. Internal comparable. (i) Company A, a United States corporation, and its subsidiaries render computer consulting services relating to systems integration and networking to business clients in various countries. Company A and its subsidiaries render only consulting services, and do not manufacture computer hardware or software nor distribute such products. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for each category of employee. The company also charges, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. The Company has established the following schedule of hourly rates:

Category	Rate
Project managers	$400 per hour.
Technical staff	$300 per hour.

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses): ([100 hrs. × $400/hr.] + [400 hrs. × $300/hr.]) = $40,000 + $120,000 = $160,000.

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of $144,000, (or [75 hrs. × $400/hr.] + [380 hrs. × $300/hr.] = $30,000 + $114,000) may be used as a measure of the arm's length price for the work performed by Company A project mangers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. See paragraph (c)(2)(ii)(A) of this section.

Example 6. Adjustments for differences. (i) The facts are the same as in *Example 5*, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources required to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A's portion of the engagement results in fees of $144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A $144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In addition, Company A's records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm's length, it is determined that no adjustments to the intercompany service charge are warranted. See § 1.482–1(d)(3)(ii) and paragraph (c)(2)(ii)(A) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction*—(i) *In general.* The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(ii) *Example.* The following example illustrates this paragraph (c)(5):

Example. Indirect evidence of comparable uncontrolled services price. (i) Company A is a United States insurance company. Company A's wholly-owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which relies on the gross value of the policies in the customer's portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors' programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).

(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer's portfolio together with other factors, the prices charged in Company B's uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm's length price for the

studies performed by Company B for Company A, Company B's proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm's length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(d) *Gross services margin method*—(1) *In general.* The gross services margin method 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 ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

(2) *Determination of arm's length price*—(i) *In general.* The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

(ii) *Relevant uncontrolled transaction.* The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) *Applicable uncontrolled price.* The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

(iv) *Appropriate gross services profit.* The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in § 1.482–1(d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) *Arm's length range.* See § 1.482–1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from 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 § 1.482–1(c). The application of these factors under the gross services margin method is discussed in paragraphs (d)(3)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of § 1.482–1(d). A gross services profit provides compensation for services or functions that bear a relationship to the relevant uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. Therefore, although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties. In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions.

(B) *Other comparability factors.* Comparability under this method is not dependent on close similarity of the relevant uncontrolled transaction to the related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the relevant uncontrolled transaction and the relevant transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the relevant uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective relevant transactions. Thus, it ordinarily would be expected that the services or functions performed in the controlled and uncontrolled transactions would be with respect to relevant transactions involving the transfer of property within the same product categories or the provision of services of the same general type (for example, information-technology systems design). Furthermore, significant differences in the intangibles (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions of § 1.482–1(d)(2). For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services

profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include—

(*1*) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(*2*) Intangibles (if any) used in performing the services or function;

(*3*) Geographic market in which the services or function are performed or in which the relevant uncontrolled transaction takes place; and

(*4*) Risks borne, including, if applicable, inventory-type risk.

(D) *Buy-sell distributor.* If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the gross services margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482–1(c) (best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

(4) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

Example 1. Agent services. Company A and Company B are members of a controlled group. Company A is a foreign manufacturer of industrial equipment. Company B is a U.S. company that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the U.S. market. Company B does not take title to the equipment but instead receives from Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated foreign manufacturers to unrelated purchasers in the U.S. market. Company B charges these unrelated foreign manufacturers a commission fee of 5% of the sales price charged by the unrelated foreign manufacturers to the unrelated U.S. purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated foreign manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. If the comparable gross services profit margin is 5% of the price charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to 5% of the applicable uncontrolled price charged by Company A in sales of equipment in the relevant uncontrolled transactions.

Example 2. Agent services. The facts are the same as in *Example 1*, except that Company B does not act as a commission agent for unrelated parties and it is not possible to obtain reliable information concerning commission rates charged by uncontrolled commission agents that engage in comparable transactions with respect to relevant sales of property. It is possible, however, to obtain reliable information regarding the gross profit margins earned by unrelated parties that briefly take title to and then resell similar property in uncontrolled transactions, in which they purchase the property from foreign manufacturers and resell the property to purchasers in the U.S. market. Analysis of the facts and circumstances indicates that, aside from certain minor differences for which adjustments can be made, the uncontrolled parties that resell property perform similar functions and assume similar risks as Company B performs and assumes when it acts as a commission agent for Company A's sales of property. Under these circumstances, the gross profit margin earned by the unrelated distributors on the purchase and resale of property may be used, subject to any adjustments for any material differences between the controlled and uncontrolled transactions, as a comparable gross services profit margin. The appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is therefore equal to this comparable gross services margin, multiplied by the applicable uncontrolled price charged by Company A in its sales of equipment in the relevant uncontrolled transactions.

Example 3. Agent services. (i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation that renders computer consulting services, including systems integration and networking, to business clients.

(ii) In undertaking engagements with clients, Company A in some cases pays a commission of 3% of its total fees to unrelated parties that assist Company A in obtaining consulting engagements. Typically, such fees are paid to non-computer consulting firms that provide strategic management services for their clients. When Company A obtains a consulting engagement with a client of a non-computer consulting firm, Company A does not subcontract with the other consulting firm, nor does the other consulting firm play any role in Company A's consulting engagement.

(iii) Company B, a Country X subsidiary of Company A, assists Company A in obtaining an engagement to perform computer consulting services for a Company B banking industry client in Country X. Although Company B has an established relationship with its Country X client and was instrumental in arranging for Company A's engagement with the client, Company A's particular expertise was the primary consideration in motivating the client to engage Company A. Based on the relative contributions of Companies A and B in obtaining and undertaking the engagement, Company B's role was primarily to facilitate the consulting engagement between Company A and the Country X client. Information regarding the commissions paid by Company A to unrelated parties for providing similar services to facilitate Company A's consulting engagements is sufficiently complete to conclude that it is likely that all material differences between these uncontrolled transactions and the controlled transaction between Company B and Company A have been identified and that appropriate adjustments have been made for any such differences. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company A in its relevant uncontrolled consulting engagement with Company B's client.

Example 4. Intermediary function. (i) The facts are the same as in *Example 3,* except that Company B contracts directly with its Country X client to provide computer consulting services and Company A performs the consulting services on behalf of Company B. Company A does not enter into a consulting engagement with Company B's Country X client. Instead, Company B charges its Country X client an uncontrolled price for the consulting services, and Company B pays a portion of the uncontrolled price to Company A for performing the consulting services on behalf of Company B.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the consulting contract indicates that Company B functioned primarily as an intermediary contracting party, and the gross services margin method is the most reliable method for determining the amount that Company B may retain as compensation for its intermediary function with respect to Company A's consulting services. In this case, therefore, because Company B entered into the relevant uncontrolled transaction to provide services, Company B receives the applicable uncontrolled price that is paid by the Country X client for the consulting services. Company A technically performs

services for Company B when it performs, on behalf of Company B, the consulting services Company B contracted to provide to the Country X client. The arm's length amount that Company A may charge Company B for performing the consulting services on Company B's behalf is equal to the applicable uncontrolled price received by Company B in the relevant uncontrolled transaction, less Company B's appropriate gross services profit, which is the amount that Company B may retain as compensation for performing the intermediary function.

(iii) Reliable data concerning the commissions that Company A paid to uncontrolled parties for assisting it in obtaining engagements to provide consulting services similar to those it has provided on behalf of Company B provide useful information in applying the gross services margin method. However, consideration should be given to whether the third party commission data may need to be adjusted to account for any additional risk that Company B may have assumed as a result of its function as an intermediary contracting party, compared with the risk it would have assumed if it had provided agent services to assist Company A in entering into an engagement to provide its consulting service directly. In this case, the information regarding the commissions paid by Company A to unrelated parties for providing agent services to facilitate its performance of consulting services for unrelated parties is sufficiently complete to conclude that all material differences between these uncontrolled transactions and the controlled performance of an intermediary function, including possible differences in the amount of risk assumed in connection with performing that function, have been identified and that appropriate adjustments have been made. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in Company B's relevant uncontrolled transactions, then the appropriate gross services profit that Company B may retain as compensation for performing an intermediary function (and the amount, therefore, that is deducted from the applicable uncontrolled price to arrive at the arm's length price that Company A may charge Company B for performing consulting services on Company B's behalf) is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company B in its contract to provide services to the uncontrolled party.

Example 5. External comparable. (i) The facts are the same as in *Example 4,* except that neither Company A nor Company B engages in transactions with third parties that facilitate similar consulting engagements.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the contract indicates that Company B's role was primarily to facilitate the consulting arrangement between Company A and the Country X client. Although no reliable internal data are available regarding comparable transactions with uncontrolled entities, reliable data exist regarding commission rates for similar facilitating services between uncontrolled parties. These data indicate that a 3% commission (3% of total engagement fee) is charged in such transactions. Information regarding the uncontrolled comparables is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the appropriate gross services profit margin is 3% of total fees, then an arm's length result of the controlled services transaction is for Company B to retain an amount equal to 3% of total fees paid to it.

(e) *Cost of services plus method*—(1) *In general.* 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 markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. This method is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement, as described in paragraph (i)(2) of this section.

