

Applying the Temporary Reg. §1.482-9T Services Cost Method

By Robert Feinschreiber and Margaret Kent

Robert Feinschreiber and Margaret Kent describe the application of the services cost method in Temporary Reg. § 1.482-9T, which permits taxpayers, under specified circumstances, to determine the arm's-length charge for controlled services transactions by reference to total services costs, with no mark-up. They also correlate the services cost method examples in the regulation with the specified covered services in Rev. Proc. 2007-13.

Temporary Reg. §1.482-9T, promulgated in 2006, provides guidance in determining taxable income for taxpayers engaged in controlled services transactions.¹ It affords the taxpayer with seven distinct pricing alternatives in ascertaining its intercompany services costs. Temporary Reg. §1.482-9T provides that the taxpayer is to determine the arm's-length amount charged in a controlled services transaction by selecting among these seven alternatives. One such transfer pricing method, the Temporary Reg. §1.482-9T(b) services cost method, enables the taxpayer to charge for the services performed for a wide range of services to its related entities, doing so without imposing a mark-up. It is no surprise, then, that taxpayers typically seek to apply the Temporary Reg. §1.482-9T(b) services cost method. However, it is important for the taxpayer to realize that the services cost method imposes preconditions and limitations on intercompany transactions.

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Seven Services Methods

As a general matter, Temporary Reg. §1.482-9T(a) provides that the taxpayer must determine the arm's-length amount that it charges in a controlled services transaction under one of the seven methods that Temporary Reg. §1.482-9T provides:

- (1) The services cost method, described in Temporary Reg. §1.482-9T(b)
- (2) The comparable uncontrolled services price method, described in Temporary Reg. §1.482-9T(c)
- (3) The gross services margin method, described in Temporary Reg. §1.482-9T(d)
- (4) The cost of services plus method, described in Temporary Reg. §1.482-9T(e)
- (5) The comparable profits method, described in Reg. §1.482-5 and in Temporary Reg. §1.482-9T(f)
- (6) The profit split method, described in Reg. §1.482-6 and in Temporary Reg. §1.482-9T(g)
- (7) Unspecified methods, described in Temporary Reg. §1.482-9T(h)

The taxpayer is to apply each method selected in accordance with the provisions of Reg. §1.482-1. The taxpayer, then, is to take into account each of the following general transfer pricing parameters, except as modified under Temporary Reg. §1.482-9T, in apply-

ing the applicable services method under Temporary Reg. §1.482-9T:

- The best method rule of Reg. §1.482-1(c)
- The comparability analysis of Reg. §1.482-1(d)
- The arm's-length range of Reg. §1.482-1(e)

Introductory Issues Behind the Services Cost Method

Temporary Reg. §1.482-9T(b)(1) provides that, as a general matter, the services cost method evaluates whether the amount that the taxpayer charges for covered services is arm's-length in meeting the requirements of Temporary Reg. §1.482-9T(b)(2) and (3). The taxpayer makes this arm's-length determination by reference to its total services costs, as defined in Temporary Reg. §1.482-9T(j). The Temporary Reg. §1.482-9T(b) services cost method is a mechanism under which the taxpayer charges total services costs to a member of a controlled party, with no excess costs or markup.

Temporary Reg. §1.482-9T(j) defines *total services costs* as 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 the services or are reasonably allocated in accordance with the principles of Temporary Reg. §1.482-9T(k)(2) to the services. In general, "costs" for this purpose pertains to all resources expended, used or made available to achieve the specific objective for which the service is rendered.

Reference to generally accepted accounting principles (GAAP) or to federal income tax accounting rules may provide a useful starting point in determining costs. Nevertheless, reference to GAAP or federal income tax accounting 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 Reg. §1.901-2(a) or domestic income taxes.

The basic issue for the taxpayer in ascertaining the cost method is to determine whether covered services might meet the conditions of Temporary Reg. §1.482-9T(b) and the consequences of that determination. The IRS will consider the services cost method as the best transfer pricing method for purposes of Reg. §1.482-1(c) if covered services, in fact, meet the conditions of Temporary Reg. §1.482-9T(b). In the event that the IRS considers the services

cost method as the best transfer pricing method for purposes of Reg. §1.482-1(c), the Commissioner will limit its allocations under the services cost method to adjusting the amount the taxpayer charges for such services to the properly determined amount of such total services costs.

Covered and Excluded Services

Temporary Reg. §1.482-9T(b)(2) addresses the exclusion of covered services. In that regard, Temporary Reg. §1.482-9T(b)(2) makes reference to the following generic undefined standards to determine the inclusion or exclusion of covered services:

- the reliance on the reasonableness of conclusions reached,
- business judgment,
- key competitive advantages,
- core capabilities, and
- fundamental risks of success or failure.

Temporary Reg. §1.482-9T(b)(2) provides taxpayers should apply these nonspecific standards to include or exclude covered services. As tax practitioners, we expect that subsequent litigation will address the Temporary Reg. §1.482-9T(b)(2) definitional issues. Note that Temporary Reg. §1.482-9T(b)(4) itself defines "covered services."

The drafters sought to exclude services that are essential, important or significant from being treated as covered services that are eligible to be taken into account without markup. The operative provisions of Temporary Reg. §1.482-9T(b)(2) provide that covered services are not services that contribute significantly to fundamental risks of business success or failure. Applying the aforementioned standards, 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. Temporary Reg. §1.482-9T(b)(2) provides that the IRS will give consideration to all the facts and circumstances in evaluating the reasonableness of the conclusion required of the taxpayer.

