Reg. 1.482-9
Methods to determine taxable income in connection with a controlled services transaction

(a) In general. The arm's length amount charged in a controlled services transaction must be
determined under one of the methods provided for in this section. Each method must be applied in
accordance with the provisions of § 1.482-1, including the best method rule of § 1.482-1(c), the
comparability analysis of § 1.482-1(d), and the arm's length range of § 1.482-1(e), except as those
provisions are modified in this section. The methods are—

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

(b) Services cost method.

(1) In general. The services cost method evaluates whether the amount charged for certain
services is arm’s length by reference to the total services costs (as defined in paragraph (j) of this section)
with no markup. If a taxpayer applies the services cost method in accordance with the rules of this
paragraph (b), then it will be considered the best method for purposes of § 1.482-1(c), and the
Commissioner’s allocations will be limited to adjusting the amount charged for such services to the
properly determined amount of such total services costs.

(2) Eligibility for the services cost method. To apply the services cost method to a service in
accordance with the rules of this paragraph (b), all of the following requirements must be satisfied with
respect to the service—

(i) The service is a covered service as defined in paragraph (b)(3) of this section;
(ii) The service is not an excluded activity as defined in paragraph (b)(4) of this section;
(iii) The service is not precluded from constituting a covered service by the business
judgment rule described in paragraph (b)(5) of this section; and
(iv) Adequate books and records are maintained as described in paragraph (b)(6) of this
section.

(3) Covered services. For purposes of this paragraph (b), covered services consist of a controlled
service transaction or a group of controlled service transactions (see § 1.482-1(f)(2)(i) (aggregation of
transactions)) that meet the definition of specified covered services or low margin covered services.

(i) Specified covered services. Specified covered services are controlled services
transactions that the Commissioner specifies by revenue procedure. Services will be included in such
revenue procedure based upon the Commissioner’s determination that the specified covered services are
support services common among taxpayers across industry sectors and generally do not involve a
significant median comparable markup on total services costs. For the definition of the median comparable markup on total services costs, see paragraph (b)(3)(ii) of this section. The Commissioner may add to, subtract from, or otherwise revise the specified covered services described in the revenue procedure by subsequent revenue procedure, which amendments will ordinarily be prospective only in effect.

(ii) Low margin covered services. Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the median comparable markup on total services costs means the excess of the arm’s length price of the controlled services transaction determined under the general section 482 regulations without regard to this paragraph (b), using the interquartile range described in § 1.482-1(e)(2)(iii)(C) and as necessary adjusting to the median of such interquartile range, over total services costs, expressed as a percentage of total services costs.

(4) Excluded activity. The following types of activities are excluded activities:

(i) Manufacturing.
(ii) Production.
(iii) Extraction, exploration, or processing of natural resources.
(iv) Construction.
(v) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement.
(vi) Research, development, or experimentation.
(vii) Engineering or scientific.
(viii) Financial transactions, including guarantees.
(ix) Insurance or reinsurance.

(5) Not services that contribute significantly to fundamental risks of business success or failure. A service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does 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 controlled group, as defined in § 1.482-1(i)(6). In evaluating the reasonableness of the conclusion required by this paragraph (b)(5), consideration will be given to all the facts and circumstances.

(6) Adequate books and records. Permanent books of account and records are maintained for as long as the costs with respect to the covered services are incurred by the renderer. Such books and records must include a statement evidencing the taxpayer’s intention to apply the services cost method to evaluate the arm’s length charge for such services. Such books and records must be adequate to permit verification by the Commissioner of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question in accordance with paragraph (k) of this section.

(7) Shared services arrangement.

(i) In general. If the services cost method is used to evaluate the amount charged for covered services, and such services are the subject of a shared services arrangement, then 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 this paragraph (b) that is properly allocated to such participant pursuant to the arrangement.
(ii) Requirements for shared services arrangement. A shared services arrangement must meet the requirements described in this paragraph (b)(7).

(A) Eligibility. To be eligible for treatment under this paragraph (b)(7), a shared services arrangement must—

(1) Include two or more participants;

(2) Include as participants all controlled taxpayers that reasonably anticipate a benefit (as defined under paragraph (l)(3)(i) of this section) from one or more covered services specified in the shared services arrangement; and

(3) Be structured such that each covered service (or each reasonable aggregation of services within the meaning of paragraph (b)(7)(iii)(B) of this section) confers a benefit on at least one participant in the shared services arrangement.

(B) Allocation. The costs for covered services 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. Reasonably anticipated benefits are benefits as defined in paragraph (l)(3)(i) of this section. The allocation of costs 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 § 1.482-1(c). The allocation must be applied on a consistent basis for all participants and 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. If the taxpayer reasonably concluded that the shared services arrangement (including any aggregation pursuant to paragraph (b)(7)(iii)(B) of this section) 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 this paragraph (b)(7), then the Commissioner may not adjust such allocation basis.

(C) Documentation. The taxpayer must maintain sufficient documentation to establish that the requirements of this paragraph (b)(7) are satisfied, and include—

(1) 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;

(2) A list of the participants and the renderer or renderers of covered services under the shared services arrangement;

(3) A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and

(4) A description of any aggregation of covered services for purposes of the shared services arrangement, and an indication whether this aggregation (if any) differs from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section.

(iii) Definitions and special rules.

(A) Participant. A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to a shared services arrangement that substantially complies with the requirements described in this paragraph (b)(7).

(B) Aggregation. Two or more covered services may be aggregated in a reasonable manner taking into account all the facts and circumstances, including whether the relative magnitude of reasonably anticipated benefits of the participants sharing the costs of such aggregated services may be reasonably reflected by the allocation basis employed pursuant to paragraph (b)(7)(ii)(B) of this section.

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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 paragraph (b)(3)(ii) of this section, provided that such alternative aggregation can be implemented on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary.

(C) Coordination with cost sharing arrangements. To the extent that an allocation is made to a participant in a shared services arrangement that is also a participant in a cost sharing arrangement subject to § 1.482-7T, such amount with respect to covered services is first allocated pursuant to the shared services arrangement under this paragraph (b)(7). Costs allocated pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible property development activity under § 1.482-7T and other activities of the participant.

(8) Examples. The application of this section is illustrated by the following examples. No inference is intended whether the presence or absence of one or more facts is determinative of the conclusion in any example. For purposes of Examples 1 through 14, 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 Example 15, 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 16 through 24, 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) and that Company P and its subsidiaries satisfy all of the requirements for a shared services arrangement specified in paragraphs (b)(7)(ii) and (iii) of this section.

Example 1. Data entry services. (i) Company P, Company Q, and Company R own and operate hospitals. Each owns an electronic database of medical information gathered by doctors and nurses during interviews and treatment of its patients. All three databases are maintained and updated by Company P's administrative support employees who perform data entry activities by entering medical information from the paper records of Company P, Company Q, and Company R into their respective databases.

