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# Proposed Services Regs Miss the Boat and Mine the Safe Harbour

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## Proposed Services Regs Miss the Boat and Mine the Safe Harbour

### Introduction

On September 10, 2003, the Treasury Department and the Internal Revenue Service published proposed regulations that would replace the current 1968 regulations governing intercompany services transactions. The proposed regulations would eliminate the longstanding rule of Treas. Reg. §1.482-2(b)(3) which deems the arm's length charge of services that are not "an integral part of the business activity" of either the renderer or the recipient to equal costs or deductions incurred, and the arm's length charge for "integral" services to equal "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances . . . ." In its place, the proposed regulations would adopt specified methods similar to those applicable for transfers of tangible and intangible property. These new specified methods, listed in Prop. Reg. §1.482-9(a), include the comparable uncontrolled services price method, the gross services margin method, the comparable profits method, the simplified cost-based method, and the profit split method. Similar to the regulations governing transfers of tangible and intangible property, the proposed services regulations would allow the use of unspecified methods in limited circumstances.

The simplified cost-based method ("SCBM") of Prop.

Reg. 1.482-9(f) would replace the current cost-based safe harbour for non-integral services of Treas. Reg. §1.482-2(b)(7). According to the Preamble to the proposed regulations:

*"The proposed regulation provides for a new simplified cost-based method for low-margin services, such as routine back-office services. This simplified method is intended by the Treasury Department and the IRS to serve the same purpose as the current regulations relating to the pricing of non-integral services by providing reduced compliance and administrative burdens with respect to the transfer pricing of low-margin services. Such reduced burdens allow both taxpayers and the IRS to direct their resources appropriately to other issues."*

Nevertheless, the proposed regulations fail to provide a true safe harbour allowing back-office services (such as accounting, human resources, information technology, legal, and accounting) to be charged-out at cost. Under the proposed regulations, an intercompany services transaction would only be eligible for the SCBM if the arm's length markup on total services costs does not exceed 10 percent, and the intercompany transaction is not described in any of the excluded categories of services listed in Prop. Reg. §1.482-9(f)(4). Under the "sliding scale" approach of Prop. Reg. §1.482-9(f)(2)(ii), an intercompany services transaction otherwise eligible for the SCBM could only be charged-out at cost if the arm's length markup on such service does not exceed 6 percent.

The current cost-based safe harbour of Treas. Reg. §1.482-2(b)(7) treats intercompany services transactions as

“non-integral,” and thus eligible for the cost-based safe harbour, if neither the renderer nor the recipient is in the trade or business of rendering similar services to unrelated parties, and such services pass the quantitative tests of Treas. Reg. §1.482-2(b)(7)(ii) and (iv) and the “peculiarly capable” test of Treas. Reg. §1.482-2(b)(7)(iii). The Treasury Department believes that this safe harbour has resulted in taxpayers applying the cost-based safe harbour in inappropriate circumstances, such as intangibles-laden services transactions or services similar to those that the taxpayer provides to unrelated parties at a profit.

Thus, the goal of the proposed regulations is to update the 1968 regulations, and to limit the ability to charge-out services at cost to back-office or similar “routine” services. These back-office service functions are typically performed on a centralized basis as cost centres rather than profit centres, and cannot be reliably compared to uncontrolled services providers that provide value-added services for a profit to third parties.

The SCBM will substantially increase compliance costs for routine back-office services without addressing any real or perceived abuses. Business decisions with respect to these services, such as whether to perform these services on a centralized group-wide or regional basis, whether to perform these services in the U.S. or another jurisdiction, and whether to perform these services internally at all or to outsource to a third party, are driven almost exclusively by cost and other factors wholly unrelated to tax consequences. Therefore, little is gained by adopting a comparables-based approach (under the SCBM) that would require a transfer pricing study to confirm that an intercompany service has an arm’s length markup of less than 10 percent (and is therefore eligible for the SCBM) and further, that the service transaction has an arm’s length markup of less than 6 percent, and can therefore be priced at cost without risk of adjustment.

Principal problems associated with the SCBM are summarized as follows:

#### **Rationale for Pricing Routine Back-Office Services at Cost**

The SCBM potentially requires a markup on total costs for *any* intercompany services if the arm’s length markup for “comparable” services performed by uncontrolled taxpayers exceeds six percent. Routine back-office services are typically and appropriately viewed as cost centres, or general administrative costs of doing business, as opposed to profit centres. These costs are often the result of reporting or compliance requirements imposed by regulatory agencies, such as the IRS, SEC, EPA, and their regulatory counterparts in the EU. The rationale for performing these services internally, on a centralized basis, is to reap the efficiencies associated with economies of scale, rather than to exploit the advantages of the services rendered for profit. Consequently, requiring that these services be charged out at a profit could potentially lead to income distortion with respect to these intercompany services transactions.