Application of the Services Cost Method

Temporary Reg. §1.482-9T(b)(3) imposes three specific conditions on the taxpayer in applying the

services cost method. The IRS will evaluate the arm's-length amount that a taxpayer charges in a controlled services transaction under the services cost method if the transaction meets the requirements of Temporary Reg. §1.482-9T(b)(3)(i) as to the following:

- maintenance of adequate books and records,
- compliance with "an intention standard," and
- compliance with "an adequacy standard."

The IRS will not evaluate the arm's-length amount charged in a controlled services transaction under the services cost method if the Temporary Reg. §1.482-9T(b)(3)(ii) regulations exclude the transaction from applying the Temporary Reg. §1.482-9T(b) services cost method.

Temporary Reg. §1.482-9T(b)(3)(i) requires the taxpayer seeking to apply the services cost method to maintain adequate books and records. However, Temporary Reg. §1.482-9T(b)(3)(i), in mandating that the taxpayer retain books and records, only obliquely addresses the issue of the duration for which the taxpayer must retain its books and records. Temporary Reg. §1.482-9T(b)(3)(i) requires that the taxpayer is to maintain permanent books of account and records "for as long as" the renderer incurs these costs with respect to the covered services. Temporary Reg. §1.482-9T(b)(3)(i) imposes two specific requirements as to the adequate books and records requirement imposed on the taxpayer: an intention standard and an adequacy standard.

The Temporary Reg. §1.482-9T(b)(3)(i) intention standard requires the taxpayer to include in its books and records a statement that evidences the taxpayer's intention to apply the services cost method to evaluate the arm's-length charge for such services. The regulations apparently do not require the taxpayer to make that costing decision before the fact. The taxpayer, to alleviate ambiguities that otherwise could arise, might find it advantageous to establish a formal agreement to specify the costs involved, and to specify the manner in which the taxpayer is to apply the services cost method. The taxpayer might find that a Domestic International Sales Corporation (DISC) franchise agreement requires a parallel intent and construction of books and records.

Temporary Reg. §1.482-9T(b)(3)(i) requires that the taxpayer's books and records meet an adequacy standard: *i.e.*, the books and records must be ad-

equated to permit verification by the Commissioner of the total services costs incurred by the renderer. The regulations impose the following specific adequacy standard requirements:

- The taxpayer must describe the services in question.
- The taxpayer must identify the renderer of such services.
- The taxpayer must provide the identification of the recipient of such services.
- The taxpayer must also provide sufficient documentation to allow the IRS to verify the

methods the taxpayer uses to allocate and apportion such costs to the services in question.

Such costs must be allocated and apportioned in accordance with Temporary Reg. §1.482-9T(k).

However, it is important for the taxpayer to realize that the services cost method imposes preconditions and limitations on intercompany transactions.

Excluded Transactions

The following transactions are not, in whole or part, covered services as to the services cost method, but are excluded transactions. Temporary Reg. §1.482-9T(b)(3)(ii) provides that the following nine transactions are excluded transactions in applying the services cost method:

- Manufacturing, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(A)
- Production, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(B)
- Extraction, exploration or processing of natural resources, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(C)
- Construction, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(D)
- Reselling, distribution, acting as a sales or purchasing agent or acting under a commission or other similar arrangement, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(E)
- Research, development or experimentation, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(F)
- Engineering or scientific services, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(G)
- Financial transactions, including guarantees, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(H)
- Insurance or reinsurance, as specified under Temporary Reg. §1.482-9T(b)(3)(ii)(I)

Temporary Reg. §1.482-9T(b)(3)(ii) fails further to

define these nine parameters, and fails to correlate these activities with Code Sec. 199.

Scope of “Covered Services”

Temporary Reg. §1.482-9T(b)(4) defines the scope of *covered services* within the services cost method. In general, the services cost method provides for two types of covered services:

- *Specified covered services*, as specified by Temporary Reg. §1.482-9T(b)(4)(i)
- *Low margin covered services*, as specified by Temporary Reg. §1.482-9T(b)(4)(ii)

For purposes of Temporary Reg. §1.482-9T(b)(4), covered services consist of a controlled transaction or a group of controlled service transactions. See Reg. §1.482-1(f)(2)(i) as to the aggregation of transactions that meets the definition of specified covered services or the definition of low margin covered services.

The *specified covered services* provision, as specified by Temporary Reg. §1.482-9T(b)(4)(i), provides that specified covered services are controlled services transactions that the Commissioner specifies by revenue procedure. Temporary Reg. §1.482-9T(b)(4)(i) provides that the IRS will include specified services in such revenue procedure based upon the Commissioner’s determination that:

- they are support services common among taxpayers across industry sectors, and
- they generally do not involve a significant median comparable markup on total services costs.

On December 20, 2006, the IRS issued Rev. Proc. 2007-13 that enumerates 101 specified covered services, categorized in the following 20 areas²:

1. Payroll (“covered service numbers” 1-4)
2. Premiums for Unemployment, Disability and Workers Compensation (5-6)
3. Accounts Receivable (7-10)
4. Accounts Payable (11-13)
5. General Administrative (14-20)
6. Corporate and Public Relations (21-22)
7. Meeting Coordination and Travel Planning (23-27)
8. Accounting and Auditing (28-37)
9. Tax (38-44)

10. Health, Safety, Environmental and Regulatory Affairs (45-52)
11. Budgeting (53-55)
12. Treasury Activities (56-59)
13. Statistical Assistance (60-61)
14. Staffing and Recruiting (62-74)
15. Training and Employee Development (75-79)
16. Benefits (80-86)
17. Information and Technology (87-94)
18. Legal Services (95-96)
19. Insurance Claims Management (97-99)
20. Purchasing (100-101)

A number of U.S. taxpayers have set up service centers in India to perform low-value services by their affiliated entities.