(ii) Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 2. Data entry services. (i) Company P, Company Q, and Company R specialize in data entry, data processing, and data conversion. Company Q and Company R's data entry activities involve converting medical information data contained in paper records to a digital format. Company P specializes in data entry activities. This specialization reflects, in part, proprietary quality control systems and specially trained data entry experts used to ensure the highest degree of accuracy of data entry services. Company P is engaged by Company Q and Company R to perform these data entry activities for them. Company Q and Company R then charge their customers for the data entry activities performed by Company P.

(ii) Assume that these services performed by Company P relating to data entry are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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.

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Example 3. Recruiting services. (i) 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 by attending job fairs and other recruitment events. For recruiting higher-level managers and engineers, each of these companies uses recruiters from unrelated executive search firms.

(ii) Assume that these services relating to recruiting are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (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. (i) Company Q and Company R are executive recruiting service companies that are hired by other companies to recruit professionals. Company P is a recruiting agency that is engaged by Company Q and Company R to perform recruiting activities on their behalf in certain geographic areas.

(ii) Assume that the services performed by Company P are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 5. Credit analysis services. (i) Company P is a manufacturer and distributor of clothing for retail stores. Company Q and Company R are distributors of clothing for retail stores. As part of its operations, personnel in Company P perform credit analysis on its customers. Most of the customers have a history of purchases from Company P, and the credit analysis involves a review of the recent payment history of the customer’s account. For new customers, the personnel in Company P perform a basic credit check of the customer using reports from a credit reporting agency. 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 method as Company P uses for itself.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (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. (i) Company P, Company Q, and Company R lease furniture to retail customers who present a significant credit risk and are generally unable to lease furniture from other providers. As part of its leasing operations, personnel in Company P perform credit analysis on each of the potential lessees. The personnel 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. Also, as part of its operations, Company P performs similar credit analysis services for Company Q and Company R, which charge correspondingly high monthly lease payments.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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. (i) Company P is a large full-service bank, which provides products and services to corporate and consumer markets, including unsecured loans, secured loans, lines of credit, letters of credit, conversion of foreign currency, consumer loans, trust services, and sales of certificates of deposit. Company Q makes routine consumer loans to individuals, such as auto loans and home equity loans. Company R makes only business loans to small businesses.

(ii) 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, rate of interest, and loan terms).

(iii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the credit analysis services constitute part of a “financial transaction” described in paragraph (b)(4)(viii) of this section. 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. (i) 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, and identifies any inaccuracies in the records, such as double-payments and double-charges.

(ii) Assume that these services relating to verification of data are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (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. (i) Company P gathers and inputs information regarding accounts payable and accounts receivable from unrelated parties and utilizes its own computer system to analyze that information for purposes of identifying errors in payment and receipts (data mining). Company P is compensated for these services based on a fee that reflects a percentage of amounts collected by customers as a result of the data mining services. These activities 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.

(ii) Assume that these services relating to data mining are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 10. Legal services. (i) 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 used by industrial customers. 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

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(ii) Company P seeks to maintain in-house legal staff with 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. These include the preparation and review of corporate contracts relating to, for example, product sales, equipment purchases and leases, business liability insurance, real estate, employee salaries and benefits. Company P relies on outside attorneys for major business transactions and highly technical matters such as patent licenses. The in-house legal staffs of Company Q and Company R are much more limited. It is necessary for Company P to retain several local law firms to handle litigation and business disputes arising from the activities of Company Q and Company R. Although Company Q and Company R pay the fees of these law firms, the hiring authority and general oversight of the firms’ representation is in the legal department of Company P.

(iii) In determining what portion of the legal expenses of Company P may be allocated to Company Q and Company R, Company P first excludes any expenses relating to legal services that constitute shareholder activities and other items that are not properly analyzed as controlled services. Assume that the remaining services relating to general legal functions performed by in-house legal counsel are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (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 services. (i) Company P is a domestic holding company whose operating companies, Company Q and Company R, generate electric power for consumers by operating nuclear plants. Assume that, although Company P owns 100% of the stock of Companies Q and R, the companies do not elect to file a consolidated Federal income tax return with Company P.

(ii) Company P maintains an in-house legal department that includes attorneys who are experts in the areas of Federal utilities regulation, Federal labor and environmental law, and securities law. Companies Q and R maintain their own, smaller in-house legal staffs comprising 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 and 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.

(iii) 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 United States 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 Q and Company R do not have in-house legal staff with experience in the NRC area. Company P maintains a group of in-house attorneys with specialized expertise in the NRC area that exclusively represents Company Q and Company R before the NRC. Although Company P occasionally hires an outside law firm or industry

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expert to assist on particular NRC matters, the majority of the work is performed by the specialized legal staff of Company P.

(iv) Certain of the legal services performed by Company P constitute duplicative or shareholder activities that do not confer a benefit on the other companies and therefore do not need to be allocated to the other companies, while certain other legal services are eligible to be charged to Company Q and Company R in accordance with the services cost method.

(v) 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 paragraph (b)(3)(i) of this section. 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. (i) 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 such as inputting data relating to accounts payable and accounts receivable into the system and extracting data relating to accounts receivable and accounts payable in the form of reports or electronic media and providing those data to all three companies. Periodically, Company P’s computer specialists also modify the ERP system to adapt to changing business functions in all three companies. Company P’s computer specialists make these changes by either modifying the underlying software program or by purchasing additional software or hardware from unrelated third party vendors.

(ii) Assume that the services relating to accounts payable and accounts receivable are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

(iii) 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 paragraph (b)(3) of this section as 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). If these services do not constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section, then Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 13. Group of services. (i) Company P manufactures and sells widgets under an exclusive contract to Customer 1. Company Q and Company R sell widgets under exclusive contracts to Customer 2 and Customer 3, respectively. At least one year in advance, each of these customers can accurately forecast its need for widgets. 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.

(ii) 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.

(iii) Company P’s personnel also obtain orders from all three companies’ customers to draw up purchase orders for widgets as well as make payment to suppliers for widget replacement parts. In addition, Company P’s personnel use data entry to input information regarding orders and sales of widgets and replacement parts for all three companies into a centralized computer system. Company P’s personnel also maintain the centralized computer system and extract data for all three companies when necessary.

(iv) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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 this paragraph (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. (i) 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 information regarding orders and sales of gadgets for all three companies into a centralized computer. 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 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.

(ii) Unrelated suppliers deliver the components directly to Company P, Company Q and Company R. Each company 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.

(iii) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. 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, and determines the amount charged as its total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm’s length markups on total services costs for these accounting services is between 3% and 9%, and the median is 6%. Because the median comparable markup on total services costs is 6%, which is less than 7%, the accounting services constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section.

Example 16. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized data processing facility that performs automated

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invoice processing and order generation for all of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from the centralized data processing services, the total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefits shares, because value of merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.

(iii) 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 17. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized center that performs human resources functions, such as administration of pension, retirement, and health insurance plans that are made available to employees of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) 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, because total revenues do not bear a relationship to the shares of reasonably anticipated benefits from the underlying services.

