

# **Analysis of the New §1.482 Services Regulations**

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# Overview

- Description of new regulations
- Services Cost Method (SCM)
- Transfer pricing methods for services
- Shared Services
- Intangible property
- Residual profit method
- Likely audit issues

# Description of New Regulations

- Effective for tax years after December 2006
- Replaces “old” 1968 services regulations
- Apply to “controlled services transactions” that provides a benefit – something an uncontrolled taxpayer would pay for
- Unlike prior regulations, new regulations provide methods for determining fair market value of services
  - Similar to tangible and intangible property rules under §1.482

# Description of New Regulations

- Also provides a new cost safe harbor: Services Cost Method which is more limited in scope
  - Services previously charged at cost may now have to be priced at fair market value, i.e., cost plus
  - Application of business judgment rule
  - List of included (covered) functions or transactions
    - Rev Proc 2007-13 provides list
  - “Low margin” functions also covered as long as meet business judgment rule

# Description of New Regulations

- Certain transactions are excluded from SCM
- Shared services agreements (similar to cost sharing)
- Contingent payments
- Integrated transactions: services + intangibles
- Residual profit split method has been modified

# Services Cost Method

- New method for charging services at cost
  - Business judgment test – services do not contribute to key competitive advantages, core capabilities, or fundamental risks of success or failure
  - “White List” of specified covered functions/ transactions
  - Low margin functions covered if median markup of comparables does not exceed 7 percent
- “Black List” of specified excluded functions/ transactions do not qualify for SCM

# Services Cost Method

- Business judgment test – replaces the “non-integral” tests in old regulations
  - Concepts of “core competencies” “competitive advantages” and “risks of success or failure” are not defined
    - Uncertainty and audit issues may arise here
    - Deference to taxpayer’s judgment

Taxpayers should state clearly their justification for application of this test

IRS audits should focus on such justifications

# Services Cost Method

- White List of covered transactions focuses on routine, back office, support-type services
  - Believed to be low value
  - Includes areas such as payroll, treasury, accounting, budgeting, legal
  - Other areas may present some difficulties
    - Training (transfer of high value human capital)
    - Computer support (software development)
    - Database administration (data mining)
    - Public relations (marketing)

What happens if covered functions contribute significant value to the controlled entity?

# Services Cost Method

- Black List of excluded functions expands the list from the old regulations
  - Believed to be high value (implication is margins greater than 7%)
  - Includes: manufacturing, production, extraction, exploration or processing of natural resources, construction, reselling, distribution, research & development, engineering & scientific, financial transactions and insurance and reinsurance

Can the taxpayer be exempt from the “Black List” if it shows one of these functions is not “high value?”

# Services Cost Method

- Low margin functions also qualify for the SCM
  - Low margin is defined as median comparable markup of 7% or less
    - Documentation required including a CPM analysis
  - Multi-year averaging to determine median
  - Frequency of updates (annual?)
  - Reasonable groupings of services

Typical issues will arise regarding choice of comparables, functions, returns

# Services Cost Method

- Other issues:
  - Maintain adequate books and records
  - Verify services total costs and cost allocations
  - Nature of services
  - Required statement of intent to apply SCM
  - 6662(e) documentation
- Greater burden on taxpayers than with old regulations

# Transfer Pricing Methods

- Generally the same as tangible and intangible property rules

<b>Services Method</b>	<b>Tangible Property Method</b>
Comparable Uncontrolled Services Price (CUSP)	Comparable Uncontrolled Price (CUP)
Gross Services Margin Method	Resale Price Method
Cost of Services Plus Method	Cost Plus Method
Comparable Profits Method	Comparable Profits Method
Profit Split Method	Profit Split Method

# Shared Services

- “Cost sharing” for services
  - Brings U.S. transfer pricing more closely aligned with OECD cost contribution arrangements
- Requirements:
  - At least two participants
  - All that expect to receive a benefit from services must participate
  - At least one participant must benefit from covered service or aggregation of services
  - Must constitute “covered” services under SCM

# Shared Services

- Costs are shared in proportion to reasonably anticipated benefits
  - Consistent allocation
- Somewhat more liberal aggregation rule
  - Can be different from grouping basis for evaluating whether low margin services
- Examples of cost allocation keys include:
  - Headcount
  - Order volume
  - Transaction volume