Taxpayers doing business in India should note that the Indian tax authorities impose a value-added concept to the services in question, creating double taxation to the extent that the taxpayer must mark up its services in India by

an amount, say 25 percent of cost, while the U.S. party could deduct only the cost amount. Taxpayers in this configuration might be awaiting the promulgation of the Advance Pricing Agreement process in India, which we as tax practitioners expect in the second or third quarter of 2008.

Temporary Reg. §1.482-9T(b)(4)(ii) provides for the definition of the term “median comparable markup on total services costs.” The Commissioner may add to, subtract from or otherwise revise, the specified covered services described in the revenue procedure by subsequent revenue procedures. These amendments to the revenue procedure are to ordinarily be applied prospectively.

The *low margin covered service* provision, as specified by Temporary Reg. §1.482-9T(b)(4)(ii), provides that low margin covered services are controlled services transactions for which the median comparable markup on total services costs, as defined by Temporary Reg. §1.482-9T(b)(4)(ii), is less than or equal to seven percent. Most practitioners seeking to apply the services cost method have shied away from reliance on the Temporary Reg. §1.482-9T(b)(4)(ii), the *low margin covered service* provision, and have relied instead on the 101 covered services specified in Rev. Proc. 2007-13.

The allocation of costs that the participants select must provide the most reliable measure of the participants’ respective shares of the reasonably anticipated benefits under the principles of the best method rule.

Temporary Reg. §1.482-9T(b)(4)(ii) provides that the taxpayer is to determine the markup percentage in the following manner:

- The numerator of the markup percentage is the median comparable markup on total services costs. The median comparable markup on total services costs is the excess emanating from the arm's-length price of the controlled services transaction. The taxpayer is to follow the applicable procedure:
 - Temporary Reg. §1.482-9T(b)(4)(ii) provides that the taxpayer is to determine the excess of the arm's-length price of the controlled services transaction under the general regulations under Code Sec. 482. The taxpayer is to make this determination without regard to Temporary Reg. §1.482-9T(b).
 - The taxpayer is to use the interquartile range described in Reg. §1.482-1(e)(2)(iii)(C) and, as necessary, the taxpayer is to adjust the median of such interquartile range.
- The denominator of the markup percentage is total services costs.
- The taxpayer is to express the markup percentage as a percentage of total services costs.

Taxpayers have frequently found the Temporary Reg. §1.482-9T(b)(4)(ii) low margin covered services provision to be impractical for the following reasons:

- The taxpayer might have many diverse low-valued services.
- Issues can arise as to the aggregation of services to come within the low value margin provisions.
- The taxpayer might be engaged in providing bundled services for which there is no ready comparable.
- The taxpayer might view the low value services provision as being complex, especially compared with the 1968 services provisions and with the Rev. Proc. 2007-13 listing of 101 activities.³

Shared Services Arrangements

Temporary Reg. §1.482-9T(b)(5)(i) addresses covered services that might be the subject of a shared services arrangement. In the event that covered services are subject to a shared services arrangement, Temporary Reg. §1.482-9T(b)(5)(i) generally provides that 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 Temporary Reg. §1.482-9T(b) that is properly allocated to such participant pursuant to the arrangement.

Temporary Reg. §1.482-9T(b)(5)(ii) contains the requirements for a shared services arrangement. A shared services arrangement must meet the following requirements described in Temporary Reg. §1.482-9T(b)(5):

- Eligibility requirements, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(A)
- Allocation requirements, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(B)
- Documentation requirements, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(C)
- Temporary Reg. §1.482-9T(b)(5)(iii) provides for definitions and special rules as to shared services arrangements

Temporary Reg. §1.482-9T(b)(5)(ii)(A) provides, as to the *eligibility* requirements for a shared services arrangement, that the arrangement, to be eligible for treatment under Temporary Reg. §1.482-9T(b)(5), must meet the following *eligibility* requirements:

- The arrangement must include two or more participants, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(A)(1).
- The arrangement must include, as participants, all controlled taxpayers that reasonably anticipate a benefit, as Temporary Reg. §1.482-9T(l)(3)(i) defines "benefit," from one or more covered services specified in the shared services arrangement, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(A)(2).
- The arrangement must also be structured such that each covered service, or each reasonable aggregation of services within the meaning of Temporary Reg. §1.482-9T(b)(5)(iii)(B), confers a benefit on at least one participant in the shared services arrangement, as specified by Temporary Reg. §1.482-9T(b)(5)(ii)(A)(3).

The "reasonably anticipated benefits" rule applies in ascertaining shared services. Temporary Reg. §1.482-9T(b)(5)(ii)(B) provides, as to the allocation requirement, that the participants must allocate costs for covered services among the participants based on their respective shares of the reasonably anticipated benefits from those services. The participants are to make this determination as to benefits without regard to whether the anticipated benefits are in fact realized. "Reasonably anticipated benefits" are "benefits" as defined in Temporary Reg. §1.482-9T(l)(3)(i).