(iii) 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 18. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Under that method, Company P determines the amount charged for these services pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) 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 paragraph (k) of this section to Company X, Y and Z for service A is as follows:

<table>
<thead>
<tr>
<th>Service A</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[Total cost 300]</td>
<td></td>
</tr>
<tr>
<td>Company X</td>
<td>150</td>
</tr>
<tr>
<td>Company Y</td>
<td>75</td>
</tr>
<tr>
<td>Company Z</td>
<td>75</td>
</tr>
</tbody>
</table>

(iii) 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

(iv) Company P allocates the 300 total services costs of service A based on employee headcount as follows:

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Service A  
[Total cost 300]

<table>
<thead>
<tr>
<th>Company</th>
<th>Allocation key</th>
<th>Headcount</th>
<th>Amount</th>
</tr>
</thead>
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<tr>
<td>X</td>
<td>600</td>
<td>164</td>
<td></td>
</tr>
<tr>
<td>Y</td>
<td>250</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>Z</td>
<td>250</td>
<td>68</td>
<td></td>
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</tbody>
</table>

(v) Based on these 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 19. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key)

(i) Company P performs accounts payable services (service B) on behalf of the PXYZ Group and determines the amount charged for the services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service B is a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service B otherwise determined under the services cost method is 500.

(ii) 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 paragraph (k) of this section to Companies X, Y and Z for service B is as follows:

<table>
<thead>
<tr>
<th>Service B</th>
<th>Total cost 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td></td>
</tr>
<tr>
<td>X</td>
<td>125</td>
</tr>
<tr>
<td>Y</td>
<td>205</td>
</tr>
<tr>
<td>Z</td>
<td>170</td>
</tr>
</tbody>
</table>

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

- Company X – 600
- Company Y – 200
- Company Z – 200

(iv) 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

(v) If Company P allocated the 500 total services costs of service B based on employee headcount, the resulting allocation would be as follows:

<table>
<thead>
<tr>
<th>Service B</th>
<th>Total cost 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td></td>
</tr>
<tr>
<td>Allocation key</td>
<td>Headcount</td>
</tr>
</tbody>
</table>

Reg. § 1.482-9(b)
(vi) 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:

<table>
<thead>
<tr>
<th>Company</th>
<th>Allocation key</th>
<th>Transaction Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volume</td>
<td></td>
</tr>
<tr>
<td>X</td>
<td>2,000</td>
<td>105</td>
</tr>
<tr>
<td>Y</td>
<td>4,000</td>
<td>211</td>
</tr>
<tr>
<td>Z</td>
<td>3,500</td>
<td>184</td>
</tr>
</tbody>
</table>

(vii) 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 20. Shared services arrangement and aggregation. (i) Company P performs human resource services (service A) and accounts payable services (service B) 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 paragraph (b)(7) of this section. Service A and service B are specified covered services described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs otherwise determined under the services cost method for service A is 300 and for service B is 500; total services costs for services A and B are 800. Company P determines that aggregation of services A and B for purposes of the arrangement is appropriate.

(ii) 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 relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to paragraph (k) of this section to Companies X, Y and Z for services A and B is as follows:

<table>
<thead>
<tr>
<th>Services A and B</th>
<th>[Total cost 800]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td></td>
</tr>
<tr>
<td>X</td>
<td>350</td>
</tr>
<tr>
<td>Y</td>
<td>100</td>
</tr>
<tr>
<td>Z</td>
<td>350</td>
</tr>
</tbody>
</table>

(iii) 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
(iv) The total number of employees in each company is as follows:

- Company X – 600
- Company Y – 200
- Company Z – 200

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

<table>
<thead>
<tr>
<th>Company</th>
<th>Transaction Volume</th>
<th>Allocation key</th>
<th>Amount</th>
<th>Allocation key</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>2,000</td>
<td>Amount 160</td>
<td>600</td>
<td>Amount 480</td>
<td></td>
</tr>
<tr>
<td>Y</td>
<td>4,000</td>
<td>Amount 320</td>
<td>200</td>
<td>Amount 160</td>
<td></td>
</tr>
<tr>
<td>Z</td>
<td>4,000</td>
<td>Amount 320</td>
<td>200</td>
<td>Amount 160</td>
<td></td>
</tr>
</tbody>
</table>

(vi) In contrast, if aggregated services AB were allocated by reference to the total U.S. dollar value of sales to uncontrolled parties (trade sales) by each company, the following results would obtain:

<table>
<thead>
<tr>
<th>Company</th>
<th>Allocation Key</th>
<th>Trade sales (millions)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td></td>
<td>$400</td>
<td>314</td>
</tr>
<tr>
<td>Y</td>
<td></td>
<td>$120</td>
<td>94</td>
</tr>
<tr>
<td>Z</td>
<td></td>
<td>$500</td>
<td>392</td>
</tr>
</tbody>
</table>

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

Example 21. Shared services arrangement and aggregation. (i) 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 paragraph (b)(7) of this section. All of these services A through P constitute either specified covered services or low margin covered services described in paragraph (b)(3) of this section. 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.

(ii) 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 through P (Company Z performs services similar to services N through 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 paragraph (k) of this section to Company X, Y, and Z for services A through P is as follows:

Reg. § 1.482-9(b)
Company Services A – M Services N – P Services A – P  
(cost 490) (cost 10) (total cost 500) 
X 90 5 95 
Y 240 5 245 
Z 160 — 160 

(iii) 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  

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

<table>
<thead>
<tr>
<th>Company</th>
<th>Transaction Volume</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>2,000</td>
<td>100</td>
</tr>
<tr>
<td>Y</td>
<td>4,500</td>
<td>225</td>
</tr>
<tr>
<td>Z</td>
<td>3,500</td>
<td>175</td>
</tr>
</tbody>
</table>

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

Example 22. Renderer reasonably anticipates benefits. (i) 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% 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.

(ii) Based on an application of paragraph (b)(7) of this section, Company P charges 80 which is allocated 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 23. Coordination with cost sharing arrangement. (i) Company P performs human resource services (service A) 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 paragraph (b)(7) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) 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 total charge of 300 is allocated as follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>100</td>
</tr>
<tr>
<td>Y</td>
<td>50</td>
</tr>
<tr>
<td>Z</td>
<td>25</td>
</tr>
</tbody>
</table>
(iii) In addition to performing services, P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000.

(iv) Companies P and X enter into a cost sharing arrangement in accordance with §1.482-7T. Under the arrangement, Company P will undertake all intangible property development activities. All of Company P’s research and development (R&D) activity is devoted to the intangible property 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 property development costs in accordance with their reasonably anticipated benefits from the intangible property, and Company X will make payments to Company P as required under §1.482-7T. Company X will manufacture, market, and otherwise exploit the product in the rest of the world.

(v) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development activity undertaken by Company P. The most reliable estimate of the proportion allocable to the intangible property 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 property development activity. Companies P and X must share the intangible property development costs of the cost shared intangible property (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.