(2) *Determination of arm's length price*—(i) *In general.* The cost of services plus method measures an arm's length price by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

(ii) *Appropriate gross services profit.* The appropriate gross services profit is computed by multiplying the controlled taxpayer's comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

(iii) *Comparable transactional costs.* Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such services, and may include as well other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (j) of this section, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities are available) may provide useful guidance but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) *Arm's length range.* See § 1.482–1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* 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 § 1.482–1(c).

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482–1(d). A service renderer's gross services profit provides compensation for performing services related to the controlled services transaction under review, including an operating profit for the service renderer's investment of capital and assumptions of risks. Therefore, although all of the factors described in § 1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers. If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, in evaluating comparability the controlled taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer, because differences in functions performed may be reflected in differences in service costs other than

those included in comparable transactional costs.

(B) *Other comparability factors.* Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve services of the same general type (for example, information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer's comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the value of the services rendered, due for example to the use of valuable intangibles, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between the controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the provisions of § 1.482–1(d)(2). For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) The complexity of the services;

(*2*) The duration or quantitative measure of services;

(*3*) Contractual terms (for example, scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);

(*4*) Economic circumstances; and

(*5*) Risks borne.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the cost of services plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (e)(3)(iii)(B), the term comparable transactional costs includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm's length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

(4) *Examples.* The principles of this paragraph (e) are illustrated by the following examples:

Example 1. Internal comparable. (i) Company A designs and assembles information-technology networks and systems. When Company A renders services for uncontrolled parties, it receives compensation based on time and materials as well as certain other related costs necessary to complete the project. This fee includes the cost of hardware and software purchased from uncontrolled vendors and incorporated in the final network or system, plus a reasonable allocation of certain specified overhead costs incurred by Company A in providing these services. Reliable accounting records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its time, materials and specified overhead in providing design services during the year under examination on information technology projects for uncontrolled entities.

(ii) Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records (which are determined to be reliable under paragraph (e)(3) of this section), it is possible to identify the comparable transactional costs involved in the controlled services transaction with reference to the costs incurred by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's length result for the controlled services transaction is equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

Example 2. Inability to adjust for differences in comparable transactional costs. The facts are the same as in *Example 1,* except that Company A's staff that rendered the services to Company B consisted primarily of engineers in training status or on temporary rotation from other Company A subsidiaries. In addition, the Company B network incorporated innovative features, including specially designed software suited to Company B's requirements. The use of less-experienced personnel and staff on temporary rotation, together with the special features of the Company B network, significantly increased the time and costs associated with the project as compared to time and costs associated with similar projects completed for uncontrolled customers. These factors constitute material differences between the controlled and the uncontrolled transactions that affect the determination of Company A's comparable transactional costs associated with the controlled services transaction, as well as the gross services profit markup. Moreover, it is not possible to perform reliable adjustments for these differences on the basis of the available accounting data. Under these circumstances, the reliability of the cost of services plus method as a measure of an arm's length price is substantially reduced.

Example 3. Operating loss by reference to total services costs. The facts and analysis are the same as in *Example 1,* except that an unrelated Company C, instead of Company A, renders similar services to uncontrolled parties and publicly available information indicates that Company C earned a gross services profit markup of 10% on its time, materials and certain specified overhead in providing those services. As in *Example 1,* Company A still provides services for its Country X subsidiary, Company B. In accordance with the requirements in paragraph (e)(3)(ii) of this section, the

taxpayer performs additional analysis and restates the results of Company A's controlled services transaction with its Country X subsidiary, Company B, in the form of a markup on Company A's total services costs. This analysis by reference to total services costs shows that Company A generated an operating loss on the controlled services transaction, which indicates that functional differences likely exist between the controlled services transaction performed by Company A and uncontrolled services transactions performed by Company C, and that these differences may not be reflected in the comparable transactional costs. Upon further scrutiny, the presence of such functional differences between the controlled and uncontrolled transactions may indicate that the cost of services plus method does not provide the most reliable measure of an arm's length result under the facts and circumstances.

Example 4. Internal comparable. (i) Company A, a U.S. corporation, and its subsidiaries perform computer consulting services relating to systems integration and networking for business clients in various countries. Company A and its subsidiaries render only consulting services and do not manufacture or distribute computer hardware or software to clients. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) On some occasions, Company A and its subsidiaries undertake engagements directly for clients. On other occasions, they work as subcontractors for uncontrolled parties on more extensive consulting engagements for clients. In undertaking the latter engagements with third-party consultants, Company A typically prices its services at four times the compensation costs of its consultants, defined as the consultants' base salary plus estimated fringe benefits, as defined in this table:

Category	Rates
Project managers	$100 per hour.
Technical staff	$75 per hour.

(iii) In uncontrolled transactions, Company A also charges the customer, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of (100 hrs. × $100/hr.) + (400 hrs. × $75/hr.) = $10,000 + $30,000 = $40,000. Applying the markup of 300%, the total fee charged would thus be (4 × $40,000), or $160,000, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm's length result for the controlled services transaction is equal to $144,000. This is calculated as follows: [4 × (75 hrs. × $100/hr.)] + [4 × (380 hrs. × $75/hr.)] = $30,000 + $114,000 = $144,000, reflecting a 4× markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A's pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(f) *Comparable profits method*—(1) *In general.* The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in § 1.482–5 relating to the comparable profits method apply to controlled services transactions, except as modified in this paragraph (f).

(2) *Determination of arm's length result*—(i) *Tested party.* This paragraph (f) applies where the relevant business activity of the tested party as determined under § 1.482–5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under § 1.482–5(b)(2) is instead the recipient of the controlled services, the rules under this paragraph (f) are not applicable to determine the arm's length result.

(ii) *Profit level indicators.* In addition to the profit level indicators provided in § 1.482–5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting.* Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as ''cost of goods sold'' and ''selling, general, and administrative expenses.'' Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in § 1.482–5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) *Examples.* The principles of this paragraph (f) are illustrated by the following examples:

Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator. (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under § 1.482–5(c). Neither Company A nor the comparable companies use valuable intangibles in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

Example 2. Application of the operating profit to total services costs profit level indicator. (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its year 1 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company B incurs in performing the consulting services and do not make use of valuable intangibles or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables report only an aggregate figure for costs of goods sold and operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 1 through 3, Company B shows the following results for the services performed for Company A:

	Year 1	Year 2	Year 3	Average
Revenues	1,200,000	1,100,000	1,300,000	1,200,000
Cost of Goods Sold	100,000	100,000	(*)	66,667
Operating Expenses	1,100,000	1,000,000	1,300,000	1,133,333
Operating Profit	0	0	0	0

* N/A.

(v) After adjustments have been made to account for identified material differences between the relevant business activity of Company B and the comparables, the average ratio for the taxable years 1 through 3 of operating profit to total services costs is calculated for each of the uncontrolled service providers. Applying each ratio to Company B's average total services costs from the relevant business activity for the taxable years 1 through 3 would lead to the following comparable operating profit (COP) for the services rendered by Company B:

Uncontrolled service provider	OP/total service costs (%)	Company B COP
Company 1	15.75	$189,000
Company 2	15.00	180,000
Company 3	14.00	168,000
Company 4	13.30	159,600
Company 5	12.00	144,000
Company 6	11.30	135,600
Company 7	11.25	135,000
Company 8	11.18	134,160
Company 9	11.11	133,320
Company 10	10.75	129,000

(vi) The available data are not sufficiently complete to conclude that it is likely that all material differences between the relevant business activity of Company B and the comparables have been identified. Therefore, an arm's length range can be established only pursuant to § 1.482–1(e)(2)(iii)(B). The arm's length range is established by reference to the interquartile range of the results as calculated under § 1.482–1(e)(2)(iii)(C), which consists of the results ranging from $168,000 to $134,160. Company B's reported average operating profit of zero ($0) falls outside this range. Therefore, an allocation may be appropriate.

(vii) Because Company B reported income of zero, to determine the amount, if any, of the allocation, Company B's reported operating profit for year 3 is compared to the comparable operating profits derived from the comparables' results for year 3. The ratio of operating profit to total services costs in year 3 is calculated for each of the comparables and applied to Company B's year 3 total services costs to derive the following results:

Uncontrolled service provider	OP/total service costs (for year 3) (%)	Company B COP
Company 1	15.00	$195,000
Company 2	14.75	191,750
Company 3	14.00	182,000
Company 4	13.50	175,500
Company 5	12.30	159,900
Company 6	11.05	143,650
Company 7	11.03	143,390
Company 8	11.00	143,000
Company 9	10.50	136,500

Uncontrolled service provider	OP/total service costs (for year 3) (%)	Company B COP
Company 10	10.25	133,250

(viii) Based on these results, the median of the comparable operating profits for year 3 is $151,775. Therefore, Company B's income for year 3 is increased by $151,775, the difference between Company B's reported operating profit for year 3 of zero and the median of the comparable operating profits for year 3.