Participants must allocate the costs that are applicable to the benefits. The allocation of costs that the participants select 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 Reg. §1.482-1(c) as to the definition of best method. The participant must apply the shares of the reasonably anticipated benefits allocation on a consistent basis for all participants and for all 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. The Commissioner may not adjust such allocation basis if the taxpayer reasonably concluded that the shared services arrangement, including any aggregation pursuant to Temporary Reg. §1.482-9T(b)(5)(iii)(B), 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 Temporary Reg. §1.482-9T(b)(5). For allocation purposes, taxpayers need not prove to the IRS that their allocation is necessarily the best transfer pricing method, only that the taxpayer's method is reasonable and the allocation method reliably reflects respective shares of the reasonably anticipated benefits attributable to such services.

Temporary Reg. §1.482-9T(b)(5)(ii)(C) provides, as to the documentation requirement within the shared services provisions, that the taxpayer must maintain sufficient documentation to establish that the taxpayer satisfies the requirements of Temporary Reg. §1.482-9T(b)(5). The taxpayer is to include the following six facets to demonstrate its documentation:

- 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 pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(1)
- A list of the participants under the shared services arrangement pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(2)
- A list of the renderer or the renderers of covered services under the shared services arrangement pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(2)
- A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(3)
- A description of any aggregation of covered services for purposes of the shared services

arrangement pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(4)

- An indication whether this aggregation (if any) pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(C)(4) differs from the aggregation used to evaluate the median comparable markup for any low margin covered services described in Temporary Reg. §1.482-9T(b)(4)(ii)

Temporary Reg. §1.482-9T(b)(5)(iii) provides three definitions and special rules for shared services arrangements:

- Temporary Reg. §1.482-9T(b)(5)(iii)(A) defines the term *participant* to mean a controlled taxpayer that reasonably anticipates benefits from covered services subject to a shared services arrangement that substantially complies with the requirements described in Temporary Reg. §1.482-9T(b)(5).
- Temporary Reg. §1.482-9T(b)(5)(iii)(B) provides, as to *aggregation*, that a taxpayer can aggregate two or more covered services that meet the following criteria:
 - The aggregation takes place in a reasonable manner
 - The aggregation takes into account all the facts and circumstances
 - The facts and circumstances take into account whether the relative magnitude of reasonably anticipated benefits of the participants that share the costs of such aggregated services are reasonably reflected by the allocation basis employed pursuant to Temporary Reg. §1.482-9T(b)(5)(ii)(B)
 - 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 Temporary Reg. §1.482-9T(b)(4)(ii)
 - However, a taxpayer seeing to aggregate services can do so provided that the taxpayer can implement such alternative aggregation on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary
- Temporary Reg. §1.482-9T(b)(5)(iii)(C) provides, as to the *coordination with cost sharing arrangements*, that:
 - A taxpayer can make an allocation to a participant in a shared services arrangement that is also a participant in a cost sharing arrangement subject to Reg. §1.482-7.

- The taxpayer can make this cost sharing arrangement allocation to the extent that such amount with respect to covered services is first allocated pursuant to the shared services arrangement under Temporary Reg. §1.482-9T(b)(5).
- Costs that a taxpayer allocates pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible development activity under Reg. §1.482-7 and other activities of the participant.
- Company P, in addition to owning and operating hospitals, also owns and operates a computer system.
- Doctors and nurses gather information during interviews and treatment of patients.
- Company P's computer system maintains medical information that doctors and nurses obtain from patients.
- The fact pattern the regulations provide fails to address the relative importance of the hospitals and the medical computer system.
- The fact pattern fails to specify whether the medical computer system is a revenue raiser within the corporate group or as to unrelated parties.

Services Cost Method Examples

Temporary Reg. §1.482-9T(b)(6) provides 26 examples that illustrate the services cost method. The drafters do not intend an inference as to whether the presence or absence of one or more facts is determinative of the conclusion in any example. The reader should note the following factual parameters:

- For purposes of *Examples 1 through 14*, the fact patterns 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*, the fact patterns 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*, the fact patterns 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). The fact pattern assumes that Company P and its subsidiaries satisfy all of the requirements for a shared services arrangement as specified in Temporary Reg. §1.482-9T(b)(5)(ii) and (iii).

Example 1. Data Entry Services

- Company P, Company Q and Company R own and operate hospitals.
- Category 15 refers to General Administrative: Performing data entry through use of a keyboard

As tax practitioners, it is our view that the Treasury, in promulgating the services cost method, could achieve more certain services results by delineating the taxpayer's profit centers as opposed to the taxpayer's cost centers.

within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).

■ The Treasury promulgated Temporary Reg. §1.482-9T(b)(4)(i) before the IRS issued Rev. Proc. 2007-13. As a result, Temporary Reg. §1.482-9T(b) *Example 1*, pertaining to Data Entry Services, fails to specifically select a covered service.

- Based on the facts presented, it appears that the IRS would view *Example 1*, Data Entry Services, as being within covered service category 15 under Rev. Proc. 2007-13.

or scanning device, including verifying data and preparing materials for printing.

- The assumption as to the data entry services as being within the services cost method begs the question, as the data entry services might or might not be part and parcel of the medical information computer system.
- If the data entry services are part of the medical information computer system, it is possible for the IRS to argue that these services are part of the business's core capabilities, and for that reason, the medical information system is outside the scope of the services cost method.
- 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 Temporary Reg. §1.482-9T(b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.
- The practical concern in *Example 1* is to demonstrate that the data entry services are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).