Furthermore, the back-office service functions of multinational enterprises, operated as cost centres, differ significantly from independent service providers in terms of allocation of certain risks affecting the profitability of services companies. In general, independent service providers assume the economic risks associated with the cost of providing services, and the risks associated with matching its capacity to supply services with the volume

of services demanded. By contrast, in most intercompany services arrangements, the service recipient, not the service provider, bears these risks, raising doubts as to the comparability of any independent services provider.

#### **Example**

To provide an example of the rationale for centralizing routine back-office service functions, assume that a U.S. multinational controlled group has similar operating subsidiaries in four other countries—France, Germany, the U.K., and India. The parent company and each of the operating subsidiaries incurs total annual costs to provide these services in the amount of \$500. As a cost-reduction strategy (typically implemented in response to competitive forces in the market), the parent establishes a shared services centre in the United States to provide all of the back-office services for all members of the group. The shared services centre has total annual costs of \$250, though it might have been done for \$125 had it been set up in India. The group as a whole has reduced its overall costs to provide back-office services by \$250. This cost reduction is the primary purpose for establishing the shared services activity.

#### **Example**

To provide another example of the benefits of economies of scale obtained from centralization of routine functions, suppose that a corporation provides certain services (legal, accounting, HR, IT, and purchasing) for other members of its controlled group, which cost the corporation \$100 per year. In a subsequent year, the corporation provides these services to third party joint venture partners in addition to providing these same services to its affiliates. The corporation agrees to perform these services for its unrelated joint venture partner at cost. Although the corporation in effect doubles the total quantity of services that it provides, its costs only increase to \$180 (not \$200) as a result of efficiencies attributable to economies of scale. The corporation’s costs of providing these back-office services to its affiliates are reduced from \$100 to \$90. The reduced costs of providing these necessary but routine services to affiliates is a real benefit derived by the corporation. Thus, by agreeing to perform these services for unrelated parties at cost, the corporation is not giving away something for nothing. The services provided at cost to the joint venture (which in reality, does happen) effectively serve as a comparable transaction to confirm that pricing at cost is the arm’s length result for the identical intercompany services performed by the corporation.

Nevertheless, a countervailing argument may be made that conceptually, any intercompany service contributes to the profits of the controlled group. This view is based on the premise that a profit maximizing enterprise would not perform any service that it did not believe would enhance its bottom line, however indirect the nexus between the service and the enterprise’s operating profits may be. Thus, theoretically any intercompany service must be charged at the economically correct arm’s length price. Notwithstanding this view, the IRS and the Treasury Department recognize that economic theory must yield to practical reality. As explained by the Preamble to the proposed regulations: “[t]his simplified method is intended by the Treasury Department and the IRS to serve the same purpose as the current regulations relating to the pricing of non-integral services by providing

reduced compliance and administrative burdens with respect to the transfer pricing of low-margin services.” In other words, for certain services, such as routine back-office services, the need for simplicity and administrability trumps any policy that would require every controlled services transaction to be charged out at the economically correct arm’s length price. Since routine back-office services do not effect disguised transfers of intangibles and otherwise present no opportunity for tax planning, such services should not be subject to a transfer pricing methodology that potentially requires a markup on total costs, depending on the results of uncontrolled services providers of questionable comparability.

#### **Problems Associated with the Comparables-Based Approach of the SCBM**

For the reasons discussed in detail above, fundamental doubts exist as to the comparability of the services performed by any independent companies to the routine back-office services performed by multinational enterprises on a centralized basis. Multinational enterprises operate their centralized back-office services as cost centres of pooled resources to reap the benefits of economies of scale, whereas independent service providers necessarily perform these services as profit centres. Consequently, the value-added services performed by independent service providers for a profit may not be comparable to routine back-office services performed by multinational enterprises on a centralized basis, which can be considered administrative costs of doing business. Furthermore, doubts exist about the comparability of uncontrolled and controlled routine services transactions because of differences in allocations of risks—in the case of uncontrolled services transactions, key economic risks are shifted to the service provider, whereas in intercompany services transactions, these risks are generally retained by the service recipient.

Requiring a comparables-based analysis to determine the appropriate markup or range of appropriate markups for routine back-office services will inevitably lead to new disputes and a “battle of comparables” between taxpayers and the IRS. In performing a comparables analysis for any services, the observed markup on the total cost of the uncontrolled services providers will substantially vary with (i) the screening criteria used to select comparables (*e.g.*, intangible ownership, R&D/sales ratios, losses, tangible asset ownership, and company size); (ii) “cherry-picking” individual companies based on subjective judgment; and (iii) the time period which should be used for selecting the benchmark (*e.g.*, whether arm’s length markups should be determined using 3-year, 5-year, or 10-year average results).