Example 24. Coordination with cost sharing arrangement. (i) The facts and analysis are the same as in Example 25, except that Company X also performs intangible property 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 300 of service costs is allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
<th>Z</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100</td>
<td>50</td>
<td>25</td>
<td>125</td>
</tr>
</tbody>
</table>

(ii) In addition to performing services, Company P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000. Company X undertakes 400 of R&D and incurs manufacturing and other costs of 600.

(iii) Companies P and X enter into a cost sharing arrangement in accordance with §1.482-7T. Under the arrangement, both Companies P and X will undertake intangible property development activities. All of the research and development activity conducted by Companies P and X is devoted to the intangible property development activity under the cost sharing arrangement. Both Companies P and X will manufacture, market, and otherwise exploit the product in their respective territories and will share intangible property development costs in accordance with their reasonably anticipated benefits from the intangible property, and both will make payments as required under §1.482-7T.

(iv) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development activities undertaken by Companies P and X. The most reliable estimate of the portion allocable to Company P’s intangible property 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 property development activity.

(v) In addition, it is necessary 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 property development activities under the cost sharing arrangement. The most reliable estimate of the portion allocable to Company X’s intangible property development activity is 400 (Company X’s R&D expenses) divided by 1,000 (Company X’s costs), or 40%. Accordingly, 40% of the 100 that was allocated to Company X, or 40, is allocated in turn to Company X’s intangible property development activities. Company X makes a payment to Company P of 100 under the shared services arrangement and includes 40 of services cost method charges in the pool of intangible property development costs.

(vi) The parties’ respective contributions to intangible property development costs under the cost sharing arrangement are as follows:

\[
P: \quad 500 + (0.333 \times 125) = 542 \\
X: \quad 400 + (0.40 \times 100) = 440
\]

(c) **Comparable uncontrolled services price method.**

(1) In general. The comparable uncontrolled services price method evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the amount charged in a comparable uncontrolled services transaction.

(2) Comparability and reliability considerations.

(i) In general. Whether results derived from application of this method are the most reliable measure of the arm’s length result must be determined using the factors described under the best method rule in § 1.482-1(c). The application of these factors under the comparable uncontrolled services price method is discussed in paragraphs (c)(2)(ii) and (iii) of this section.

(ii) Comparability.

(A) In general. The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of § 1.482-1(d). Although all of the factors described in § 1.482-1(d)(3) must be considered, similarity of the services rendered, and of the intangible property (if any) used in performing the services, generally will have the greatest effects on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm’s length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm’s length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm’s length result.

(B) Adjustments for differences between controlled and uncontrolled transactions. If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability...
provisions of § 1.482-1(d)(2). Specific examples of factors that may be particularly relevant to application of this method include—

(1) Quality of the services rendered;
(2) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and whether costs were incurred without a provision for current reimbursement);
(3) Intangible property (if any) used in rendering the services;
(4) Geographic market in which the services are rendered or received;
(5) Risks borne (for example, costs incurred to render the services, without provision for current reimbursement);
(6) Duration or quantitative measure of services rendered;
(7) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and
(8) Alternatives realistically available to the renderer and the recipient.

(iii) Data and assumptions. The reliability of the results derived from the comparable uncontrolled services price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482-1(c) (best method rule).

(3) Arm’s length range. See § 1.482-1(e)(2) for the determination of an arm’s length range.

(4) Examples. The principles of this paragraph (c) are illustrated by the following examples:

Example 1. Internal comparable uncontrolled services price. Company A, a United States corporation, performs shipping, stevedoring, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of $60 per container to place loaded cargo containers in Country X on oceangoing vessels for marine transportation. Company A also performs identical services in Country X for its wholly-owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled transactions. In evaluating the appropriate measure of the arm’s length price for the container-loading services performed for Company B, because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the comparable uncontrolled services price constitutes the best method for determining the arm’s length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in comparable uncontrolled transactions, a loading charge of $60 per cargo container will be considered the most reliable measure of the arm’s length price for the services rendered to Company B. See paragraph (c)(2)(ii)(A) of this section.

Example 2. External comparable uncontrolled services price. (i) The facts are the same as in Example 1, except that Company A performs services for Company B, but not for uncontrolled parties. Based on information obtained from unrelated parties (which is determined to be reliable under the comparability standards set forth in paragraph (c)(2) of this section), it is determined that uncontrolled parties in Country X perform services comparable to those rendered by Company A to Company B, and that such parties charge $60 per cargo container.

(ii) In evaluating the appropriate measure of an arm’s length price for the loading services that Company A renders to Company B, the $60 per cargo container charge is considered evidence of a comparable uncontrolled services price. See paragraph (c)(2)(ii)(A) of this section.

Reg. § 1.482-9(c)
Example 3. External comparable uncontrolled services price. The facts are the same as in Example 2, except that uncontrolled parties in Country X render similar loading and stevedoring services, but only under contracts that have a minimum term of one year. If the difference in the duration of the services has a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of § 1.482-1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Use of valuable intangible property. (i) Company A, a United States corporation in the biotechnology sector, renders research and development services exclusively to its affiliates. Company B is Company A's wholly-owned subsidiary in Country X. Company A renders research and development services to Company B.

(ii) In performing its research and development services function, Company A uses proprietary software that it developed internally. Company A uses the software to evaluate certain genetically engineered compounds developed by Company B. Company A owns the copyright on this software and does not license it to uncontrolled parties.

(iii) No uncontrolled parties can be identified that perform services identical or with a high degree of similarity to those performed by Company A. Because there are material differences for which reliable adjustments cannot be made, the comparable uncontrolled services price method is unlikely to provide a reliable measure of the arm's length price. See paragraph (c)(2)(ii)(A) of this section.

Example 5. Internal comparable. (i) Company A, a United States corporation, and its subsidiaries render computer consulting services relating to systems integration and networking to business clients in various countries. Company A and its subsidiaries render only consulting services, and do not manufacture computer hardware or software nor distribute such products. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for each category of employee. The company also charges, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. The Company has established the following schedule of hourly rates:

<table>
<thead>
<tr>
<th>Category</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project managers</td>
<td>$400 per hour</td>
</tr>
<tr>
<td>Technical staff</td>
<td>$300 per hour</td>
</tr>
</tbody>
</table>

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses):

\[
(100 \text{ hrs.} \times $400/\text{hr.}) + (400 \text{ hrs.} \times $300/\text{hr.}) = $40,000 + $120,000 = $160,000.
\]

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of $144,000, (or [75 hrs. \times $400/\text{hr.}] + [380 hrs. \times $300/\text{hr.}] = $30,000 + $114,000) may be

Reg. § 1.482-9(c)
used as a measure of the arm's length price for the work performed by Company A project managers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. See paragraph (c)(2)(ii)(A) of this section.