Example 2. Data Entry Services

- 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."
- A player's card is a smart card device that a player uses in Company P's gambling establishments to track a player's bets, winnings, losses, hotel accommodations and food and drink purchases.
- Company P uses the player's cards to obtain marketing information from its customers.
- Company Q and Company R acquire marketing information from Company P about P's 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.
- These customized vacation packages take into account the users' individual preferences and spending patterns.

- Annual reports for the PQR Controlled Group state that this smart card data constitutes an important element of the group's overall strategic business planning, which impacts advertising and accommodations.
- Rev. Proc. 2007-13 would not apply to the data entry services because this smart card data constitutes an important element of the group's overall strategic business planning.
- As a result, the PQR Controlled Group does not meet the specified covered services provisions.
- We assume that these services relating to data entry would otherwise be specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i), *i.e.*, category 15 under Rev. Proc. 2007-13, but for the extent that the activities involve player's cards and the importance of that activity.
- 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 limitations on the services cost method.
- As a result, P is entitled to earn a profit on its "player's card" activities.

Example 3. Recruiting Services

- 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.
- The facts presented are not specific on this point, but it appears that Company P does not recruit middle managers and engineers for unrelated parties.
- The facts presented are not specific on this point, but it appears that Company P does not treat its resource department as being a profit center.
- Company P's human resources department attends job fairs and other recruitment events to recruit middle managers and engineers.
- Each of these companies, P, Q and R, uses recruiters from unrelated executive search firms for recruiting higher-level managers and engineers.
- The drafters would have us assume that these services relating to recruiting are specified covered

services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).

- In this regard, within Rev. Proc. 2007-13, see covered service number 68, implementing the recruiting plan, within the broader Staffing and Recruiting category.
- 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 Temporary Reg. §1.482-9T(b), 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

- Company P, Company Q and Company R are talent agencies that represent celebrities in the entertainment industry.
- The PQR companies have highly compensated agents.
- The highly compensated agents are among the most important resources of these talent agencies because of the personal relationships these agents have with celebrities in the entertainment industry.
- Company P implements a recruiting plan to hire highly compensated agents for itself.
- Company P implements a recruiting plan to hire other highly compensated agents for each of its wholly owned subsidiaries in foreign countries for Company Q and for Company R.
- The drafters would have us assume that these services relating to recruiting are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- As tax practitioners, we view these recruiting services for talent agencies as beyond the scope of staffing and recruiting, as elucidated in Rev. Proc. 2007-13, covered service numbers 62-74.
- The example fails to address the parameters in ascertaining whether in fact the services contribute significantly to the controlled group's key competitive advantages, core capabilities or fundamental risks of success or failure in the group's business.
- As tax practitioners, it is our view that recruiting services contribute significantly to the controlled group's key competitive advantages.

- Under the facts and circumstances in *Example 4*, 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 recruiting services to Company Q and Company R in accordance with the services cost method.
- As tax practitioners, we would have relied on Rev. Proc. 2007-13 to exclude talent agency services from the cost safe harbor; the drafters reached the same result by relying on the key competitive advantage test.

Example 5. Credit Analysis Services

- Company P is a manufacturer and distributor of clothing for retail stores.
- Company Q and Company R are distributors of clothing for retail stores.
- Personnel in Company P perform credit analysis on its customers as part of its operations.
- Company P has a history of purchases from most of the customers.
- The credit analysis involves a review of the recent payment history of the customer's account.
- The personnel in Company P perform a basic credit check of customers, using reports from a business credit reporting agency for new customers.
- 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 analysis method Company P uses for itself.
- Based on the facts presented, it appears that Company P does not perform this credit service outside the PQR Group, and does not treat credit services as a profit center; nevertheless, Temporary Reg. §1.482-9T(b) does not address this parameter.
- Assume that these services relating to credit analysis are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- As tax practitioners, we would view P's credit analysis as being part of an accounts receivable process, service category number 7 in Rev. Proc. 2007-13.
- 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 Temporary Reg. §1.482-9T(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

- Company P, Company Q and Company R lease furniture to retail customers.
- Company P, Company Q and Company R lessees present a significant credit risk to the companies.
- The lessees are generally unable to lease furniture from other providers.
- Personnel in Company P perform credit analysis on each of the potential lessees as part of its leasing operations.
- The personnel in Company P 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.
- Company P charges more than the market lease rate charged to customers with average credit ratings in order to compensate for the specialized analysis of a customer's default risk, as well to compensate for the default risk itself.
- Company P, as part of its operations, performs similar credit analysis services for Company Q and Company R, which charge correspondingly high monthly lease payments.
- The drafters would have us assume that these services relating to credit analysis are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- It is our view that Rev. Proc 2007-13 would treat this credit analysis as service category number seven, under accounts receivable.
- 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

- Company P is a large full-service bank.
- Company P provides products and services to corporate and consumer markets.
- Such products and services that Company P provides include unsecured loans, secured loans, lines of credit, letters of credit, foreign currency conversion, consumer loans, trust services and sales of certificates of deposit.
- Company Q makes routine consumer loans to individuals.
- Company Q makes auto loans and home equity loans.
- Company R makes business loans to small businesses only.
- 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, the rate of interest and loan terms.
- The drafters treat the credit analysis as specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- The credit card analytical services appear to be reflected in Rev. Proc. 2007-13, service category number seven, as part of the accounts receivable process.
- Under the facts and circumstances, the credit analysis services constitute part of a "financial transaction" described in Temporary Reg. §1.482-9T(b)(3)(ii)(H).
- Such transactions, then, are specifically excluded transactions.
- 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

- 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.
- *Example 8* implicitly assumes that Company P's accounting department does not perform accounting services for others outside the PQR Controlled Group.