Example 3. Material difference in accounting for stock-based compensation. (i) Taxpayer, a U.S. corporation the stock of which is publicly traded, performs controlled services for its wholly-owned subsidiaries. The arm's length price of these controlled services is evaluated under the comparable profits method for services in this paragraph, by reference to the net cost plus profit level indicator (PLI). Taxpayer is the tested party under paragraph (f)(2)(i) of this section. The Commissioner identifies the most narrowly identifiable business activity of the tested party for which data are available that incorporate the controlled transaction (the relevant business activity). The Commissioner also identifies four uncontrolled domestic service providers, Companies A, B, C, and D, each of which performs exclusively activities similar to the relevant business activity of Taxpayer that is subject to analysis under this paragraph (f). The stock of Companies A, B, C, and D is publicly traded on a U.S. stock exchange. Assume that Taxpayer makes an election to apply these regulations to earlier taxable years.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 500 for the taxable year in question. In evaluating the controlled services, Taxpayer includes salaries, fringe benefits, and related compensation of these employees in ''total services costs,'' as defined in paragraph (j) of this section. Taxpayer does not include any amount attributable to stock options in total services costs, nor does it deduct that amount in determining ''reported operating profit'' within the meaning of § 1.482–5(d)(5), for the year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Under a fair value method in accordance with U.S. generally accepted accounting principles, the comparables include in total compensation the value of the stock options attributable to the employees' performance of the relevant business activity for the annual financial reporting period, and treat this amount as an expense in determining operating profit for financial accounting purposes. The treatment of employee stock options is summarized in the following table.

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	0
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	10,000	4,500	4,500
Company D	15,000	2,000	2,000

(iv) A material difference exists in accounting for stock-based compensation, as defined in § 1.482–7(d)(2)(i). Analysis indicates that this difference would materially affect the measure of an arm's length result under this paragraph (f). In making an adjustment to improve comparability under §§ 1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner includes in total services costs of the tested party the total compensation costs of 1,500 (including stock option fair value). In addition, the Commissioner calculates the net cost plus PLI by reference to the financial-accounting data of Companies A, B, C, and D, which take into account compensatory stock options.

Example 4. Material difference in utilization of stock-based compensation.

(i) The facts are the same as in paragraph (i) of Example 3.

(ii) No stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Thus, no deduction for stock options is made in determining ''reported operating profit'' within the meaning of § 1.482–5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table.

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	0	(*)
Company A	7,000	2,000	0
Company B	4,300	250	0
Company C	12,000	4,500	0
Company D	15,000	2,000	0

* N/A.

(iv) A material difference in the utilization of stock-based compensation exists within the meaning of § 1.482–7(d)(2)(i). Analysis indicates that these differences would materially affect the measure of an arm's length result under this paragraph (f). In evaluating the comparable operating profits of the tested party, the Commissioner uses Taxpayer's total services costs, which include total compensation costs of 1,000. In considering whether an adjustment is necessary to improve comparability under

§§ 1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner recognizes that the total compensation provided to employees of Taxpayer is comparable to the total compensation provided to employees of Companies A, B, C, and D. Because Companies A, B, C, and D do not expense stock-based compensation for financial accounting purposes, their reported operating profits must be adjusted in order to improve comparability with the tested party. The Commissioner increases each comparable's total services costs, and also reduces its reported operating profit, by the fair value of the stock-based compensation incurred by the comparable company.

(v) The adjustments to the data of Companies A, B, C, and D described in paragraph (iv) of this *Example 4* are summarized in the following table:

	Salaries and other non-option compensation	Stock options	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (%)
Per financial statements:					
Company A	7,000	2,000	25,000	6,000	24.00
Company B	4,300	250	12,500	2,500	20.00
Company C	12,000	4,500	36,000	11,000	30.56
Company D	15,000	2,000	27,000	7,000	25.93
As adjusted:					
Company A	7,000	2,000	27,000	4,000	14.80
Company B	4,300	250	12,750	2,250	17.65
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

Example 5. Non-material difference in utilization of stock-based compensation.

(i) The facts are the same as in paragraph (i) of *Example 3.*

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 50 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in ''total services costs,'' as defined in paragraph (j) of this section, and deducts these amounts in determining ''reported operating profit'' within the meaning of § 1.482–5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table.

	Salaries and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	50	50
Company A	7,000	100	0
Company B	4,300	40	0
Company C	10,000	130	0
Company D	15,000	75	0

(iv) Analysis of the data reported by Companies A, B, C, and D indicates that an adjustment for differences in utilization of stock-based compensation would not have a material effect on the determination of an arm's length result.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (%)
Per financial statements:					
Company A	7,000	100	25,000	6,000	24.00
Company B	4,300	40	12,500	2,500	20.00
Company C	12,000	130	36,000	11,000	30.56
Company D	15,000	75	27,000	7,000	25.93
As adjusted:					
Company A	7,000	100	25,100	5,900	23.51
Company B	4,300	40	12,540	2,460	19.62
Company C	12,000	130	36,130	10,870	30.09
Company D	15,000	75	27,075	6,925	25.58

(v) Under the circumstances, the difference in utilization of stock-based compensation would not materially affect the determination of the arm's length result under this paragraph (f). Accordingly, in calculating the net cost plus PLI, no comparability adjustment is made to the data of Companies A, B, C, or D pursuant to §§ 1.482–1(d)(2) and 1.482–5(c)(2)(iv).

Example 6. Material difference in comparables' accounting for stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3.*

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance

with U.S. generally accepted accounting principles, the fair value of such stock options attributable to employees' performance of the relevant business activity is 500 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in ''total services costs,'' as defined in paragraph (j) of this section and deducts these amounts in determining ''reported operating profit'' within the meaning of § 1.482–5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Companies A and B expense the stock options for financial accounting purposes in accordance with U.S. generally accepted accounting principles. Companies C and D do *not* expense the stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies C and D disclose the fair value of these options in their financial statements. The utilization and accounting treatment of options are depicted in the following table.

	Salary and other non-option compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	500
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in accounting for stock-based compensation exists, within the meaning of § 1.482–7(d)(2)(i). Analysis indicates that this difference would materially affect the measure of the arm's length result under paragraph (f) of this section. In evaluating the comparable operating profits of the tested party, the Commissioner includes in total services costs Taxpayer's total compensation costs of 1,500 (including stock option fair value of 500). In considering whether an adjustment is necessary to improve comparability under §§ 1.482–1(d)(2) and 1.482–5(c)(2)(iv), the Commissioner recognizes that the total employee compensation (including stock options provided by Taxpayer and Companies A, B, C, and D) provides a reliable basis for comparison. Because Companies A and B expense stock-based compensation for financial accounting purposes, whereas Companies C and D do not, an adjustment to the comparables' operating profit is necessary. In computing the net cost plus PLI, the Commissioner uses the financial-accounting data of Companies A and B, as reported. The Commissioner increases the total services costs of Companies C and D by amounts equal to the fair value of their respective stock options, and reduces the operating profits of Companies C and D accordingly.

(v) The adjustments described in paragraph (iv) of this Example 6 are depicted in the following table. For purposes of illustration, the unadjusted data of Companies A and B are also included.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (%)
Per financial Statements:					
Company A	7,000	2,000	27,000	4,000	14.80
Company B	4,300	250	12,750	2,250	17.65
As adjusted:					
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

(g) *Profit split method*—(1) *In general.* 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. For application of the profit split method (both the comparable profit split and the residual profit split), see § 1.482–6. The residual profit split method is ordinarily used in controlled services transactions involving a combination of nonroutine contributions by multiple controlled taxpayers.

(2) *Examples.* The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Residual profit split. (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A's database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also take place. 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 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, where it receives information on spare parts available for auction. Company B has also designed a specialized communications network that connects its data center to Company A's data center in Country X. The communications network allows Company B to enter data from uncontrolled companies on Company A's database located in Country X. Company B's communications network also allows uncontrolled companies to access Company A's interactive database and purchase spare parts. Company B bore the risks and cost of developing this specialized communications network. Company B enters into contracts with uncontrolled companies and provides the companies access to Company A's database through the Company B network.

(ii) Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangibles that they use to conduct the spare parts auction business. Company A bore the economic risks of developing and maintaining software and the interactive database. Company B bore the economic risks of developing the necessary technology to transmit information from its server to Company A's data center, and to allow uncontrolled companies to access Company A's database. Company B helped to

enhance the value of Company A's trademark and to establish a network of customers in Country Y. In addition, there are no market comparables for the transactions between Company A and Company B to reliably evaluate them separately. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of an arm's length result.

(iii) Under the residual profit split method, profits are first allocated based on the routine contributions of each taxpayer. Routine contributions include general sales, marketing or administrative functions performed by Company B for Company A for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions of each taxpayer. Since both Company A and Company B provided nonroutine contributions, the residual profits are allocated based on these contributions.

Example 2. Residual profit split. (i) Company A, a Country 1 corporation, provides specialized services pertaining to the processing and storage of Level 1 hazardous waste (for purposes of this example, the most dangerous type of waste). Under long-term contracts with private companies and governmental entities in Country 1, Company A performs multiple services, including transportation of Level 1 waste, development of handling and storage protocols, recordkeeping, and supervision of waste-storage facilities owned and maintained by the contracting parties. Company A's research and development unit has also developed new and unique processes for transport and storage of Level 1 waste that minimize environmental and occupational effects. In addition to this novel technology, Company A has substantial know-how and a long-term record of safe operations in Country 1.