To illustrate, suppose a U.S.-based multinational enterprise performs routine back-office accounting services at the U.S. parent level on a centralized basis for all of its subsidiaries worldwide. With the finalization of the proposed regulations, this taxpayer would be required to perform a comparable companies analysis to determine the arm’s length markup of its routine accounting services for the first time. The category of accounting services is quite diverse. It often comprises accounting, audits, bookkeeping, tax planning, and preparation of tax returns, but can also include cash flow management; strategic planning; consulting; tax structuring of business transactions such as mergers and acquisitions; outsourced chief

financial officer services and other financial staffing services; financial investment analysis; succession, retirement, and estate planning; and profitability, operational, and efficiency enhancement consulting. One therefore should not be surprised that finding companies that would be comparable to the narrowly defined service of financial record-keeping would be a daunting task. The selection of comparable companies for routine back-office accounting functions would ultimately be based on choice of screening criteria and subjective judgment as to the potential comparable companies’ business description.

For instance, two economists (one employed by the taxpayer, one employed by the IRS) may disagree as to whether accounting staffing or management services providers are comparable to the routine back-office accounting functions performed by the taxpayer on a centralized intercompany basis. One economist may argue in favour of including these companies in the set of comparables, while the second economist may argue that the operating results are biased because such companies provide information technology, financial, legal, human resources, and administrative/clerical/office staffing in addition to accounting staffing services. Similarly, one economist may believe that company size should not be used as a screening criteria, while a second economist may reasonably, but subjectively, contend that companies with annual revenues in excess of \$1 billion are too large to be good comparables. Hence, the battle of the comparables.

Consequently, taxpayers and the IRS will inevitably disagree on the proper set of comparable companies to test routine services, leading to disputes as to (i) whether a particular service is eligible for the SCBM; and (ii) if so, whether the service may be charged out at cost-plus no markup. This high risk of disputes will inevitably lead taxpayers to seek transfer pricing studies for routine back-office services, thereby defeating one of the key purposes of the SCBM, as stated in the Preamble, to “preserve aspects of the current rules that provide appropriately reduced administrative and compliance burdens for low margin services . . . .”

Furthermore, in addition to selecting a set of “comparable” companies, taxpayers applying the SCBM must choose a time period to serve as a benchmark for testing the controlled services transactions. The observed markup on total costs for independent services providers may not be static over time, but could instead vary substantially from year-to-year. The SCBM therefore fails to provide a stable safe harbour, because the arm’s length markup for independent services providers, which affects both eligibility for the SCBM and the selection of cost or a specific markup under the method, can and does change from year to year. This problem could be mitigated, but not eliminated, by coordination provisions in the section 6662 regulations that would (i) conclusively allow a taxpayer to rely on a one-time transfer pricing study undertaken for purposes of applying the SCBM (rather than requiring such a transfer pricing study to be performed each year); and (ii) clarify that the use of multi-year data to smooth out year-to-year peaks and valleys in results of comparable companies is expressly permissible.

#### **SCBM Provides No Safe Harbour for Inbound Transactions**

The SCBM effectively excludes all inbound services transfers, since Prop. Reg. §1.482-9(f)(2)(v)(B) explicitly

provides that this method does not limit allocations where the taxpayer's markup on the total costs of intercompany services transactions exceeds the arm's length markup. The proposed regulations would therefore impose substantial compliance costs and burdens on multinational enterprises performing intercompany services outside the United States for U.S. affiliates. These multinational enterprises, which likely also avail themselves of the cost-based safe harbour of Treas. Reg. §1.482-2(b)(7), would be forced to apply a specified method other than the SCBM. The resulting compliance costs would be potentially higher than the substantial costs that will be incurred by companies with outbound services transactions eligible for the SCBM, without addressing any real or perceived tax abuse.

#### Penalty Coordination Provisions

The proposed regulations provide inadequate assurance that taxpayers charging out routine back-office services at cost or a specific markup under the SCBM will not be subject to the substantial valuation misstatement penalties of section 6662(e) or the gross valuation misstatement penalty of section 6662(h), if the Internal Revenue Service determines that the specific service is ineligible for the method or the taxpayer inappropriately charged out an intercompany service at cost or selected an inappropriate specific markup. Multinational enterprises that currently and appropriately charge out routine back-office services at cost will inevitably perform comparable companies analyses and invest in transfer pricing studies at a substantial cost in order to satisfy the documentation requirements of the SCBM.