- Company P's accounting department identifies any inaccuracies in the records, such as double-payments and double-charges.
- The drafters would have us assume that these services relating to verification of data are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- We treat the verification activities as a covered service under Rev. Proc. 2007-13, category number 29, which pertains to the accuracy of figures, *etc.*
- 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 Temporary Reg. §1.482-9T(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

- Company P gathers information from unrelated customers that pertains to accounts payable and accounts receivable.
- Company P utilizes its own computer system to analyze accounts payable and accounts receivable information for purposes of identifying errors in payment and receipts as to data mining services.
- Users compensate Company P for these services.
- The fee reflects a percentage of amounts collected by customers as a result of the data mining services.
- These activities that Company P undertakes 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.
- These services relating to data mining are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- Rev. Proc. 2007-13 reflects accounts receivable as service categories seven through 10 and accounts payable as categories 11 through 13.
- 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.
- In the opinion of the authors, as tax practitioners, the taxpayer's pricing structure, *i.e.*, the percentage collected, may be determinative in precluding the services cost method.
- In the opinion of the authors, Company P operates these activities as a profit center, and for that reason, Company P should be ineligible to apply the services cost method.

Example 10. Legal Services

- 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 that industrial customers use.
- 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.
- Company P seeks to maintain in-house legal staff having 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 than Company P's in-house legal staff.
- It is necessary for Company P to retain several local law firms to handle litigation and business disputes that arise from the activities of Company Q and Company R.
- Although Company Q and Company R pay the fees of these law firms that handle their work, the legal department of Company P is the hiring authority and provides general oversight of the firms' representation.
- Company P must determine what portion of the legal expenses of Company P may be allocated to Company Q and to Company R.

- In making that allocation, Company P first excludes any expenses relating to legal services that constitute shareholder activities.
- Company P then excludes other items that do not constitute controlled services.
- The drafters assume that the remaining services relating to general legal functions performed by in-house legal counsel are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- It appears the legal activities are within the scope of Rev. Proc. 2007-13 as legal services specified in service category number 95.
- 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 Temporary Reg. §1.482-9T(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 Service

- Company P is a domestic holding company whose operating companies generate electric power for consumers by operating its nuclear plants.
- Company P has several domestic operating companies, including Companies Q and R.
- Assume that, although Company P owns 100 percent of the stock of Companies Q and R, the companies do not elect to file a consolidated Federal income tax return with Company P.
- 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.
- Company P's legal department 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.
- 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 U.S. 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 specialized legal staff of Company P performs the majority of the work.
- Certain of the legal services performed by Company P constitute duplicative or shareholder activities that do not confer a benefit on the other companies.
- Company P does not need to allocate duplicative or shareholder activities to the other companies.
- Certain other legal services are eligible to be charged to Company Q and Company R in accordance with the services cost method.
- 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 Temporary Reg. §1.482-9T(b)(4)(i).
- 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

- 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.
- Company P's personnel input data relating to accounts payable and accounts receivable into the system.
- Company P's personnel extract data relating to accounts receivable and accounts payable in the form of reports or electronic media and provide that data to all three companies.
- Company P's computer specialists periodically modify the ERP system to adapt to changing business functions in all three companies.
- Company P's computer specialists make the above-mentioned changes by either modifying the underlying software program or by purchasing additional software or hardware from unrelated third-party vendors.
- The fact pattern in the example infers that Company P is not in the business providing an ERP system as a profit center, but the drafters do not address this issue.
- Assume that these services relating to accounts payable and accounts receivable are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- These accounts payable and accounts receivable activities would be treated as service category numbers 11 and eight, respectively, under Rev. Proc. 2007-13.
- 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 Temporary Reg. §1.482-9T(b), Company P will be eligible to charge these services to Company Q

and Company R in accordance with the services cost method.

- 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 Temporary Reg. §1.482-9T(b)(4) 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 such services to Company Q and Company R in accordance with the services cost method.
- Such a specific exclusion mentioned above is a secondary example to *Example 12*.

Example 13. Group of Services

- Company P manufactures and sells widgets under an exclusive contract to Customer One.
- Company Q and Company R sell widgets under exclusive contracts to Customer Two and Customer Three, respectively.
- Each of these customers can accurately forecast its need for widgets at least one year in advance.
- 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.
- 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.
- Company P's personnel also obtain orders from all three companies' customers to draw up purchase orders for widgets, as well as to make payment to suppliers for widget replacement parts.
- In addition, Company P's personnel use data entry to input, into a centralized computer system, information regarding orders and sales of widgets and replacement parts for all three companies.

- Company P's personnel also maintain the centralized computer system and extract order and sales data for all three companies when necessary.
- Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- The reader should note, however, that purchasing activities, as specified in Rev. Proc. 2007-13, service category numbers 100-101, are narrow in scope.
- The above-mentioned purchasing activities are beyond the scope of the activities in Rev. Proc. 2007-13, service category number 100: "planning and executing procurement of services and material pursuant to company standard for support functions."
- 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 Temporary Reg. §1.482-9T(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

- 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, into a centralized computer, information regarding orders and sales of gadgets for all three companies.
- 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's 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.