(ii) Company A's subsidiary, Company B, has been in operation continuously for a number of years in Country 2. Company B has successfully completed several projects in Country 2 involving Level 2 and Level 3 waste, including projects with government-owned entities. Company B has a license in Country 2 to handle Level 2 waste (Level 3 does not require a license). Company B has established a reputation for completing these projects in a responsible manner. Company B has cultivated contacts with procurement officers, regulatory and licensing officials, and other government personnel in Country 2.

(iii) Country 2 government publishes invitations to bid on a project to handle the country's burgeoning volume of Level 1 waste, all of which is generated in government-owned facilities. Bidding is limited to companies that are domiciled in Country 2 and that possess a license from the government to handle Level 1 or Level 2 waste. In an effort to submit a winning bid to secure the contract, Company B points to its Level 2 license and its record of successful completion of projects, and also demonstrates to these officials that it has access to substantial technical expertise pertaining to processing of Level 1 waste.

(iv) Company A enters into a long-term technical services agreement with Company B. Under this agreement, Company A agrees to supply to Company B project managers and other technical staff who have detailed knowledge of Company A's proprietary Level 1 remediation techniques. Company A commits to perform under any long-term contracts entered into by Company B. Company B agrees to compensate Company A based on a markup on Company A's marginal costs (pro rata compensation and current expenses of Company A personnel). In the bid on the Country 2 for Level 1 waste, Company B proposes to use a multi-disciplinary team of specialists from Company A and Company B. Project managers from Company A will direct the team, which will also include employees of Company B and will make use of physical assets and facilities owned by Company B. Only Company A and Company B personnel will perform services under the contract. Country 2 grants Company B a license to handle Level 1 waste.

(v) Country 2 grants Company B a five-year, exclusive contract to provide processing services for all Level 1 hazardous waste generated in County 2. Under the contract, Company B is to be paid a fixed price per ton of Level 1 waste that it processes each year. Company B undertakes that all services provided will meet international standards applicable to processing of Level 1 waste. Company B begins performance under the contract.

(vi) Analysis of the facts and circumstances indicates that both Company A and Company B make nonroutine contributions to the Level 1 waste processing activity in Country 2. In addition, it is determined that reliable comparables are not available for the services that Company A provides under the long-term contract, in part because those services incorporate specialized knowledge and process intangibles developed by Company A. It is also determined that reliable comparables are not available for the Level 2 license in Country 2, the successful track record, the government contacts with Country 2 officials, and other intangibles that Company B provided. In view of these facts, the Commissioner determines that the residual profit split method for services in paragraph (g) of this section provides the most reliable means of evaluating the arm's length results for the transaction. In evaluating the appropriate returns to Company A and Company B for their respective contributions, the Commissioner takes into account that the controlled parties incur different risks, because the contract between the controlled parties provides that Company A will be compensated on the basis of marginal costs incurred, plus a markup, whereas the contract between Company B and the government of Country 2 provides that Company B will be compensated on a fixed-price basis per ton of Level 1 waste processed.

(vii) In the first stage of the residual profit split, an arm's length return is determined for routine activities performed by Company B in Country 2, such as transportation, recordkeeping, and administration. In addition, an arm's length return is determined for routine activities performed by Company A (administrative, human resources, etc.) in connection with providing personnel to Company B. After the arm's length return for these functions is determined, residual profits may be present. In the second stage of the residual profit split, any residual profit is allocated by reference to the relative value of the nonroutine contributions made by each taxpayer. Company A's nonroutine contributions include its commitment to perform under the contract and the specialized technical knowledge made available through the project managers under the services agreement with Company B. Company B's nonroutine contributions include its licenses to handle Level 1 and Level 2 waste in Country 2, its knowledge of and contacts with procurement, regulatory and licensing officials in the government of Country 2, and its record in Country 2 of successfully handling non-Level 1 waste.

(h) *Unspecified methods.* Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm's length. Any method used under this paragraph (h) must be applied in accordance with the provisions of § 1.482–1. Consistent with the specified methods, 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 structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction (for example, outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482–1(c). Therefore, in accordance with § 1.482–1(d) (comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be

reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

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

(ii) In evaluating whether the consideration paid by Companies U, V and W to Company T was arm's length, the Commissioner may consider, subject to the best method rule of § 1.482–1(c), Company T's alternative of selling the computer program to Companies U, V and W on a compact disk or via download through the Internet. The Commissioner determines that the controlled services transactions between Company T and Companies U, V and W are comparable to the transfer of a similar software program on a compact disk or via download through the Internet between uncontrolled parties. Subject to adjustments being made for material differences between the controlled services transactions and the comparable uncontrolled transactions, the uncontrolled transfers of tangible property may be used to evaluate the arm's length results for the controlled services transactions between Company T and Companies U, V and W.

(i) *Contingent-payment contractual terms for services*—(1) *Contingent-payment contractual terms recognized in general.* In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction generally would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction generally would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered.

(2) *Contingent-payment arrangement.* For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in paragraph (i)(2)(i) of this section and is consistent with the economic substance and conduct in paragraph (i)(2)(ii) of this section.

(i) *General requirements*—(A) *Written contract.* The arrangement is set forth in a written contract entered into prior to, or contemporaneous with the start of the activity or group of activities constituting the controlled services transaction.

(B) *Specified contingency.* The contract states that payment is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of paragraph (l)(3) of this section) for the recipient directly related to the controlled services transaction.

(C) *Basis for payment.* The contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. Whether the specified contingency bears a direct relationship to the controlled services transaction, and whether the basis for payment reflects the recipient's benefit and the renderer's risk, is evaluated based on all the facts and circumstances.

(ii) *Economic substance and conduct.* The arrangement, including the contingency and the basis for payment, is consistent with the economic substance of the controlled transaction and the conduct of the controlled parties. See § 1.482–1(d)(3)(ii)(B).

(3) *Commissioner's authority to impute contingent-payment terms.* Consistent with the authority in § 1.482–1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) *Evaluation of arm's length charge.* Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this section and other applicable regulations under section 482. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm's length, the charge determined under the rules of §§ 1.482–3 and 1.482–4 for the transfer of similar property may be considered. See § 1.482–1(f)(2)(ii).

(5) *Examples.* The principles of this paragraph (i) are illustrated by the following examples:

Example 1. (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, x% of Company Y's gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in year 4. In year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in years 7 through 9 and Company Y makes the payments to Company X in years 7 through 9 that are required under the agreement.

(iii) The years under examination are years 6 though 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the conditions of paragraph (i)(2) of this section are met and whether the arrangement, including the specified contingency and basis of payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement

represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient's benefit and the renderer's risk. Consistent with § 1.482–1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties' conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. Based on all these facts, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of years 6 through 9 is arm's length, the Commissioner evaluates under this section and other applicable rules under section 482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating whether the compensation of x% of gross sales that is paid to Company X during the first four years of commercial sales of derivative products is arm's length, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

Example 2. (i) The facts are the same as in *Example 1*, except that no commercial sales ever materialize with regard to the patented compound so that, consistent with the agreement, Company Y makes no payments to Company X in years 6 through 9.

(ii) Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance, and the result (no payments in years 6 through 9) is consistent with an arm's length result.

Example 3. (i) The facts are the same as in *Example 1*, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount equal to x% of such costs, with the payment to be made in the first year in which any such sales occur. The x% markup on costs is within the range, ascertainable in year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are years 6 though 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the requirements of paragraph (i)(2) of this section were met at the time the written agreement was entered into and whether the arrangement, including the specified contingency and basis for payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus x%, representing the markup for contract research in the absence of any nonpayment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and § 1.482–1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products developed under the agreement in each of years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under this section and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products that resulted from Company X's research and development activities under the contingent-payment arrangement.

(j) *Total services costs.* For purposes of this section, total services costs means all costs of rendering those services for which total services costs are being determined. Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of paragraph (k)(2) of this section to, the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes (as defined in § 1.901–2(a)), or domestic income taxes.

(k) *Allocation of costs*—(1) *In general.* In any case where the renderer's activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group under this paragraph (k). The principles of this paragraph (k) must also be used whenever it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a

generalized or non-specific benefit be appropriate.

(2) *Appropriate method of allocation and apportionment*—(i) *Reasonable method standard.* Any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) *Use of general practices.* The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner. In determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members in apportioning costs among themselves will also be considered if the relationships with the foreign members are comparable to the relationships among the domestic members of the controlled group. For example, if for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of the controlled group, such domestic apportionment practice will be considered in determining the allocations to be made to the foreign members.

(3) *Examples.* The principles of this paragraph (k) are illustrated by the following examples:

Example 1. Company A pays an annual license fee of 500x to an uncontrolled taxpayer for unlimited use of a database within the corporate group. Under the terms of the license with the uncontrolled taxpayer, Company A is permitted to use the database for its own use and in rendering research services to its subsidiary, Company B. Company B obtains benefits from the database that are similar to those that it would obtain if it had independently licensed the database from the uncontrolled taxpayer. Evaluation of the arm's length charge (under a method in which costs are relevant) to Company B for the controlled services that incorporate use of the database must take into account the full amount of the license fee of 500x paid by Company A, as reasonably allocated and apportioned to the relevant benefits, although the incremental use of the database for the benefit of Company B did not result in an increase in the license fee paid by Company A.

