



## United States Council for International Business

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Mr. Steven Musher  
Associate Chief Counsel (International) CC:INTL:FO  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Room 4554  
Washington, DC 20224

Reference: Control Number NOT-127827-06  
Comments on TD 9728: temporary and final regulations under Section  
1.482 regarding controlled services transactions and the allocation of  
income from intangibles

Dear Mr. Musher:

We are pleased to submit the comments contained herein of the United States Council for International Business (USCIB) on the temporary and final regulations under section 1.482 concerned with controlled services transactions and allocation of income from intangibles.

This letter is in addition to our prior correspondence concerning the draft revenue procedure 'white list' of services eligible for the simplified cost method and concerning our request that the effective date of the regulations be postponed by one year.

Representing over 300 U.S.-based multinational companies, professional firms, and business associations, USCIB seeks to advance the global interests of U.S. business at home and abroad. It promotes an open system of global commerce in which business can flourish and contribute to economic growth, human welfare and protection of the environment. USCIB is the U.S. affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee to the OECD (BIAC) and the International Organization of Employers (IOE).

### **Discussion**

We appreciate the opportunity to comment. Although the regulations are scheduled to take effect very soon, we have some significant concerns and we sincerely hope full consideration will be given to them. Our comments follow.

#### **Allocations based on actual transaction terms [1.482-1T(f)(2)(ii)]**

This set of provisions begins with an appropriate general framework:

"The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance."

There is then a qualification which is overly broad and unclear:

"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."

This provision is vulnerable to misinterpretation and excessive application. As a point of contrast, consider the OECD transfer pricing guidelines, which include the following language in Chapter I, paragraph 1.37: "there are two particular circumstances where it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by the taxpayer [...]. The first [...] arises where the economic substance of a transaction differs from its form [...]. The second [...] arises where, while the form and substance [...] are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner [...]." The guidelines make clear that looking beyond the terms and structure of controlled transactions should be on an exceptional basis and where the effects are uneconomic to one of the controlled parties.

The essential point is that taxpayers are entitled to allocate risks internally and set terms by which business is done. Whether associated pricing is arm's length will be supported by reference to comparables-based analyses. If pricing is inconsistent with terms or risks, this will be evident in the comparability analysis, including potentially through the review of comparability criteria and selection of the best method, and, if necessary, can be adjusted for. We do not see the need for a supplementary grant of authority to consider *alternative* business structures. If this provision must be retained, then amplification, by example or otherwise, illustrating the limits on its potential application is called for.

#### **Methods for determining taxable income in connection with controlled services transactions [1.482-9T(a) and (b)]**

It would be helpful for the regulations to be clearer on the fact that the services cost method is elective by the taxpayer, which we understand to be the intent.

#### **Services cost method for services that do not contribute to core advantages [1.482-9T(b)(1)]**

Documentation of conclusion that a service is non-core

We are concerned with the type of documentation required to support a taxpayer's reasonable conclusion in its business judgment that a covered service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more businesses. We believe it important that the regulation clarify that any reasonable approach by a taxpayer to document its conclusion in this regard is appropriate.

In addition, we believe the examples in this area do not fully conform to the general rule set forth in -9T(b)(2) that "[i]n evaluating the reasonableness of the [business judgment conclusion [...], consideration will be given to all the facts and circumstances." It is all too easy for statements as to the sources of a company's competitive strengths or strategic advantage to be made in various forums by executives or department heads for all sorts of reasons. These should not lead to a cacophony through which the tax department must comb to reach a reasonable business judgment or from which the IRS could seek to extract contrary statements to challenge that judgment. Accordingly, we believe that it would be helpful to clarify in Examples 2 and 14 that statements in annual reports, press conferences and other public forums shall not rise to the level of creating a presumption a service is "core".

Application of standard at "controlled group" level

We are also concerned that the standard concerned with whether services contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure is required to be applied to "the renderer, the recipient, or both".

We believe that the "business judgment" test should be applied on a *controlled group* basis. If, for example, a multinational group were to *choose* to concentrate the provision of routine services in a single entity engaged in nothing else, we believe it would be inappropriate for the services to be viewed as contributing significantly to, say, the fundamental risks of that entity simply because they represent its exclusive activity. The test is more appropriately conducted on the basis of the business of the entire controlled group.

We acknowledge and appreciate the public comments by Treasury and IRS officials recognizing the appropriateness of revising the regulations to apply this test on a controlled group basis.

**Excluded transactions from services cost method [1.482-9T(b)(3)(ii)]**

As a general observation, we find the list of transactions excluded from eligibility from the services cost method to be notably broad. This is in stark contrast to the excessive specificity reflected in the draft revenue procedure 'white list'.

A particular concern with the excluded list concerns: "(H) Financial transactions, including guarantees". This needs clarification. Support service activities associated with a lending business ought not to be swept into the

exclusion for financial transactions. While we would not have ordinarily expected they would be, we are very concerned by the suggestion in Example 7 (under -9T(b)(6)).