- 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.
- Assume that these services that relate to tracking purchases and sales of inventory are specified covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(i).
- Rev. Proc. 2007-13 includes service category number 100, "planning and executing procurement of services and material pursuant to company standard for support functions."
- 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.
- Company P determines the amount charged as the total cost of rendering the services, with no markup.
- Based on an application of the regulations under Code Sec. 482 without regard to Temporary Reg. §1.482-9T(b), the interquartile range of arm's-length markups on total services costs is between three percent and six percent, and the median is four percent.

- Because the median comparable markup on total services costs is four percent, which is less than seven percent, the accounting services constitute low margin covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(ii).
- The fact pattern fails to address whether the services in question would also fall under the Rev. Proc. 2007-13 covered services.

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.
- Company P determines the amount charged as its total cost of rendering the services, with no markup.
- Based on an application of the regulations under Code Sec. 482 without regard to Temporary Reg. §1.482-9T(b), the interquartile range of arm's-length markups on total services costs is between six percent and 13 percent, and the median is nine percent.
- Because the median comparable markup on total services costs is nine percent, which exceeds seven percent, the logistics-coordination services do not constitute low margin covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(ii).
- With respect to the determination and application of the interquartile range, see Reg. §1.482-1(e)(2)(iii)(C).
- The fact pattern fails to address whether the services in question would also fall under the Rev. Proc. 2007-13 covered services.

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.
- Company P determines the amount charged as its total cost of providing the services, with no markup.
- Uncontrolled comparables perform a similar range of custodial and maintenance services for uncontrolled parties.
- The uncontrolled comparables 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 Temporary Reg. §1.482-9T(c).
- The arm's-length price for the custodial and maintenance services is determined under the general regulations under Code Sec. 482 without regard to Temporary Reg. §1.482-9T(b), using the interquartile range described in Reg. §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 Temporary Reg. §1.482-9T(j) 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 four percent.
- The median comparable markup on total services costs, as determined by an application of the regulations under Code Sec. 482 without regard to Temporary Reg. §1.482-9T(b), is four percent, which is less than seven percent.
- As a result, the custodial and maintenance services constitute low margin covered services within the meaning of Temporary Reg. §1.482-9T(b)(4)(ii).

Example 18. Shared Services Arrangement and Reliable Measure of Reasonably Anticipated Benefit (Allocation Key)

- Company P operates a centralized data processing facility that performs automated invoice processing and order generation for all of its subsidiaries.
- Company P's subsidiaries are Companies X, Y and Z.
- Company P undertakes a shared services arrangement with Companies X, Y and Z.
- Company P is to evaluate the shares of reasonably anticipated benefits from the centralized data processing services as part of the shared services arrangement.
- The total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefits shares in determining the reasonably anticipated benefits because the value of merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.

- 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)

- Company P operates a centralized center that performs human resources functions. Such human resources functions include the administration of pension, retirement and health insurance plans that are made available to employees of its subsidiaries, Companies X, Y and Z.
- Company P, X, Y and Z allocate these functions pursuant to a shared services arrangement.
- 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.
- 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.
- 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)

- Company P performs human resource services (service A) on behalf of the PXYZ Group.
- The PXYZ Group services qualify for the services cost method.
- Under the services cost method, Company P determines the amount charged for these hu-

man resource services pursuant to a shared services arrangement.

- Company P applies the Temporary Reg. §1.482-9T(b)(5) shared services arrangement.
- Service A constitutes a specified covered service described in an unspecified revenue procedure pursuant to Temporary Reg. §1.482-9T(b)(4)(i).
- For example, Rev. Proc. 2007-13 could arguably pertain to specified covered human research services.
- The total services costs for service A as otherwise determined under the services cost method is 300.
- 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 Temporary Reg. §1.482-9T(k) to Company X, Y and Z for service A is as follows:

Service A Total cost 300, delineated as follows:

X 150
Y 75
Z 75

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

Company X, Y, Z total — 1,100 employees

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
Z	250	68

Based on the preceding 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)

- Company P performs accounts payable services (service B) on behalf of the PXYZ Group.
- Company P determines the amount charged for the services under such method pursuant to a shared services arrangement based on an application of Temporary Reg. §1.482-9-T(b)(5).
- Service B is a specified covered service described in a revenue procedure pursuant to Temporary Reg. §1.482-9T(b)(4)(i).
- The total services costs for service B otherwise determined under the services cost method is 500.
- 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 Temporary Reg. §1.482-9T(k) to Companies X, Y and Z for service B is as follows:

Service B Company Total Cost	500
X	125
Y	205
Z	170

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

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

Total employees 1,000

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

Total Transaction Volume 9,500

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

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:

Allocation Key:		
Company	Transaction Volume	Amount
X	2,000	105
Y	4,000	211
Z	3,500	184

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

- Company P performs two services on behalf of PXYZ Group.
- Company P performs human resource services (service A).
- Company P performs accounts payable services (service B).
- Company P applies the services cost method to service A and to service B.
- Company P applies a shared services arrangement based on an application of Temporary Reg. §1.482-9T(b)(5) in determines the amount charged for these services.
- The example provides that Service A and service B are specified covered services described in a revenue procedure (*i.e.*, Rev. Proc. 2007-13) pursuant to Temporary Reg. §1.482-9T(b)(4)(i).
- The PXYZ Group determines the total services costs under the services cost method for service A is 300.