Example 2. (i) Company A is a consumer products company located in the United States. Companies B and C are wholly-owned subsidiaries of Company A and are located in Countries B and C, respectively. Company A and its subsidiaries manufacture products for sale in their respective markets. Company A hires a consultant who has expertise regarding a manufacturing process used by Company A and its subsidiary, Company B. Company C, the Country C subsidiary, uses a different manufacturing process, and accordingly will not receive any benefit from the outside consultant hired by Company A. In allocating and apportioning the cost of hiring the outside consultant (100), Company A determines that sales constitute the most appropriate allocation key.

(ii) Company A and its subsidiaries have the following sales:

Company	A	B	C	Total
Sales	400	100	200	700

(iii) Because Company C does not obtain any benefit from the consultant, none of the costs are allocated to it. Rather, the costs of 100 are allocated and apportioned ratably to Company A and Company B as the entities that obtain a benefit from the campaign, based on the total sales of those entities (500). An appropriate allocation of the costs of the consultant is as follows:

Company	A	B	Total
Allocation	400/500	100/500	
Amount	80	20	100

(l) *Controlled services transaction*—(1) *In general.* A controlled services transaction includes any activity (as defined in paragraph (l)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (l)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

(2) *Activity.* An activity includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.

(3) *Benefit*—(i) *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 confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient 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 for itself the same activity or a similar activity. A benefit may result to the owner of an intangible if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible. Paragraphs (l)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

(ii) *Indirect or remote benefit.* 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 determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) *Duplicative activities.* 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.

(iv) *Shareholder activities.* 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.

(v) *Passive association.* A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(4) *Disaggregation of transactions.* A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled services transaction. See the best method rule under § 1.482–1(c).

(5) *Examples.* The principles of this paragraph (l) are illustrated by the following examples. In each example, assume that Company X is a U.S. corporation and Company Y is a wholly-owned subsidiary of Company X in Country B.

Example 1. In general. In developing a worldwide advertising and promotional campaign for a consumer product, Company X pays for and obtains designation as an official sponsor of the Olympics. This designation allows Company X and all its subsidiaries, including Company Y, to identify themselves as sponsors and to use the Olympic logo in advertising and promotional campaigns. The Olympic sponsorship campaign generates benefits to Company X, Company Y, and other subsidiaries of Company X.

Example 2. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X implements certain changes in its management structure and the compensation of managers of divisions located in the United States. No changes were recommended or considered for Company Y in Country B. The internal study and the resultant changes in its management may increase the competitiveness and overall efficiency of Company X. Any benefits to Company Y as a result of the study are, however, indirect or remote. Consequently, Company Y is not considered to obtain a benefit from the study.

Example 3. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X decides to make changes to the management structure and management compensation of its subsidiaries, in order to increase their profitability. As a result of the recommendations in the study, Company X implements substantial changes in the management structure and management compensation scheme of Company Y. The study and the changes implemented as a result of the recommendations are anticipated to increase the profitability of Company X and its subsidiaries. The increased management efficiency of Company Y that results from these changes is considered to be a specific and identifiable benefit, rather than remote or speculative.

Example 4. Duplicative activities. At its corporate headquarters in the United States, Company X performs certain treasury functions for Company X and for its subsidiaries, including Company Y. These treasury functions include raising capital, arranging medium and long-term financing for general corporate needs, including cash management. Under these circumstances, the treasury functions performed by Company X do not duplicate the functions performed by Company Y's staff. Accordingly, Company Y is considered to obtain a benefit from the functions performed by Company X.

Example 5. Duplicative activities. The facts are the same as in *Example 4,* except that Company Y's functions include ensuring that the financing requirements of its own operations are met. Analysis of the facts and circumstances indicates that Company Y independently administers all financing and cash-management functions necessary to support its operations, and does not utilize financing obtained by Company X. Under the circumstances, the treasury functions performed by Company X are duplicative of similar functions performed by Company Y's staff, and the duplicative functions do not enhance Company Y's position. Accordingly, Company Y is not considered to obtain a benefit from the duplicative activities performed by Company X.

Example 6. Duplicative activities. Company X's in-house legal staff has specialized expertise in several areas, including intellectual property law. Company Y is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. Company Y retains outside counsel that specializes in intellectual property law to review the transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to Company Y and that the contracts are valid and fully enforceable. Before Company Y executes the contracts, the legal staff of Company X also reviews the transaction documents and concurs in the opinion provided by outside counsel. The activities performed by Company X substantially duplicate the legal services obtained by Company Y, but they also reduce the commercial risk associated with the transaction in a way that confers an additional benefit on Company Y.

Example 7. Shareholder activities. Company X is a publicly held corporation. U.S. laws and regulations applicable to publicly held corporations such as Company X require the preparation and filing of periodic reports that show, among other things, profit and loss statements, balance sheets, and other material financial information concerning the company's operations. Company X, Company Y and each of the other subsidiaries maintain their own separate accounting departments that record individual transactions and prepare financial statements in accordance with their local accounting practices. Company Y, and the other subsidiaries, forward the results of their financial performance to Company X, which analyzes and compiles these data into periodic reports in accordance with U.S. laws and regulations. Because Company X's preparation and filing of the reports relate solely to its role as an investor of capital or shareholder in Company Y or to its compliance with reporting, legal, or regulatory requirements, or both, these activities constitute shareholder activities and therefore Company Y is not considered to obtain a benefit from the preparation and filing of the reports.

Example 8. Shareholder activities. The facts are the same as in *Example 7,* except that Company Y's accounting department maintains a general ledger recording individual transactions, but does not prepare any financial statements (such as profit and loss statements and balance sheets). Instead, Company Y forwards the general ledger data to Company X, and Company X analyzes and compiles financial statements for Company Y, as well as for Company X's overall operations, for purposes of complying with U.S. reporting requirements. Company Y is subject to reporting requirements in Country B similar to those applicable to Company X in the United States. Much of the data that Company X analyzes and compiles regarding Company Y's operations for purposes of complying with the U.S. reporting requirements are made available to Company

Y for its use in preparing reports that must be filed in Country B. Company Y incorporates these data, after minor adjustments for differences in local accounting practices, into the reports that it files in Country B. Under these circumstances, because Company X's analysis and compilation of Company Y's financial data does not relate solely to its role as an investor of capital or shareholder in Company Y, or to its compliance with reporting, legal, or regulatory requirements, or both, these activities do not constitute shareholder activities.

Example 9. Shareholder activities. Members of Company X's internal audit staff visit Company Y on a semiannual basis in order to review the subsidiary's adherence to internal operating procedures issued by Company X and its compliance with U.S. anti-bribery laws, which apply to Company Y on account of its ownership by a U.S. corporation. Because the sole effect of the reviews by Company X's audit staff is to protect Company X's investment in Company Y, or to facilitate Company X's compliance with U.S. anti-bribery laws, or both, the visits are shareholder activities and therefore Company Y is not considered to obtain a benefit from the visits.

Example 10. Shareholder activities. Country B recently enacted legislation that changed the foreign currency exchange controls applicable to foreign shareholders of Country B corporations. Company X concludes that it may benefit from changing the capital structure of Company Y, thus taking advantage of the new foreign currency exchange control laws in Country B. Company X engages an investment banking firm and a law firm to review the Country B legislation and to propose possible changes to the capital structure of Company Y. Because Company X's retention of the firms facilitates Company Y's ability to pay dividends and other amounts and has the sole effect of protecting Company X's investment in Company Y, these activities constitute shareholder activities and Company Y is not considered to obtain a benefit from the activities.

Example 11. Shareholder activities. The facts are the same as in *Example 10,* except that Company Y bears the full cost of retaining the firms to evaluate the new foreign currency control laws in Country B and to make appropriate changes to its stock ownership by Company X. Company X is considered to obtain a benefit from the rendering by Company Y of these activities, which would be shareholder activities if conducted by Company X (see *Example 10*).

Example 12. Shareholder activities. The facts are the same as in *Example 10,* except that the new laws relate solely to corporate governance in Country B, and Company X retains the law firm and investment banking firm in order to evaluate whether restructuring would increase Company Y's profitability, reduce the number of legal entities in Country B, and increase Company Y's ability to introduce new products more quickly in Country B. Because Company X retained the law firm and the investment banking firm primarily to enhance Company Y's profitability and the efficiency of its operations, and not solely to protect Company X's investment in Company Y or to facilitate Company X's compliance with Country B's corporate laws, or to both, these activities do not constitute shareholder activities.

Example 13. Shareholder activities. Company X establishes detailed personnel policies for its subsidiaries, including Company Y. Company X also reviews and approves the performance appraisals of Company Y's executives, monitors levels of compensation paid to all Company Y personnel, and is involved in hiring and firing decisions regarding the senior executives of Company Y. Because this personnel-related activity by Company X involves day-to-day management of Company Y, this activity does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, and therefore does not constitute a shareholder activity.

Example 14. Shareholder activities. Each year, Company X conducts a two-day retreat for its senior executives. The purpose of the retreat is to refine the long-term business strategy of Company X and its subsidiaries, including Company Y, and to produce a confidential strategy statement. The strategy statement identifies several potential growth initiatives for Company X and its subsidiaries and lists general means of increasing the profitability of the company as a whole. The strategy statement is made available without charge to Company Y and the other subsidiaries of Company X. Company Y independently evaluates whether to implement some, all, or none of the initiatives contained in the strategy statement. Because the preparation of the strategy statement does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, the expense of preparing the document is not a shareholder expense.