**Example 6. Adjustments for differences.** (i) The facts are the same as in Example 5, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources required to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A’s portion of the engagement results in fees of $144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A $144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In addition, Company A’s records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm’s length, it is determined that no adjustments to the intercompany service charge are warranted. See § 1.482-1(d)(3)(ii) and paragraph (c)(2)(ii)(A) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction.*

(i) In general. The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(ii) Example. The following example illustrates this paragraph (c)(5):

**Example.** Indirect evidence of comparable uncontrolled services price. (i) Company A is a United States insurance company. Company A’s wholly-owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which relies on the gross value of the policies in the customer’s portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors’ programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).
(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer’s portfolio together with other factors, the prices charged in Company B’s uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm’s length price for the studies performed by Company B for Company A, Company B’s proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm’s length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(d) Gross services margin method.

(1) In general. The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

(2) Determination of arm’s length price.

(i) In general. The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm’s length by determining the appropriate gross profit of the controlled taxpayer.

(ii) Relevant uncontrolled transaction. The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) Applicable uncontrolled price. The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

(iv) Appropriate gross services profit. The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in § 1.482-1(d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) Arm’s length range. See § 1.482-1(e)(2) for determination of the arm’s length range.

(3) Comparability and reliability considerations.

Reg. § 1.482-9(d)
(i) In general. Whether results derived from application of this method are the most reliable measure of the arm’s length result must be determined using the factors described under the best method rule in § 1.482-1(c). The application of these factors under the gross services margin method is discussed in paragraphs (d)(3)(ii) and (iii) of this section.

(ii) Comparability.

(A) Functional comparability. The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of § 1.482-1(d). A gross services profit provides compensation for services or functions that bear a relationship to the relevant uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. Therefore, although all of the factors described in § 1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties. In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions.

(B) Other comparability factors. Comparability under this method is not dependent on close similarity of the relevant uncontrolled transaction to the related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the relevant uncontrolled transaction and the relevant transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the relevant uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective relevant transactions. Thus, it ordinarily would be expected that the services or functions performed in the controlled and uncontrolled transactions would be with respect to relevant transactions involving the transfer of property within the same product categories or the provision of services of the same general type (for example, information-technology systems design). Furthermore, significant differences in the intangible property (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) Adjustments for differences between controlled and uncontrolled transactions. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions of § 1.482-1(d)(2). For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include—
(1) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(2) Intangible property (if any) used in performing the services or function;

(3) Geographic market in which the services or function are performed or in which the relevant uncontrolled transaction takes place; and

(4) Risks borne, including, if applicable, inventory-type risk.

(D) Buy-sell distributor. If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) Data and assumptions.

(A) In general. The reliability of the results derived from the gross services margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482-1(c) (best method rule).

(B) Consistency in accounting. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

(4) Examples. The principles of this paragraph (d) are illustrated by the following examples:

Example 1. Agent services. Company A and Company B are members of a controlled group. Company A is a foreign manufacturer of industrial equipment. Company B is a U.S. company that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the U.S. market. Company B does not take title to the equipment but instead receives from Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated foreign manufacturers to unrelated purchasers in the U.S. market. Company B charges these unrelated foreign manufacturers a commission fee of 5% of the sales price charged by the unrelated foreign manufacturers to the unrelated U.S. purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated foreign manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. If the comparable gross services profit margin is 5% of the price charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm’s length price that it may charge Company A for its agent services is equal to 5% of the applicable uncontrolled price charged by Company A in sales of equipment in the relevant uncontrolled transactions.

Example 2. Agent services. The facts are the same as in Example 1, except that Company B does not act as a commission agent for unrelated parties and it is not possible to obtain reliable information concerning commission rates charged by uncontrolled commission agents that engage in comparable transactions with respect to relevant sales of property. It is possible, however, to obtain reliable information regarding the gross profit margins earned by unrelated parties that briefly take title to and then resell similar property in uncontrolled transactions, in which they purchase the property from foreign manufacturers and resell the property to purchasers in the U.S. market. Analysis of the facts and circumstances indicates that, aside from certain minor differences for which adjustments can be made, the uncontrolled parties that resell property perform similar functions and assume similar risks as Company B performs and assumes when it acts as a commission agent for Company A’s sales of property.
Under these circumstances, the gross profit margin earned by the unrelated distributors on the purchase and resale of property may be used, subject to any adjustments for any material differences between the controlled and uncontrolled transactions, as a comparable gross services profit margin. The appropriate gross services profit that Company B may earn and the arm’s length price that it may charge Company A for its agent services is therefore equal to this comparable gross services margin, multiplied by the applicable uncontrolled price charged by Company A in its sales of equipment in the relevant uncontrolled transactions.

Example 3. Agent services. (i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation that renders computer consulting services, including systems integration and networking, to business clients. (ii) In undertaking engagements with clients, Company A in some cases pays a commission of 3% of its total fees to unrelated parties that assist Company A in obtaining consulting engagements. Typically, such fees are paid to non-computer consulting firms that provide strategic management services for their clients. When Company A obtains a consulting engagement with a client of a non-computer consulting firm, Company A does not subcontract with the other consulting firm, nor does the other consulting firm play any role in Company A’s consulting engagement. (iii) Company B, a Country X subsidiary of Company A, assists Company A in obtaining an engagement to perform computer consulting services for a Company B banking industry client in Country X. Although Company B has an established relationship with its Country X client and was instrumental in arranging for Company A’s engagement with the client, Company A’s particular expertise was the primary consideration in motivating the client to engage Company A. Based on the relative contributions of Companies A and B in obtaining and undertaking the engagement, Company B’s role was primarily to facilitate the consulting engagement between Company A and the Country X client. Information regarding the commissions paid by Company A to unrelated parties for providing similar services to facilitate Company A’s consulting engagements is sufficiently complete to conclude that it is likely that all material differences between these uncontrolled transactions and the controlled transaction between Company B and Company A have been identified and that appropriate adjustments have been made for any such differences. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm’s length price that it may charge Company A for its agent services is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company A in its relevant uncontrolled consulting engagement with Company B’s client.

Example 4. Intermediary function. (i) The facts are the same as in Example 3, except that Company B contracts directly with its Country X client to provide computer consulting services and Company A performs the consulting services on behalf of Company B. Company A does not enter into a consulting engagement with Company B’s Country X client. Instead, Company B charges its Country X client an uncontrolled price for the consulting services, and Company B pays a portion of the uncontrolled price to Company A for performing the consulting services on behalf of Company B. (ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the consulting contract indicates that Company B functioned primarily as an intermediary contracting party, and the gross services margin method is the most reliable method for determining the amount that Company B may retain as compensation for its intermediary function with respect to Company A’s consulting services. In this case, therefore, because Company B entered into the relevant uncontrolled transaction to provide services, Company B receives the applicable uncontrolled price that is paid by the Country X client for the consulting services. Company A technically performs services for Company B when it performs, on behalf of Company B, the consulting services Company B contracted to perform.

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provide to the Country X client. The arm’s length amount that Company A may charge Company B for performing the consulting services on Company B’s behalf is equal to the applicable uncontrolled price received by Company B in the relevant uncontrolled transaction, less Company B’s appropriate gross services profit, which is the amount that Company B may retain as compensation for performing the intermediary function.