- The PXYZ Group determines the total services costs under the services cost method for service B is 500.
- The PXYZ Group determines the total services costs under the services cost method for service A and service B is 800.
- Company P determines that aggregation of services A and B for purposes of the arrangement is appropriate.
- 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 P precisely knew the relative reasonably anticipated benefits, the appropriate allocation of total charges pursuant to Temporary Reg. §1.482-9T(k) to Companies X, Y and Z for services A and B are as follows:

Services A and B Total Cost 800
 X — 350
 Y — 100
 Z — 350

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
 Total 10,000

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

Company — X600
 Company — Y200
 Company — Z200
 Total 1,000

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

Aggregated Services AB Total Cost 800				
Allocation Key:				
Company	Transaction Volume	Amount	Headcount	Amount
X	2,000	160	600	480
Y	4,000	320	200	160
Z	4,000	320	200	160
Total	10,000	800	1,000	800

In contrast, if P allocated the aggregated services AB by 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		
Allocation Key:		
Company	Trade Sales	Amount
X	\$400 million	314
Y	\$120 million	94
Z	\$500 million	392
Total	\$1,020 million	800

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

Example 23. Shared Services Arrangement and Aggregation³

- 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 Temporary Reg. §1.482-9T(b)(5).
- All of these services A through P constitute either specified covered services or low margin covered services described in Temporary Reg. §1.482-9T(b)(4).
- The total services costs for services A through P otherwise determined under the services cost method is 500.
- Company P determines that aggregation of services A through P for purposes of the arrangement is appropriate.
- Companies X and Y reasonably anticipate benefits from services A through P and Company Z reasonably anticipates benefits from services A through M but not from services N, O or P.
- Company Z performs services similar to services N, O and P on its own behalf.
- Company P does not reasonably anticipate benefits from services A through P.
- Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to Temporary Reg. §1.482-9T(k) to Company X, Y and Z for services A through P is as follows:

Company	Services A-M	Services N-P	Services A-P(Total)
X	90	5	95
Y	240	5	245
Z	160		160
Total Cost	490	10	500

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
- Total 10,000

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

Aggregated Services A - P Total Costs 500		
Allocation Key:		
Company	Transaction Volume	Amount
X	2,000	100
Y	4,500	225
Z	3,500	175
Total	10,000	500

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

Example 24. Renderer Reasonably Anticipates Benefits

- 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 percent 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.
- Based on an application of Temporary Reg. §1.482-9T(b)(5), Company P charges 80. P allocates this amount 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

- Company P performs human resource services (service A) on behalf of the PXYZ Group.
- Such human resource services 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 Temporary Reg. §1.482-9T(b)(5).
- Service A constitutes a specified covered service described in a revenue procedure pursuant to Temporary Reg. §1.482-9T(b)(4)(i).
- The total services costs for service A otherwise determined under the services cost method is 300.
- 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 parties allocate the total charge of 300 as follows:
 - X 100
 - Y 50
 - Z 25
 - P 125

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

- Companies P and X enter into a cost sharing arrangement in accordance with Reg. §1.482-7.
- Company P will undertake all intangible development activities under the arrangement.
- Company P devotes all of its R&D activity 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.
- Company X will make payments to Company P as required under Reg. §1.482-7.
- Company X will manufacture, market and otherwise exploit the product in the rest of the world.
- 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.
- Both Companies P and X will share intangible development costs in accordance with their reasonably anticipated benefits from the intangibles.
- Both Companies P and X will make payments as required under Reg. §1.482-7.
- 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.
- In addition, it is necessary for the taxpayer 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.

Example 26. Coordination with Cost Sharing Arrangement

- The facts and analysis in *Example 26* 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 parties allocate 300 of service costs as follows:

X — 100
 Y — 50
 Z — 25
 P — 125

- In addition to performing services, Company P undertakes 500 of R&D.
- Company P incurs manufacturing and other costs of 1,000.
- Company X undertakes 400 of R&D and incurs manufacturing and other costs of 600.
- Companies P and X enter into a cost sharing arrangement in accordance with Reg. §1.482-7.
- Both Companies P and X will undertake intangible development activities under the cost sharing arrangement.
- Companies P and X devote all of the R&D activity 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.
- 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 percent.
- Accordingly, 40 percent 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.
- Company X includes 40 of services cost method charges in the pool of intangible development costs.
- The parties' respective contributions to intangible development costs under the cost sharing arrangement are as follows:
 - P: $500 + (0.333 \times 125) = 542$
 - X: $400 + (0.40 \times 100) = 440$

Conclusion

As tax practitioners, it is our view that the Treasury, in promulgating the services cost method, could achieve more certain services results by delineating the taxpayer's profit centers as opposed to the taxpayer's cost centers. Thus, a taxpayer may reflect an activity as being within in a cost center, but not in a profit center, when the taxpayer intends to treat the activity solely as a cost. In contrast, the taxpayer

might reflect the activity in the cost center and the profit center when the taxpayer has an expectation of profit from that activity.

It is our view that the “expectation of profit” would be a concrete delineation of the activities in question. The “expectation of profit” as to these services would lead to the process of evaluating whether these services contribute significantly to fundamental risks of business success or failure. The “expectation of profit” standard could in some situations be analogous to situations in which the preexisting standard applies; *i.e.*, 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.

ENDNOTES

- ¹ Portions of this article are taken directly from Temporary Reg. §1.482-9T.
- ² Rev. Proc. 2007-13, IRB 2007-3.
- ³ Temporary Reg. §1.482-9T(b)(6), Example 23, contains an error by referring to services A-P and services A-Z interchangeably. For consistency purposes, we refer to Services A-P in this example.

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