Example 15. Passive association/benefit. Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken to date by Company Y. Company Y did not use Company X's marketing intangibles to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this section, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Example 16. Passive association/benefit. The facts are the same as in *Example 15,* except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain mileposts. This performance guarantee allowed Company Y to obtain the contract on materially more favorable terms than otherwise would have been possible. Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.

Example 17. Passive association/benefit. The facts are the same as in Example 15, except that Company X began the process of negotiating the contract with the financial institution in Country B before acquiring Company Y. Once Company Y was acquired by Company X, the contract with the financial institution was entered into by Company Y. Company Y is considered to obtain a benefit from Company X's negotiation of the contract.

Example 18. Passive association/benefit. The facts are the same as in Example 15, except that Company X sent a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y and that Company X would maintain that same percentage ownership interest in Company Y until the contract was completed. This letter allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Since this letter from Company X to the financial institution simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed, Company Y is not considered to obtain a benefit from Company X's furnishing of the letter.

Example 19. Passive association/benefit. (i) S is a company that supplies plastic containers to companies in various industries. S establishes the prices for its containers through a price list that offers customers discounts based solely on the volume of containers purchased.

(ii) Company X is the parent corporation of a large controlled group in the information technology sector. Company Y is a wholly-owned subsidiary of Company X located in Country B. Company X and Company Y both purchase plastic containers from unrelated supplier S. In year 1, Company X purchases 1 million units and Company Y purchases 100,000 units. S, basing its prices on purchases by the entire group, completes the order for 1.1 million units at a price of $0.95 per unit, and separately bills and ships the orders to each company. Companies X and Y undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iii) R1 and its wholly-owned subsidiary R2 are a controlled group of taxpayers (unrelated to Company X or Company Y) each of which carries out functions comparable to those of Companies X and Y and undertakes purchases of plastic containers from supplier S, identical to those purchased from S by Company X and Company Y, respectively. S, basing its prices

on purchases by the entire group, charges R1 and R2 $0.95 per unit for the 1.1 million units ordered. R1 and R2 undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iv) U is an uncontrolled taxpayer that carries out comparable functions and undertakes purchases of plastic containers from supplier S identical to Company Y. U is not a member of a controlled group, undertakes no bargaining with supplier S with respect to the price charged, and purchases no other products from supplier S. U purchases 100,000 plastic containers from S at the price of $1.00 per unit.

(v) Company X charges Company Y a fee of $5,000, or $0.05 per unit of plastic containers purchased by Company Y, reflecting the fact that Company Y receives the volume discount from supplier S.

(vi) In evaluating the fee charged by Company X to Company Y, the Commissioner considers whether the transactions between R1, R2, and S or the transactions between U and S provide a more reliable measure of the transactions between Company X, Company Y and S. The Commissioner determines that Company Y's status as a member of a controlled group should be taken into account for purposes of evaluating comparability of the transactions, and concludes that the transactions between R1, R2, and S are more reliably comparable to the transactions between Company X, Company Y, and S. The comparable charge for the purchase was $0.95 per unit. Therefore, obtaining the plastic containers at a favorable rate (and the resulting $5,000 savings) is entirely due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group. Consequently, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group.

Example 20. Disaggregation of transactions. (i) X, a domestic corporation, is a pharmaceutical company that develops and manufactures ethical pharmaceutical products. Y, a Country B corporation, is a distribution and marketing company that also performs clinical trials for USP in Country X. Because Y does not possess the capability to conduct the trials, it contracts with a third party to undertake the trials at a cost of $100. Y also incurs $25 in expenses related to the third-party contract (for example, in hiring and working with the third party).

(ii) Based on a detailed functional analysis, the Commissioner determines that Y performed functions beyond merely facilitating the clinical trials for X, such as audit controls of the third party performing those trials. In determining the arm's length price, the Commissioner may consider a number of alternatives. For example, for purposes of determining the arm's length price, the Commissioner may determine that the intercompany service is most reliably analyzed on a disaggregated basis as two separate transactions: in this case, the contract between Y and the third party could constitute an internal CUSP with a price of $100. Y would be further entitled to an arm's length remuneration for its facilitating services. If the most reliable method is one that provides a markup on Y's costs, then ''total services cost'' in this context would be $25. Alternatively, the Commissioner may determine that the intercompany service is most reliably analyzed as a single transaction, based on comparable uncontrolled transactions involving the facilitation of similar clinical trial services performed by third parties. If the most reliable method is one that provides a markup on all of Y's costs, and the base of the markup determined by the comparable companies includes the third-party clinical trial costs, then such a markup would be applied to Y's total services cost of $125.

Examples 21. Disaggregation of transactions. (i) X performs a number of administrative functions for its subsidiaries, including Y, a distributor of widgets in Country B. These services include those relating to working capital (inventory and accounts receivable/payable) management. To facilitate provision of these services, X purchases an ERP system specifically dedicated to optimizing working capital management. The system, which entails significant third-party costs and which includes substantial intellectual property relating to its software, costs $1000.

(ii) Based on a detailed functional analysis, the Commissioner determines that in providing administrative services for Y, X performed functions beyond merely operating the ERP system itself, since X was effectively using the ERP as an input to the administrative services it was providing to Y. In determining arm's length price for the services, the Commissioner may consider a number of alternatives. For example, if the most reliable uncontrolled data is derived from companies that use similar ERP systems purchased from third parties to perform similar administrative functions for uncontrolled parties, the Commissioner may determine that a CPM is the best method for measuring the functions performed by X, and, in addition, that a markup on total services costs, based on the markup from the comparable companies, is the most reliable PLI. In this case, total services cost, and the basis for the markup, would include appropriate reflection of the ERP costs of $1000. Alternatively, X's functions may be most reliably measured based on comparable uncontrolled companies that perform similar administrative functions using their customers' own ERP systems. Under these circumstances, the total services cost would equal X's costs of providing the administrative services excluding the ERP cost of $1000.

(m) *Coordination with transfer pricing rules for other transactions*—(1) *Services transactions that include other types of transactions.* A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. See §§ 1.482–1(b)(2) and 1.482–2(a), (c), and (d). Whether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction. See § 1.482–1(d)(3).

(2) *Services transactions that effect a transfer of intangible property.* A transaction structured as a controlled services transaction may in certain cases include an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property. Notwithstanding paragraph (m)(1) of this section, if such element relating to intangible property is material to the evaluation, the arm's length result for the element of the transaction that involves intangible property must be corroborated or determined by an analysis under § 1.482–4.

(3) *Services subject to a qualified cost sharing arrangement.* Services provided by a controlled participant under a qualified cost sharing arrangement are subject to § 1.482–7.

(4) *Other types of transactions that include controlled services transactions.* A transaction structured other than as a controlled services transaction may include one or more elements for which separate pricing methods are provided in this section. Whether such an integrated transaction is evaluated under another section of the section 482 regulations or whether one or more elements should be evaluated separately under this section depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this section, provided that the controlled services may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length results in the controlled transaction. See § 1.482–1(d)(3).

(5) *Examples.* The following examples illustrate paragraphs (m)(1) through (4) of this section:

Example 1. (i) U.S. parent corporation Company X enters into an agreement to maintain equipment of Company Y, a foreign subsidiary. The maintenance of the equipment requires the use of spare parts. The cost of the spare parts necessary to maintain the equipment amounts to approximately 25 percent of the total costs of maintaining the equipment. Company Y pays a fee that includes a charge for labor and parts.

(ii) Whether this integrated transaction is evaluated as a controlled services transaction or is evaluated as a controlled services transaction and the transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. If it is not possible to find comparable uncontrolled services transactions that involve similar services and tangible property transfers as the controlled transaction between Company X and Company Y, it will be necessary to determine the arm's length charge for the controlled services, and then to evaluate separately the arm's length charge for the tangible property transfers under § 1.482–1 and §§ 1.482–3 through 1.482–6. Alternatively, it may be possible to apply the comparable profits method of § 1.482–5, to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of measure of an arm's length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment.

Example 2. (i) U.S. parent corporation Company X sells industrial equipment to its foreign subsidiary, Company Y. In connection with this sale, Company X renders to Company Y services that consist of demonstrating the use of the equipment and assisting in the effective start-up of the equipment. Company X structures the integrated transaction as a sale of tangible property and determines the transfer price under the comparable uncontrolled price method of § 1.482–3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. In this case, the controlled services may be similar to services rendered in the transactions used to determine the comparable uncontrolled price, or they may appropriately be considered a difference between the controlled transaction and comparable transactions with a definite and reasonably ascertainable effect on price for which appropriate adjustments can be made. See § 1.482–1(d)(3)(ii)(A)(*6*). In either case, application of the comparable uncontrolled price method to evaluate the integrated transaction may provide a reliable measure of an arm's length result, and application of a separate transfer pricing method for the controlled services element of the transaction is not necessary.