(iii) Reliable data concerning the commissions that Company A paid to uncontrolled parties for assisting it in obtaining engagements to provide consulting services similar to those it has provided on behalf of Company B provide useful information in applying the gross services margin method. However, consideration should be given to whether the third party commission data may need to be adjusted to account for any additional risk that Company B may have assumed as a result of its function as an intermediary contracting party, compared with the risk it would have assumed if it had provided agent services to assist Company A in entering into an engagement to provide its consulting service directly. In this case, the information regarding the commissions paid by Company A to unrelated parties for providing agent services to facilitate its performance of consulting services for unrelated parties is sufficiently complete to conclude that all material differences between these uncontrolled transactions and the controlled performance of an intermediary function, including possible differences in the amount of risk assumed in connection with performing that function, have been identified and that appropriate adjustments have been made. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in Company B’s relevant uncontrolled transactions, then the appropriate gross services profit that Company B may retain as compensation for performing an intermediary function (and the amount, therefore, that is deducted from the applicable uncontrolled price to arrive at the arm’s length price that Company A may charge Company B for performing consulting services on Company B’s behalf) is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company B in its contract to provide services to the uncontrolled party.

Example 5. External comparable. (i) The facts are the same as in Example 4, except that neither Company A nor Company B engages in transactions with third parties that facilitate similar consulting engagements.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the contract indicates that Company B’s role was primarily to facilitate the consulting arrangement between Company A and the Country X client. Although no reliable internal data are available regarding comparable transactions with uncontrolled entities, reliable data exist regarding commission rates for similar facilitating services between uncontrolled parties. These data indicate that a 3% commission (3% of total engagement fee) is charged in such transactions. Information regarding the uncontrolled comparables is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the appropriate gross services profit margin is 3% of total fees, then an arm’s length result of the controlled services transaction is for Company B to retain an amount equal to 3% of total fees paid to it.

(e) Cost of services plus method.

(1) In general. The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. This method is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement, as described in paragraph (i)(2) of this section.

(2) Determination of arm’s length price.
In general. The cost of services plus method measures an arm’s length price by adding the appropriate gross services profit to the controlled taxpayer’s comparable transactional costs.

(ii) Appropriate gross services profit. The appropriate gross services profit is computed by multiplying the controlled taxpayer’s comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

(iii) Comparable transactional costs. Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such services, and may include as well other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (j) of this section, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities are available) may provide useful guidance but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) Arm’s length range. See § 1.482-1(e)(2) for determination of an arm’s length range.

(3) Comparability and reliability considerations.

(i) In general. Whether results derived from the application of this method are the most reliable measure of the arm’s length result must be determined using the factors described under the best method rule in § 1.482-1(c).

(ii) Comparability.

(A) Functional comparability. The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482-1(d). A service renderer’s gross services profit provides compensation for performing services related to the controlled services transaction under review, including an operating profit for the service renderer’s investment of capital and assumptions of risks. Therefore, although all of the factors described in § 1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers. If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, in evaluating comparability the controlled taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer, because differences in functions performed may be reflected in differences in service costs other than those included in comparable transactional costs.

(B) Other comparability factors. Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the
controlled and uncontrolled transactions would involve services of the same general type (for example, information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer’s comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the value of the services rendered, due for example to the use of valuable intangible property, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) Adjustments for differences between the controlled and uncontrolled transactions. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the provisions of § 1.482-1(d)(2). For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include—

(1) The complexity of the services;
(2) The duration or quantitative measure of services;
(3) Contractual terms (for example, scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);
(4) Economic circumstances; and
(5) Risks borne.

(iii) Data and assumptions.

(A) In general. The reliability of the results derived from the cost of services plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482-1(c) (Best method rule).

(B) Consistency in accounting. The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (e)(3)(iii)(B), the term comparable transactional costs includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm’s length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

(4) Examples. The principles of this paragraph (e) are illustrated by the following examples:

Example 1. Internal comparable. (i) Company A designs and assembles information-technology networks and systems. When Company A renders services for uncontrolled parties, it receives compensation based on time and materials as well as certain other related costs necessary to complete the project. This fee includes the cost of hardware and software purchased from

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uncontrolled vendors and incorporated in the final network or system, plus a reasonable allocation of

certain specified overhead costs incurred by Company A in providing these services. Reliable accounting

costs. Reliable accounting

records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its time, materials and specified overhead in providing design services during the year under examination on information technology projects for uncontrolled entities.

(ii) Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records (which are determined to be reliable under paragraph (e)(3) of this section), it is possible to identify the comparable transactional costs involved in the controlled services transaction with reference to the costs incurred by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's length result for the controlled services transaction is equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

Example 2. Inability to adjust for differences in comparable transactional costs. The facts are the same as in Example 1, except that Company A's staff that rendered the services to Company B consisted primarily of engineers in training status or on temporary rotation from other Company A subsidiaries. In addition, the Company B network incorporated innovative features, including specially designed software suited to Company B's requirements. The use of less-experienced personnel and staff on temporary rotation, together with the special features of the Company B network, significantly increased the time and costs associated with the project as compared to time and costs associated with similar projects completed for uncontrolled customers. These factors constitute material differences between the controlled and the uncontrolled transactions that affect the determination of Company A's comparable transactional costs associated with the controlled services transaction, as well as the gross services profit markup. Moreover, it is not possible to perform reliable adjustments for these differences on the basis of the available accounting data. Under these circumstances, the reliability of the cost of services plus method as a measure of an arm's length price is substantially reduced.

Example 3. Operating loss by reference to total services costs. The facts and analysis are the same as in Example 1, except that an unrelated Company C, instead of Company A, renders similar services to uncontrolled parties and publicly available information indicates that Company C earned a gross services profit markup of 10% on its time, materials and certain specified overhead in providing those services. As in Example 1, Company A still provides services for its Country X subsidiary, Company B. In accordance with the requirements in paragraph (e)(3)(ii) of this section, the taxpayer performs additional analysis and restates the results of Company A's controlled services transaction with its Country X subsidiary, Company B, in the form of a markup on Company A's total services costs. This analysis by reference to total services costs shows that Company A generated an operating loss on the controlled services transaction, which indicates that functional differences likely exist between the controlled services transaction performed by Company A and uncontrolled services transactions performed by Company C, and that these differences may not be reflected in the comparable transactional costs. Upon further scrutiny, the presence of such functional differences between the controlled and uncontrolled transactions may indicate that the cost of services plus method does not provide the most reliable measure of an arm's length result under the facts and circumstances.

Example 4. Internal comparable. (i) Company A, a U.S. corporation, and its subsidiaries perform computer consulting services relating to systems integration and networking for business clients

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in various countries. Company A and its subsidiaries render only consulting services and do not manufacture or distribute computer hardware or software to clients. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries’ respective countries.