Under Prop. Reg. §1.6662-6(d)(2)(ii)(B): "A taxpayer's selection of the simplified cost-based method for certain services, described in §1.482-9(f), 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 concluded that the controlled services transaction . . . " meets the adequate books and records requirement or the de minimis exception of §1.482-9(f)(3); does not have an arm's length markup in excess of 10 percent of total services costs (Prop. Reg. §1.482-9(f)(2)(iii)); and does not fall under the excluded categories of services listed in Prop. Reg. §1.482-9(f)(4). The regulations expressly impose a burden on a taxpayer to "reasonably conclude" that the services transactions that would be subject to the SCBM do not have an arm's length markup in excess of 10 percent, a conclusion that could vary with (among other factors) the screening criteria for selecting comparables, the time period chosen as a benchmark, and subjective judgment regarding the comparability of the service provider to the tested entity.

Although the proposed regulations do not expressly require taxpayers to reasonably conclude that their choice of cost or a specific markup on the sliding scale of Treas. Reg. §1.482-9(f)(2) is correct for purposes of avoiding penalties, the proposed regulations do not conclusively provide that a taxpayer's selection and application of the SCBM is *per se* reasonable under any circumstances. Prop. Reg. §1.6662-6(d)(2)(ii)(B), which provides that a taxpayer's selection and application of the SCBM is reasonable "only if" the taxpayer meets the three requirements for application of the method (*i.e.*, adequate books and records, and arm's length markup not in excess of 10

percent, and that the service not be described in the excluded category of services), could be interpreted as setting forth necessary, but not sufficient, conditions for reasonable application of the SCBM.

In any event, the proposed regulations effectively require taxpayers to perform, for the first time, complete transfer pricing studies for routine services that had previously been charged-out under the cost-based safe harbour of Treas. Reg. §1.482-2(b)(7). Taxpayers will not realistically attempt to comply with the SCBM by conducting a simplified, low-cost analysis because of the requirements of Sarbanes-Oxley and the general trend of conservatism observed by both corporations and accounting firms. This unintended consequence of the proposed regulations defeats one of the key purposes of the SCBM, which is to minimize administrative and compliance costs for certain intercompany services.

#### Potential for Double Taxation

Deductions under foreign tax law may not be allowed for the markup component on intercompany services provided by a U.S. corporation to a foreign affiliate that would be required by the proposed regulations, if the foreign jurisdiction believes such services are appropriately priced at cost. The United States is a relatively high-priced services market relative to its trading partners, and other Competent Authorities may logically argue that such charges are no longer arm's length, since the affiliate-recipient could potentially obtain the same or similar services locally at a reduced cost. And furthermore, international acceptance of the "sliding scale" of the SCBM is doubtful because the Treasury Department and the IRS have not provided any empirical evidence in support of the SCBM. The SCBM would inevitably lead to unproductive disputes with foreign authorities. A better approach would be to build a consensus position within the OECD for a cost-based safe harbour that would be narrower than Treas. Reg. §1.482-2(b)(7), but still provide absolute assurance that certain routine, non-profit-driven services, such as back-office services, can be appropriately charged out at cost.

#### Macroeconomic and Political Issues

For multinational enterprises that continue to perform back-office services in the United States, the additional and substantial compliance costs of the proposed regulations provide one additional economic incentive to explore the possibility of outsourcing such services to jurisdictions such as India, China, or Malaysia. These additional compliance costs would encourage more "buying" by taxpayers that undertake a make v. buy analysis with respect to these routine functions. The United States Congress would most certainly be concerned about the proposed regulations' potential to encourage outsourcing of services performed in the United States, particularly since multinational enterprises have been relying on the cost-based safe harbour of Treas. Reg. §1.482-2(b)(7) since its promulgation in 1968.

This likely but unintended consequence of the SCBM is analogous to the rise and fall of section 956A, which was intended to deter the accumulation of U.S. investments in foreign passive assets by encouraging repatriation, but was repealed after it was found to provide an incentive for investments in foreign active assets. The

SCBM is less justified than section 956A, since IRS and Treasury have not identified a perceived abuse that the proposed regulations are intended to remedy and that is worth forcing the considerable additional compliance burden onto corporate taxpayers.

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Industry Association, *Submission in Response to Notice of Proposed Rulemaking Regarding Treatment of Services Under Section 482 and Related Matters* (Jan. 12, 2004); John. P. Warner, *Too Much Ado About Something – The Proposed Regulations Governing Controlled Services Transactions*, 33 Tax Mgmt. Intl. J. 67 (Feb. 13, 1004); and Thomas M. Zollo, Christopher P. Bowers, and Jeffrey P. Cowan, Jr., *Transfer Pricing for Services: The Next Wave*, 81 Taxes 17 (Mar. 1, 2003). The authors gratefully acknowledge these commentators for their thoughtful insights.

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