In the example, Company P, a bank, provides credit analysis services to its affiliates, also engaged in the business of lending. The example indicates the services are not eligible to be charged at cost because they are "part of a 'financial transaction'". We fundamentally disagree that credit analysis should be excluded due to its connection to a "financial transaction".

More broadly, if the list of excluded services in -9T(b)(3)(ii) is to be part of the framework defining the permitted scope of application of the services cost method, it should operate through exclusion of only those services on the list, not *by a subjective association* of a service with an activity on the list.

We also believe that the reference to "guarantees" in the exclusion of financial transactions should be removed. While we understand the IRS position to be that guarantees cannot uniformly be charged at cost, many disagree. Since the Service intends to issue transfer pricing guidance regarding financial guarantees in global trading regulations, it would seem appropriate to wait until the issue is resolved in that context before making a final decision whether guarantees should be excluded from the definitional scope of "covered services".

#### **Low margin covered services [1.482-9T(b)(4)(ii)]**

We understand the purpose of the services cost method to provide administrative convenience and predictability to taxpayers and the IRS. In this respect, in the case of a taxpayer availing of the method by virtue of establishing that a particular service is low margin (i.e., where the median comparable mark-up is equal to or less than 7 percent), it would be helpful if the regulations could afford a clear mechanism permitting the taxpayer to refresh comparables data less frequently than annually. Acceptability of such an approach to the IRS might be enhanced if, in the years when the analysis is done, multi-year data is compiled.

#### **Interaction of Rev Proc 'white list' and 'low margin' services transactions**

We understand the 'white list' in the draft revenue procedure to reflect a view of services which are routine and therefore expected to command a low margin. One specific point which has come to our attention since we previously submitted comments on the draft revenue procedure concerns information technology. In items 45 and 46 of the list, while certain information technology services are described, there is then a very broad exclusion indicating the approved services are "not to include analyzing user needs or developing hardware or software solutions (such as systems integration, website design, writing computer programs, modifying general applications software, or recommending the purchase of commercially available hardware or software)."

Again, this is a manifestation of a major concern we have with the 'white list': it crafts permitted services in an exceedingly narrow manner, pre-supposes that taxpayers can devote resources to an effort to segment the costs of services which in practice are provided in an integrated manner, and, in this case, excludes services which, although they may have the aura of being valuable, are in fact truly routine in the context of multinational corporations. We believe it is not appropriate to exclude such services from the 'white list'.

Certainly, we think that the 'white list' should be limited to identifying general activities that qualify as covered services and therefore should not create a 'gray list' by specifying *excluded* items. In any event, it should be clarified that an explicit exclusion or omission from the 'white list' should *not* be seen to create a presumption that the service in question may not otherwise satisfy the (7 percent) threshold of being low margin.

### **Shared services arrangements**

We commend the recognition given in the regulations to shared services arrangements under 1.482-9T(b)(5). However, it is unfortunate that, in this respect, the regulations are limited in their application to "covered services" (i.e., those which are on the revenue procedure 'white list' or are otherwise 'low margin').

The principal reason shared services arrangements are put in place is to facilitate and simplify business processes; therefore, it is not practical to restrict such arrangements to "covered services" as defined in tax regulations. If the Treasury and IRS are not willing to permit a broader range of support services to, in essence, be subject to a "cost contribution" style regime along the lines of what the OECD guidelines would permit, we request that at least the regulations make clear that a shared services arrangement which includes more than "covered services" remains a valid arrangement within the construct of the regulations. In particular, taxpayers, applying reasonable allocation methods consistently, should be permitted to estimate the approximate costs of "covered services" *within* such an arrangement and effect charges for those services at cost.

#### Examples 20 through 23

In the context of shared services arrangements, these examples focus on testing the reasonableness of the cost allocation key by reference to an assumption that "relative reasonably anticipated benefits were precisely known". We do not find these examples to be meaningful, as precise knowledge of relative benefits is highly unlikely in the vast majority of situations. Indeed, the whole point of cost allocations in shared services arrangements is to have a *reasonable* sharing *in lieu of* an exhaustive and non-productive analysis of precisely what benefits are actually conferred to what recipients at a given point in time.

The extent of knowledge of relative benefits assumed by the examples could be read by examiners to create an inference that the reasonableness of allocation methods should be tested against actual benefits. This would be

highly unproductive and contrary to the simplified administration intended by shared services arrangements.

Fundamentally, as stated in -9T(b)(5)(ii)(B), there is one test, and one test only, that is: "costs 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." Appropriate support for such an allocation should be based on a reasonably evident relationship between the allocation method and the nature of the benefits. There should not be any inference that taxpayers in a shared services arrangement should quantify actual benefits to the participants.

#### **Total services costs [1.482-9T(j)]**

In the regulations, "total services costs" are defined to include "provision for all resources expended, used, or made available to achieve the specific objective" of the service. These are to "include all costs in cash or in kind (including stock-based compensation) [...] directly identified with, or reasonably allocated [...] to, the services." In measuring costs, the paragraph further indicates that reference to GAAP or to Federal income tax accounting principles may provide a "useful starting point but will not necessarily be conclusive".