(ii) On some occasions, Company A and its subsidiaries undertake engagements directly for clients. On other occasions, they work as subcontractors for uncontrolled parties on more extensive consulting engagements for clients. In undertaking the latter engagements with third-party consultants, Company A typically prices its services at four times the compensation costs of its consultants, defined as the consultants’ base salary plus estimated fringe benefits, as defined in this table:

<table>
<thead>
<tr>
<th>Category</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project managers</td>
<td>$100 per hour.</td>
</tr>
<tr>
<td>Technical staff</td>
<td>$75 per hour.</td>
</tr>
</tbody>
</table>

(iii) In uncontrolled transactions, Company A also charges the customer, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of $(100 \text{ hrs.} \times \$100/\text{hr.}) + (400 \text{ hrs.} \times \$75/\text{hr.}) = \$10,000 + \$30,000 = \$40,000$. Applying the markup of 300%, the total fee charged would thus be $(4 \times \$40,000)$, or $\$160,000$, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm’s length result for the controlled services transaction is equal to $\$144,000$. This is calculated as follows: $[4 \times (75 \text{ hrs.} \times \$100/\text{hr.})] + [4 \times (380 \text{ hrs.} \times \$75/\text{hr.})] = \$30,000 + \$114,000 = \$144,000$, reflecting a 300% markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A’s pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(f) **Comparable profits method.**

(1) **In general.** The comparable profits method evaluates whether the amount charged in a controlled transaction is arm’s length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in § 1.482-5 relating to the comparable profits method apply to controlled services transactions, except as modified in this paragraph (f).

(2) **Determination of arm’s length result.**

(i) Tested party. This paragraph (f) applies where the relevant business activity of the tested party as determined under § 1.482-5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under § 1.482-5(b)(2) is instead the recipient of the controlled services, the rules under this paragraph (f) are not applicable to determine the arm’s length result.
(ii) **Profit level indicators.** In addition to the profit level indicators provided in § 1.482-5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) **Comparability and reliability considerations.** Data and assumptions—Consistency in accounting. Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as “cost of goods sold” and “selling, general, and administrative expenses.” Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in § 1.482-5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) **Examples.** The principles of this paragraph (f) are illustrated by the following examples:

**Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator.** (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm’s length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under § 1.482-5(c). Neither Company A nor the comparable companies use valuable intangible property in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

**Example 2. Application of the operating profit to total services costs profit level indicator.** (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its year 1 taxable year. Company B renders management consulting services to Company A. Company B’s consulting function includes analyzing Company A’s operations, benchmarking Company A’s financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A’s operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting
services rendered to Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm’s length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company B incurs in performing the consulting services and do not make use of valuable intangible property or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables report only an aggregate figure for costs of goods sold and operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 1 through 3, Company B shows the following results for the services performed for Company A:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>1,200,000</td>
<td>1,100,000</td>
<td>1,300,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>100,000</td>
<td>100,000</td>
<td>N/A</td>
<td>66,667</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>1,100,000</td>
<td>1,000,000</td>
<td>1,300,000</td>
<td>1,133,333</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

(v) After adjustments have been made to account for identified material differences between the relevant business activity of Company B and the comparables, the average ratio for the taxable years 1 through 3 of operating profit to total services costs is calculated for each of the uncontrolled service providers. Applying each ratio to Company B’s average total services costs from the relevant business activity for the taxable years 1 through 3 would lead to the following comparable operating profit (COP) for the services rendered by Company B:

<table>
<thead>
<tr>
<th>Uncontrolled Service Provider</th>
<th>OP/Total Service Costs</th>
<th>Company B COP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company 1</td>
<td>15.75%</td>
<td>$189,000</td>
</tr>
<tr>
<td>Company 2</td>
<td>15.00%</td>
<td>$180,000</td>
</tr>
<tr>
<td>Company 3</td>
<td>14.00%</td>
<td>$168,000</td>
</tr>
<tr>
<td>Company 4</td>
<td>13.30%</td>
<td>$159,600</td>
</tr>
<tr>
<td>Company 5</td>
<td>12.00%</td>
<td>$144,000</td>
</tr>
<tr>
<td>Company 6</td>
<td>11.30%</td>
<td>$135,600</td>
</tr>
<tr>
<td>Company 7</td>
<td>11.25%</td>
<td>$135,000</td>
</tr>
<tr>
<td>Company 8</td>
<td>11.18%</td>
<td>$134,160</td>
</tr>
<tr>
<td>Company 9</td>
<td>11.11%</td>
<td>$133,320</td>
</tr>
<tr>
<td>Company 10</td>
<td>10.75%</td>
<td>$129,000</td>
</tr>
</tbody>
</table>

Reg. § 1.482-9(f)
(vi) The available data are not sufficiently complete to conclude that it is likely that all material differences between the relevant business activity of Company B and the comparables have been identified. Therefore, an arm’s length range can be established only pursuant to § 1.482-1(e)(2)(iii)(B). The arm’s length range is established by reference to the interquartile range of the results as calculated under § 1.482-1(e)(2)(iii)(C), which consists of the results ranging from $168,000 to $134,160. Company B’s reported average operating profit of zero (0) falls outside this range. Therefore, an allocation may be appropriate.

(vii) Because Company B reported income of zero, to determine the amount, if any, of the allocation, Company B’s reported operating profit for year 3 is compared to the comparable operating profits derived from the comparables’ results for year 3. The ratio of operating profit to total services costs in year 3 is calculated for each of the comparables and applied to Company B’s year 3 total services costs to derive the following results:

<table>
<thead>
<tr>
<th>Uncontrolled Service Provider</th>
<th>OP/Total COP</th>
<th>Company B COP</th>
</tr>
</thead>
<tbody>
<tr>
<td>(for year 3)</td>
<td></td>
<td>$195,000</td>
</tr>
<tr>
<td>Company 1</td>
<td>15.00%</td>
<td>$195,000</td>
</tr>
<tr>
<td>Company 2</td>
<td>14.75%</td>
<td>$191,750</td>
</tr>
<tr>
<td>Company 3</td>
<td>14.00%</td>
<td>$182,000</td>
</tr>
<tr>
<td>Company 4</td>
<td>13.50%</td>
<td>$175,500</td>
</tr>
<tr>
<td>Company 5</td>
<td>12.30%</td>
<td>$159,900</td>
</tr>
<tr>
<td>Company 6</td>
<td>11.05%</td>
<td>$143,650</td>
</tr>
<tr>
<td>Company 7</td>
<td>11.03%</td>
<td>$143,390</td>
</tr>
<tr>
<td>Company 8</td>
<td>11.00%</td>
<td>$143,000</td>
</tr>
<tr>
<td>Company 9</td>
<td>10.50%</td>
<td>$136,500</td>
</tr>
<tr>
<td>Company 10</td>
<td>10.25%</td>
<td>$133,250</td>
</tr>
</tbody>
</table>

(viii) Based on these results, the median of the comparable operating profits for year 3 is $151,775. Therefore, Company B’s income for year 3 is increased by $151,775, the difference between Company B’s reported operating profit for year 3 of zero and the median of the comparable operating profits for year 3.