Example 3. (i) The facts are the same as in Example 2 except that, after assisting Company Y in start-up, Company X also renders ongoing services, including instruction and supervision regarding Company Y's ongoing use of the equipment. Company X structures the entire transaction, including the incremental ongoing services, as a sale of tangible property, and determines the transfer price under the comparable uncontrolled price method of § 1.482–3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. It may not be possible to identify comparable uncontrolled transactions in which a seller of merchandise renders services similar to the ongoing services rendered by Company X to Company Y. In such a case, the incremental services in connection with ongoing use of the equipment could not be taken into account as a comparability factor because they are not similar to the services rendered in connection with sales of similar tangible property. Accordingly, it may be necessary to evaluate separately the transfer price for such services under this section in order to produce the most reliable measure of an arm's length result. Alternatively, it may be possible to apply the comparable profits method of § 1.482–5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform the combined functions of selling equipment and rendering ongoing after-sale services associated with such equipment. In that case, it would not be necessary to separately evaluate the transfer price for the controlled services under this section.

Example 4. (i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both companies perform research and development activities relating to integrated circuits. In addition, Company Y manufactures integrated circuits. In years 1 through 3, Company X engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report. In years 1 through 3, Company X generates overall net operating losses as a result of the expenditures associated with this research and development effort. At the beginning of year 4, Company X enters into a technical assistance agreement with Company Y. As part of this agreement, the researchers from Company X responsible for this project meet with the researchers from Company Y and provide them with a copy of the written report. Three months later, the researchers from Company Y apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researchers from Company X.

(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (such as, know-how). Because the element relating to the intangible property is material to the arm's length evaluation, the arm's length result for that element must be corroborated or determined by an analysis under § 1.482–4.

(n) *Effective date*—(1) *In general.* This section is generally applicable for taxable years beginning after December 31, 2006. In addition, a person may elect to apply the provisions of this section, § 1.482–9T, to earlier taxable years. See paragraph (n)(2) of this section.

(2) *Election to apply regulations to earlier taxable years*—(i) *Scope of election.* A taxpayer may elect to apply §§ 1.482–1T, 1.482–2T, 1.482–4T, 1.482–6T, 1.482–8T, and 9T, 1.861–8T, § 1.6038A–3T, § 1.6662–6T and § 31.3121(s)-1T of this chapter to any taxable year beginning after September 10, 2003. Such election requires that all of the provisions of this section, §§ 1.482–1T, 1.482–2T, 1.482–4T, 1.482–6T, 1.482–8T, and 1.482–9T, as well as the related provisions, §§ 1.861–8T, 1.6038A–3T, 1.6662–6T and 31.3121(s)–1T of this chapter be applied to such taxable year and all subsequent taxable years (earlier taxable years) of the taxpayer making the election.

(ii) *Effect of election.* An election to apply the regulations to earlier taxable years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see Chapter 66 of the Internal Revenue Code).

(iii) *Time and manner of making election.* An election to apply the regulations to earlier taxable years must be made by attaching a statement to the taxpayer's timely filed U.S. tax return (including extensions) for its first taxable year after December 31, 2006.

(iv) *Revocation of election.* An election to apply the regulations to earlier taxable years may not be revoked without the consent of the Commissioner.

(3) *In general.* The applicability of § 1.482–9T expires on or before July 31, 2009.

■ Par. 15. Section 1.861–8 is amended as follows:

■ 1. Paragraph (a)(5)(ii) is redesignated as paragraph (a)(5)(iii).

■ 2. A new paragraph (a)(5)(ii) is added.

■ 3. Paragraph (e)(4) is revised.

■ 4. Paragraph (f)(4)(i) is revised.

■ 5. Paragraph (g), *Example 17*, *Example 18*, and *Example 30* are revised.

The addition and revisions read as follows:

§ 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) * * *

(5) * * *

(ii) [Reserved]. For further guidance, see § 1.861–8T(a)(5) (ii).

* * * * *

(e) * * *

(4) [Reserved]. For further guidance, see § 1.861–8T(e)(4).

(f) * * *

(4) * * * (i)[Reserved]. For further guidance, see § 1.861–8T(f)(4)(i).

* * * * *

(g) * * *

Example 17. [Reserved]. For further guidance, see § 1.861–8T(g), *Example 17.*

Example 18. [Reserved]. For further guidance, see § 1.861–8T(g), *Example 18.*

* * * * *

Example 30. [Reserved]. For further guidance, see § 1.861–8T(g), *Example 30.*

* * * * *

■ **Par. 16.** Section 1.861–8T is amended as follows:

■ 1. Paragraphs (a)(3) and (a)(4) are removed and reserved and paragraph (a)(5)(ii) is revised.

■ 2. Paragraphs (b)(3) are revised.

■ 3. Paragraph (e)(4) is added.

■ 4. Paragraph (f)(4)(i) is revised.

■ 5. Paragraph (g), *Example 17*, *Example 18*, and *Example 30* are added.

■ 6. Paragraph (h) is revised.

The addition and revisions read as follows:

§ 1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

(a) * * *

(5) * * *

(ii) Paragraph (e)(4), the last sentence of paragraph (f)(4)(i), and paragraph (g), *Example 17*, *Example 18*, and *Example 30* of this section are generally applicable for taxable years beginning after December 31, 2006. In addition, a person may elect to apply the provisions of paragraph (e)(4) of this section to earlier years. Such election shall be made in accordance with the rules set forth in § 1.482–9T(n)(2).

(b) * * *

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) to expenses other than expenses attributable to stewardship activities, see *Examples 19* through *21* of paragraph (g) of this section. See paragraph (e)(4)(ii) of this section for the allocation and apportionment of deductions attributable to stewardship expenses. However, supportive deductions that are described in 1.861–14T(e)(3) shall be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in 1.861–14T.

* * * * *

(e) * * *

(4) *Stewardship and controlled services*—(i) *Expenses attributable to controlled services.* If a corporation performs a controlled services transaction (as defined in § 1.482–9T(l)(3)), which includes any activity by one member of a group of controlled taxpayers that results in a benefit to a related corporation, and the rendering corporation charges the related corporation for such services, section 482 and these regulations provide for an allocation where the charge is not consistent with an arm's length result as determined. The deductions for expenses of the corporation attributable to the controlled services transaction are considered definitely related to the amounts so charged and are to be allocated to such amounts.

(ii) *Stewardship expenses attributable to dividends received.* Stewardship expenses, which result from ''overseeing'' functions undertaken for a corporation's own benefit as an investor in a related corporation, shall be considered definitely related and allocable to dividends received, or to be received, from the related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from ''duplicative activities'' (as defined in § 1.482–9T(l)(3)(iii)) or ''shareholder activities'' (as defined in § 1.482–9T(l)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include 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. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign-source royalties, and gross income of foreign branches), some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate United States source income (such as fees for services performed in the United States). Permissible methods of apportionment with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See § 1.482–9T(l)(5) for examples that illustrate the principles of § 1.482–9T(l)(3). See *Example 17* and *Example 18* of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship expenses, such as expenses in the nature of day-to-day management, and paragraph (e)(5) of this section generally for the allocation and apportionment of deductions attributable to legal and accounting fees and expenses.

(f) * * *

(4) *Adjustments made under other provisions of the Code*—(i) *In general.* If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the Commissioner shall be made using the same method of allocation and

apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the Commissioner to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent corporation continues to incur expenses in connection with protecting its capital investment in the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the Commissioner to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(g) * * *

Example 17. Stewardship Expenses (Consolidation). (i) (A) *Facts.* X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general limitation income from sources within South America, and all of N's income is general limitation income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
Total	550,000	370,000

(B) Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the sole effect of the entire $30,000 of deductions is to protect X's capital investment in M, N, and O. X properly categorizes the $30,000 of deductions as stewardship expenses. The remainder of X's deductions ($20,000) relates to production of United States source income from its plant in the United States.

(ii) (A) *Allocation.* X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to general limitation income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to general limitation income earned from sources without the United States, and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the foreign tax credit limitation; the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, the X consolidated group has taxable income from sources without the United States in the amount of $75,000, computed as follows:

Foreign source general limitation gross income:	
($250,000 from M + $150,000 from N)	$400,000
Less: Deductions allocable to foreign source general limitation gross income:	
($25,000 from X, $100,000 from M, and $200,000 from N)	325,000
Total foreign-source taxable income	75,000

(B) Thus, in the combined computation of the general limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000.

Example 18. Stewardship and Supportive Expenses. (i) (A) *Facts.* X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year that is general limitation income described in section 904(d)(1). X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed by X	1,000,000
Total gross income	40,000,000

(B) In addition, X incurs expenses of its supervision department of $1,500,000.