# Shared Services

- Additional documentation requirements
  - Evidence of intent to apply SCM to covered services in a shared services arrangement
- Potential issues:
  - Only covered services included – this could change from one year to the next
  - Beneficiaries could also change
  - Aggregation issues
  - Need to maintain multiple allocation systems

# Intangible Property

- Services transactions may include intangibles
  - So called “mixed” transactions
  - Intangible rules (§1.482-4) may apply if a material element in the transaction
- Reliability concerns require careful consideration of such integrated transactions

# Intangible Property

- Regulations also deal with pricing of intangibles
- Practical control
  - Legal ownership
    - Importance of contractual arrangements to establish ownership
- If related party provides services that increase value of the owner's intangible, owner must pay for services

# Intangible Property

- Under certain circumstances, IRS may impute contractual terms
  - Marketing activities borne by distributor
  - If consideration for marketing not reflected in supplier's transfer price to distributor, then may impute contingent payment or long term license arrangement
  - See examples
- Endorsement of contingent payment contracts
  - Well suited for services whose outcome is uncertain, e.g., R&D

# Residual Profit Split Method

- New regulations include a revised residual profit split method (§1.482-6)
  - Changes relate to “routine” vs. “non-routine” profits
    - No longer an issue of high value vs. low value
    - Now it is a matter of whether profits may be measured with external benchmarks
    - If so, then “routine” profits; if not, then “non-routine”
  - Issue is how to split the value of the non-routine profits?

# Residual Profit Split Method

- If non-routine profits result from intangible property, can still apply a capitalized cost of developing the intangible as a reliable means to determine the split
- If the non-routine profits stem from another factor such as assumption of risk or unusual market conditions, then it may be more difficult to determine split

Disagreements may result when residual profit cannot be split using an internal measure

# Likely Audit Issues

- Business judgment test: when does a “service” constitute a core competency or competitive advantage?
  - Specialized legal services
  - Recruitment of specialized human capital
  - Training of specialized labor force
  - Unique order processing/IT capability
  - Unique public relations/marketing capability
- Provide a business judgment statement from taxpayer

# Likely Audit Issues

- Business judgment test: how does one define a core competency or competitive advantage?
  - Must it be “unique” or just better than others?
  - Better than average delivery time which gives a firm a 2% cost advantage relative to competition
    - What about a 5% cost advantage? 10%??
  - Emulation a competitor’s inventory control/IT system that is better than the other 4 competitors but not as good as the leading competitor
    - Is this a core competency? When does it become one?
- Where and when does the auditor defer to the taxpayer’s “judgment”

# Likely Audit Issues

- What qualifies as a low margin service?
- CPM of various functions shows differing results

Function	No. of Companies	Median Result - Return on Cost			Qualify as Low Margin?
		2007	3yr. Avg	5 yr. Avg	
Market research	17	11.64%	11.03%	10.61%	NO
Logistics	117	5.86%	6.13%	5.68%	YES
Procurement	8	3.95%	4.65%	3.51%	YES
Information Technology	238	8.50%	8.74%	8.09%	NO
Training	5	8.26%	7.21%	5.91%	MAYBE
Marketing	101	10.54%	10.26%	9.03%	NO
Project Management	85	9.95%	9.54%	10.53%	NO

Source: Capital IQ

# Likely Audit Issues

- Can an excluded service qualify as a low margin service?
- Possible examples:
  - “Routine” research and testing services provided to pharmaceutical companies
  - “Routine” distribution or resale functions

# Likely Audit Issues

- Choice of cost allocation factor or key under shared services arrangement - determination of reasonably anticipated benefit (not *ex post*)
  - Volume
  - Time spent
  - Headcount or number of people served
  - Compensation

# Likely Audit Issues

- Aggregation of services
  - Payroll, treasury, tax and IT in aggregate constitute low margin, (i.e., <7%), but IT generates a 10% margin when considered separately
  - Could qualify under shared services arrangement, but IT would not qualify as a covered service if no shared service arrangement in existence

# Likely Audit Issues

- Consideration of “mixed” transactions
  - Training of foreign nationals includes transfer of intangibles
    - Know-how, specialized expertise, process technology
    - May require separation of transaction into two
      - Royalty for transfer of intangible
      - SCM applied to training

# Likely Audit Issues

- Application of residual profit split method
  - When does intangible property provide a routine return?
    - Basic research vs. product development
    - Marketing: pre-launch vs. maintenance marketing
- Allocation of residual (non-routine) profit