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New Guidance on Related-Party Services and Intangible Property Transactions

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Transfer Pricing Alert

Overview of New Temporary U.S. Transfer Pricing Services and Intangibles Regulations

Date:

On July 31, 2006 the IRS revised the proposed intercompany services regulations under Internal Revenue Code (IRC) § 1.482-9, first published in September 2003, incorporating public comments and refining the initial guidance for evaluation of related-party services and intangible property transactions.

Details:

The regulations have been issued in a temporary form with a delayed effective date for years beginning after December 31, 2006; however taxpayers can elect to apply these rules to any taxable year beginning after September 10, 2003. The regulations are issued in proposed and temporary form with a delayed effective date in order to allow taxpayers sufficient time to implement any necessary administrative and operational changes, and to provide further comments before finalization.

The intent of the temporary regulations has been to lessen the burden of contemporaneous documentation requirements on taxpayers; however, in practice, the new Internal Revenue Service (IRS) changes, particularly in the area of management service allocations, has actually increased the amount of documentation to be maintained by the taxpayers.

Services:

The core focus of the services regulations, in their proposed and temporary form, is twofold: (i) to clarify the definition and methods for determination of the appropriate cost pool that is to be charged to an affiliate, and (ii) to introduce pricing methodologies for

Overview of Temporary Regulations (cont'd)

intercompany services that contribute to the “core” capabilities of the beneficiary of such services.

The new temporary regulations still require a best method analysis and attempt to streamline the service transactions to be more uniform with the methodologies offered for analyzing tangible and intangible property transactions. The temporary regulations set out six specific methods that can be used to evaluate service transactions, including: (i) Services Cost Method, (ii) Profit Split Method, (iii) Comparable Uncontrolled Services Price Method, (iv) Gross Services Margin Method, (v) Cost of Services Plus Method, and (vi) Comparable Profits Method. The methodologies are similar to the proposed regulations published in September 2003, with one notable exception.

After consideration of public comments received, IRS replaced the proposed Simplified Cost-Based Method (SCBM), which effectively eliminated the cost safe harbor, with the Services Cost Method (SCM). Under the SCM, services can be charged at cost provided that the following conditions are met: (i) services are part of the “covered services list” provided in Revenue Procedure Announcement 2006-50, comprised of restrictive and specific back-office functions for multinational enterprises, (ii) services are not value-added to the render/recipient, (iii) services subjected to low margin mark-up (i.e., services for which the median comparable arm’s-length mark up is equal to or less than seven percent), and (iv) the taxpayer is able to provide and maintain specific documentation of costs/allocations and intention to apply the SCM.

In an effort to clarify past terminology, the IRS also narrowed the definition of stewardship, under IRC § 1.861-8, to include activities whose sole effect is to protect an investment or comply with regulatory requirements. The regulations contain specific examples that distinguish stewardship expenses from activities that confer some benefit on an affiliate, for which reimbursement is required. Additionally, the IRS has also re-evaluated its approach to allocation methodology as the temporary regulations mandate inclusion of stock-based compensation expense in the total services costs. In general, taxpayers are encouraged to perform a detailed analysis of the allocation of costs pertaining to the provision of intercompany services to determine the appropriate basis of total service costs.

Finally, the regulations outline the requirements for a Shared Services Arrangement (SSA) among two or more affiliated taxpayers. The SSA applies to routine services that qualify for the SCM approach and allows for the aggregation of services.

Companies have approximately five months to develop practical and defensible transfer pricing policies by identifying all relevant transactions, and perform an analysis under the rules of the new regulations. It is expected that the focus of the U.S. tax authorities on intercompany services will increase significantly as a result of these new services regulations.

Intangible Property:

Taxpayers who develop valuable intangible property, and provide intercompany services that enhance or utilize this property, may face additional scrutiny from the IRS if the legal ownership of the intangible property is not clearly delineated. Although the temporary regulations do not discount the importance of economic substance, they do adopt legal title as a primary determination of ownership of intangible property. Additionally, to lessen the business judgment, the regulations clarify that a license or other forms of “right to use” may constitute intellectual property, and thus place added importance on contractual agreements.

Overview of Temporary Regulations (cont'd)

Recommended Action:

Multinational corporations (and domestic companies that operate in multi-state jurisdictions) should carefully review intercompany agreements pertaining to the provision of services and the use and development of intangible property to help ensure compliance with the temporary regulations, and to help optimize intercompany pricing structures. Pursuing this initiative may help companies avoid a potential reassessment of income, the burden of associated penalties, and double taxation.

How Can BDO Help?

Our transfer pricing professionals may help your organization:

- Analyze the existing transfer pricing agreements and protocols;
- Recommend defensible, arm's-length methodologies;
- Review compliance structures and allocation methodologies; and
- Implement a tax-efficient intercompany pricing structure in compliance with the new temporary regulations.

BDO has extensive experience in structuring inbound and outbound transactions and developing objective transfer pricing planning ideas in a timely manner. The Transfer Pricing Analytical Services Practice provides dedicated resources to assist astute tax professionals with complex international and domestic transfer pricing issues.

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