(C) X's supervision department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries,

and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $900,000 (which results in a total charge to U of $1,000,000). The second type consists of activities described in § 1.482–9(l)(3)(iii) that are in the nature of shareholder oversight that duplicate functions performed by the subsidiaries' own employees and that do not provide an additional benefit to the subsidiaries. For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. These activities do not provide an additional benefit to the related corporations. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) *Allocation.* The Department's outlay of $900,000 for services rendered for the benefit of U is allocated to the $1,000,000 in fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U, and V and royalties from T and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary services and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) (A) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Department's expenses and related supportive expenses which are allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the foreign tax credit limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

(B) The gross receipts of the subsidiaries were as follows:

S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000
Total	9,000,000

(C) Thus, the expenses of the Department are apportioned for purposes of the foreign tax credit limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income: $540,000 × [($3,000,000 + $500,000 + $1,500,000)/$9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income: $540,000 × [$4,000,000/9,000,000]	240,000
Total: Apportioned stewardship expense	540,000

* * * * *

Example 30. Income Taxes. (i) (A) *Facts.* As in *Example 17* of this paragraph, X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general limitation income from sources within South America, and all of N's income is general limitation income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of U.S. source income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign-source general limitation taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign-source general limitation loss of $50,000. O has gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike *Example 17* of this paragraph (g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the Federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in *Example 25*, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property, and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(C)

(i) *Allocation and apportionment.* Assume that under *Example 29*, it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under *Example 17*, without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated general limitation foreign tax credit limitation.

(h) *Effective dates*—(1) *In general.* In general, the rules of this section, as well as the rules of §§ 1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–14T apply for taxable years beginning after December 31, 1986, except for paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), paragraph (g) *Example 17*, *Example 18*, and *Example 30*, and paragraph (h) of this section, which are generally applicable for taxable years beginning after December 31, 2006. However, see 1.861–8(e)(12)(iv) and 1.861–14(e)(6) for rules concerning the allocation and apportionment of deductions for charitable contributions. In the case of corporate taxpayers, transition rules set forth in 1.861–13T provide for the gradual phase-in of certain provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(i) Section 1.861–9T(b)(2) (concerning the treatment of certain foreign currency).

(ii) Section 1.861–9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens).

(iii) Section 1.861–10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception).

(iv) Section 1.861–10T(b)(6) (concerning excess collaterilzation of nonrecourse borrowings).

(2) In addition, 1.861–10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is applicable for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by 1.861–13T, see 1.861–8 (revised as of April 1, 1986).

(3) *Expiration date.* The applicability of the paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), paragraph (g) *Example 17*, *Example 18*, and *Example 30*, and paragraph (h) of this section, expires on or before July 31, 2009.

■ **Par. 17.** Section 1.6038A–3(a)(3) is amended by revising paragraph (a)(3), *Example 4* to read:

§ 1.6038A–3 Record maintenance.

(a) * * *

(3) * * *

Example 4. [Reserved]. For further guidance, see § 1.6038A–3T, Example 4.

* * * * *

■ **Par. 18.** Section 1.6038A–3T is added to read as follows:

§ 1.6038A–3T Record maintenance (temporary).

(a)(1) through (3) *Examples 1* through *3* [Reserved]. For further guidance, see § 1.6038A–3(a)(1) through (3) *Examples 1* through *3*.

Example 4. S, a U.S. reporting corporation, provides computer consulting services for its foreign parent, X. Based on the application of section 482 and the regulations, it is determined that the cost of services plus method, as described in § 1.482–9T(e), will provide the most reliable measure of an arm's length result, based on the facts and circumstances of the controlled transaction between S and X. S is required to maintain records to permit verification upon audit of the comparable transactional costs (as described in § 1.482–9T(e)(2)(iii)) used to calculate the arm's length price. Based on the facts and circumstances, if it is determined that X's records are relevant to determine the correct U.S. tax treatment of the controlled transaction between S and X, the record maintenance requirements under section 6038A(a) and this section will be applicable to the records of X.

(b)(1) through (h) [Reserved]. For further guidance, see § 1.6038A–3T(b)(1) through (h).

(i) Effective date—(1) *In general.* This provision is generally applicable for taxable years beginning after December 31, 2006.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) *Expiration date.* The applicability of this section expires on or before July 31, 2009.

■ **Par. 19.** Section 1.6662–6 is amended as follows:

■ 1. Paragraphs (d)(2)(ii)(A) through (d)(2)(ii)(G) are redesignated as paragraphs (d)(2)(ii)(A)(*1*) through (d)(2)(ii)(A)(*7*) and paragraph (d)(2)(ii) introductory text as paragraph (d)(2)(ii)(A), respectively.

■ 2. A new paragraph (d)(2)(ii)(B) is added.

■ 3. Paragraphs (d)(2)(iii)(B)(*4*) and (d)(2)(iii)(B)(*6*) are revised

■ 4. Paragraph (g) is revised.

The additions and revisions read as follows:

§ 1.6662–6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(B) [Reserved]. For further guidance, see § 1.6662–6T(d)(2)(ii)(B).

* * * * *

(iii) * * *

(B) * * *

(*4*) [Reserved]. For further guidance, see § 1.6662–6T(d)(2)(iii)(B)(*4*).

* * * * *

(*6*) [Reserved]. For further guidance, see § 1.6662–6T(d)(2)(iii)(B)(*6*).

* * * * *

(g) [Reserved]. For further guidance, see § 1.6662–6T(g).

■ **Par. 20.** Section 1.6662–6T is added to read as follows:

§ 1.6662–6T Transactions between parties described in section 482 and net section 482 transfer price adjustments (temporary).

(a) through (d)(2)(ii)(A) [Reserved]. For further guidance, see § 1.6662–6(a) through (d)(2)(ii)(A).

(d)(2)(ii)(B) *Services cost method.* A taxpayer's selection of the services cost method for certain services, described in § 1.482–9T(b), and its application of that method to a controlled services transaction will be considered reasonable for purposes of the specified method requirement only if the taxpayer reasonably allocated and apportioned costs in accordance with § 1.482–9T(k), reasonably concluded that the controlled services transaction meets the conditions of § 1.482–9T(b)(3), and reasonably concluded that the controlled services transaction is not described in paragraph § 1.482–9T(b)(2). Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include those described in paragraph (d)(2)(ii)(A) of this section, to the extent applicable.

(d)(2)(iii)(A) through (d)(2)(iii)(B)(*3*) [Reserved]. For further guidance, see § 1.6662–6(d)(2)(iii)(A) through (d)(2)(iii)(B)(*3*).

(d)(2)(iii)(B)(*4*) A description of the method selected and an explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;

(d)(2)(iii)(B)(*5*) [Reserved]. For further guidance, see § 1.6662–6(d)(2)(iii)(B)(*5*).

(d)(2)(iii)(B)(*6*) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity. Similarly, if a cost-based method (such as the cost plus method, the services cost method for certain services, or a comparable profits method with a cost-based profit level indicator) is applied, the documentation must include a description of the manner in which relevant costs are determined and are allocated and apportioned to the relevant controlled transaction.

(d)(2)(iii)(B)(*7*) through (f) [Reserved]. For further guidance, see § 1.6662–6(d)(2)(iii)(B)(*7*) through (f).

(g) *Effective date*—(1) This section is generally effective February 9, 1996. However, taxpayers may elect to apply this section to all open taxable years beginning after December 31, 1993.

(2)(i) The provisions of paragraphs (d)(2)(ii)(B), (d)(2)(iii)(B)(*4*) and (d)(2)(iii)(B)(*6*) of this section are applicable for taxable years beginning after December 31, 2006.

(ii) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2) of this chapter.

(iii) *Expiration date.* The applicability of § 1.6662–6T expires on or before July 31, 2009.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE

■ **Par. 21.** The authority citation for part 31 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 22.** Section 31.3121(s)–1 is amended by revising paragraphs (c)(2)(iii) and (d) to read as follows:

§ 31.3121(s)–1 Concurrent employment by related corporations with common paymaster.

* * * * *

(c) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see § 31.3121(s)–1T(c)(2)(iii).

* * * * *

(d) [Reserved]. For further guidance, see § 31.3121(s)–1T(d).

■ **Par. 23**. Section 31.3121(s)–1T is added to read as follows:

§ 31.3121(s)–1T Concurrent employment by related corporations with common paymaster (temporary).

(a) through (c)(2)(ii) [Reserved]. For further guidance, see § 31.3121(s)–1(a) through (c)(2)(ii).

(c)(2)(iii) *Group-wide allocation rules.* Under the group-wide method of allocation, the district director may allocate the taxes imposed by sections 3102 and 3111 in an appropriate manner to a related corporation that remunerates an employee through a common paymaster if the common paymaster fails to remit the taxes to the Internal Revenue Service. Allocation in an appropriate manner varies according to the circumstances. It may be based on sales, property, corporate payroll, or any other basis that reflects the distribution of the services performed by the employee, or a combination of the foregoing bases. To the extent practicable, the Commissioner may use the principles of § 1.482–2(b) of this chapter in making the allocations with respect to wages paid after December 31, 1978, and on or before December 31, 2006. To the extent practicable, the Commissioner may use the principles of § 1.482–9T of this chapter in making the allocations with respect to wages paid after December 31, 2006.

(d) *Effective date*—(1) *In general.* This section is applicable with respect to wages paid after December 31, 1978. [§ 31.3121(s)–1]. The fourth sentence of paragraph (c)(2)(iii) of this section is applicable with respect to wages paid after December 31, 1978, and on or before December 31, 2006. The fifth sentence of paragraph (c)(2)(iii) of this section is applicable with respect to wages paid after December 31, 2006.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the fifth sentence of paragraph (c)(2)(iii) of this section to earlier taxable years in accordance with the rules set forth in § 1.482–9T(n)(2).

(3) The applicability of § 31.3121(s)–1T expires on or before July 31, 2009.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: July 11, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

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