Clearly, the definition of costs is at the heart of the regulations and clarity in this area is necessary to effective regulation. We do not believe sufficient clarity is present.

As to stock-based compensation specifically, taxpayers are left in a very uncertain position. The standards under GAAP and Federal income tax law for accounting for stock options are significantly different, in relation to both timing and amount of expense recognition.

More broadly, the concern on stock options is a manifestation of the problems inherent in the reluctance exhibited in the regulations to defer to a consistently applied source of accounting standards, such as GAAP or Federal income tax law. As a general principle, we believe taxpayers should not be expected to charge, or to mark-up, costs in excess of those they are entitled to deduct. Further, we continue to believe it is unreasonable to cite basic principles (financial reporting and tax) as a *starting point* and leave it open from there. Taxpayers deserve deference where they apply a method that (i) is grounded in *recognized and accepted* accounting standards (such as GAAP or Federal income tax) and (ii) is *applied consistently* over time.

#### **Benefit test / shareholder activities [1.482-9T(l)(3)]**

The regulations apply the 'benefit test' in defining the scope of "controlled services transactions" for which a charge is required.

Both the preamble to the regulations and the general language under -9T(l)(3) place emphasis on what we consider to be an appropriate standard in the

determination of when a benefit is considered to be conferred, that being whether "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 [...] or [...] otherwise would have performed for itself the same [...] or a similar activity."

The regulations proceed to spell out some situations where no benefit is considered conferred, for example in the case of indirect or remote benefits, duplicative and shareholder activities, etc.

We are very concerned, however, that such situations are defined in an overly narrow fashion. We are also concerned that the examples which follow in the regulations lack a grounding in the core 'willingness to pay' principle.

#### Shareholder activities

Among the specified carve-out areas where no benefit is conferred, our concern is especially with shareholder activities. Here, the regulations narrow the definition of shareholder activities to those having a "sole effect" to protect the renderer's capital investment or to facilitate the renderer satisfying its compliance requirements. We believe the *sole effect* standard is too narrow. It seems to mean that activities predominantly carried out in a shareholder capacity nevertheless fall outside "shareholder activities" because of a minor benefit to the investee.

We urge that terminology referring to a *predominant* effect be applied, or that some other, practical mechanism be incorporated which at least clearly grants relief from the need to charge for the reasonably estimated shareholder-benefiting *portion* of a broader bundle of activities.

#### Willingness to pay

As to the broader concern that the examples do not reflect an explicit and clear grounding in the 'willingness to pay' principle, we note the fact that they are almost entirely concerned with illustrating the specific carve-outs for indirect or remote benefits, duplicative and shareholder activities, etc. These specific carve-outs do not necessarily represent the full scope of situations where the willingness to pay may be lacking. Also, we believe that the way in which the carve-outs are illustrated reflects an overly narrow conception which could be tempered if the willingness to pay standard were more firmly embedded.

We note that, of the 19 examples under -9T(l)(5) dealing with the benefit test, none includes an explicit mention of the willingness to pay standard. A manifestation of our concern which results may be seen in Example 6, where Company Y conducts its own negotiations to enter into a transaction and engages the advice of its own legal counsel. Company X internal counsel reviews the transaction documents (the example is silent as to what initiated the review) in a manner which the examples posits as duplicative of the service procured by Company Y from outside counsel. However, because the Company X review is assumed in the example to reduce commercial risk to Company Y, it is found to confer a benefit.

The example reaches its conclusion without a basis in compelling reasons and does not sufficiently take account of the practical realities. If Company Y did not solicit Company X's review and that review was substantively duplicative, it would likely be unwilling to pay for it.

This sort of situation is prevalent: a parent corporation will often undertake activities at its own discretion as a check on its affiliates, or to impose uniform systems or practices. These situations involve difficult judgments as to whether a benefit is conferred, as they are often driven more by the parent acting in a shareholder capacity to reduce corporate risk.

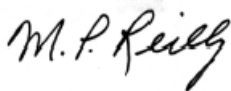
We believe the general framework of the regulations is right in being concerned with whether the recipient's position is enhanced, implying there should be a charge where a benefit is *received*, the key condition of this being the recipient's willingness to pay or to perform the service for itself. But there should be a stronger sense in the way the specific carve-outs, such as shareholder activities, are defined, and a clearer expression across the examples that willingness to pay (on the basis of the reasonable expectations of the parties at the time the activity is performed, not based on an *ex post* analysis) is a condition to finding a benefit.

Certainly, that is the standard which foreign governments look to in practice in examining the deductibility of charges. That the U.S. regulations adopt a benefit test, but then seem to waiver to the point that charges could arise in situations where an uncontrolled party would *not* be willing to pay, risks placing U.S. taxpayers, in complying with Section 482, at odds with foreign governments and facing double taxation.

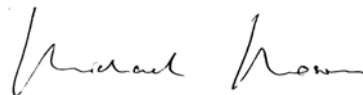
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We appreciate the opportunity to submit these comments and your consideration of them.

Respectfully submitted,



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