Example 3. Material difference in accounting for stock-based compensation. (i) Taxpayer, a U.S. corporation the stock of which is publicly traded, performs controlled services for its wholly-owned subsidiaries. The arm’s length price of these controlled services is evaluated under the comparable profits method for services in paragraph (f) of this section by reference to the net cost plus profit level indicator (PLI). Taxpayer is the tested party under paragraph (f)(2)(i) of this section. The Commissioner identifies the most narrowly identifiable business activity of the tested party for which data are available that incorporate the controlled transaction (the relevant business activity). The Commissioner also identifies four uncontrolled domestic service providers, Companies A, B, C, and D, each of which performs exclusively activities similar to the relevant business activity of Taxpayer that is subject to analysis under paragraph (f) of this section. The stock of Companies A, B, C, and D is publicly traded on a U.S. stock exchange. Assume that Taxpayer makes an election to apply these regulations to earlier taxable years.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees’ performance of the relevant business activity is 500 for the taxable year in question. In evaluating the controlled services,
Taxpayer includes salaries, fringe benefits, and related compensation of these employees in "total services costs," as defined in paragraph (j) of this section. Taxpayer does not include any amount attributable to stock options in total services costs, nor does it deduct that amount in determining "reported operating profit" within the meaning of § 1.482-5(d)(5), for the year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Under a fair value method in accordance with U.S. generally accepted accounting principles, the comparables include in total compensation the value of the stock options attributable to the employees' performance of the relevant business activity for the annual financial reporting period, and treat this amount as an expense in determining operating profit for financial accounting purposes. The treatment of employee stock options is summarized in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Salaries and other compensation</th>
<th>Stock options fair value</th>
<th>Stock options expensed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer</td>
<td>1,000</td>
<td>500</td>
<td>0</td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>4,500</td>
<td>4,500</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

(iv) A material difference in accounting for stock-based compensation (within the meaning of § 1.482-7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of an arm's length result under this paragraph (f). In making an adjustment to improve comparability under §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner includes in total services costs of the tested party the total compensation costs of 1,500 (including stock option fair value). In addition, the Commissioner calculates the net cost plus PLI by reference to the financial-accounting data of Companies A, B, C, and D, which take into account compensatory stock options.

**Example 4. Material difference in utilization of stock-based compensation.** (i) The facts are the same as in paragraph (i) of Example 3.

(ii) No stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Thus, no deduction for stock options is made in determining "reported operating profit" (within the meaning of § 1.482-5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:

<table>
<thead>
<tr>
<th></th>
<th>Salaries and other non-option compensation</th>
<th>Stock options fair value</th>
<th>Stock options expensed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer</td>
<td>1,000</td>
<td>0</td>
<td>N/A</td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>2,000</td>
<td>0</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>250</td>
<td>0</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>4,500</td>
<td>0</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>2,000</td>
<td>0</td>
</tr>
</tbody>
</table>
(iv) A material difference in the utilization of stock-based compensation (within the meaning of § 1.482-7T(d)(3)(i)) exists. Analysis indicates that these differences would materially affect the measure of an arm’s length result under this paragraph (f). In evaluating the comparable operating profits of the tested party, the Commissioner uses Taxpayer’s total services costs, which include total compensation costs of 1,000. In considering whether an adjustment is necessary to improve comparability under §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner recognizes that the total compensation provided to employees of Companies A, B, C, and D. Because Companies A, B, C, and D do not expense stock-based compensation for financial accounting purposes, their reported operating profits must be adjusted in order to improve comparability with the tested party. The Commissioner increases each comparable’s total services costs, and also reduces its reported operating profit, by the fair value of the stock-based compensation incurred by the comparable company.

(v) The adjustments to the data of Companies A, B, C, and D described in paragraph (iv) of this Example 4 are summarized in the following table:

<table>
<thead>
<tr>
<th>Salaries and Total</th>
<th>Stock options</th>
<th>Operating profit</th>
<th>Net cost plus PLI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other non-option compensation fair value (A)</td>
<td>(B)</td>
<td>(B/A)</td>
<td></td>
</tr>
<tr>
<td><strong>Per financial statements:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>2,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>250</td>
<td>12,500</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>4,500</td>
<td>36,000</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>2,000</td>
<td>27,000</td>
</tr>
</tbody>
</table>

| As adjusted: |
| Company A | 7,000 | 2,000 | 27,000 | 4,000 | 14.81% |
| Company B | 4,300 | 250 | 12,750 | 2,250 | 17.65% |
| Company C | 12,000 | 4,500 | 40,500 | 6,500 | 16.05% |
| Company D | 15,000 | 2,000 | 29,000 | 5,000 | 17.24% |

Example 5. *Non-material difference in utilization of stock-based compensation.* (i) The facts are the same as in paragraph (i) of Example 3.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees’ performance of the relevant business activity is 50 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in “total services costs,” as defined in paragraph (j) of this section, and deducts these amounts in determining “reported operating profit” within the meaning of § 1.482-5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:
<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Salaries and other compensation</th>
<th>Stock options fair value</th>
<th>Stock options expensed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>130</td>
<td>0</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>75</td>
<td>0</td>
</tr>
</tbody>
</table>

(iv) Analysis of the data reported by Companies A, B, C, and D indicates that an adjustment for differences in utilization of stock-based compensation would not have a material effect on the determination of an arm’s length result.

<table>
<thead>
<tr>
<th>Salaries and other non-option compensation</th>
<th>Stock options fair value</th>
<th>Total services costs (A)</th>
<th>Operating profit (B)</th>
<th>Net cost plus PLI (B/A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per financial statements:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>100</td>
<td>25,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>40</td>
<td>12,500</td>
<td>2,500</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>130</td>
<td>36,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>75</td>
<td>27,000</td>
<td>7,000</td>
</tr>
<tr>
<td>As adjusted:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>100</td>
<td>25,100</td>
<td>5,900</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>40</td>
<td>12,540</td>
<td>2,460</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>130</td>
<td>36,130</td>
<td>10,870</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>75</td>
<td>27,075</td>
<td>6,925</td>
</tr>
</tbody>
</table>

(v) Under the circumstances, the difference in utilization of stock-based compensation would not materially affect the determination of the arm’s length result under this paragraph (f). Accordingly, in calculating the net cost plus PLI, no comparability adjustment is made to the data of Companies A, B, C, or D pursuant to §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv).

Example 6. Material difference in comparables’ accounting for stock-based compensation. (i) The facts are the same as in paragraph (i) of Example 3.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to employees’ performance of the relevant business activity is 500 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in “total services costs,” as defined in paragraph (j) of this section, and deducts these amounts in determining “reported operating profit” (within the meaning of § 1.482-5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Companies A and B expense the stock options for financial accounting purposes in accordance with U.S. generally accepted accounting principles. Companies C and D do not expense the stock options for financial
accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies C and D disclose the fair value of these options in their financial statements. The utilization and accounting treatment of options are depicted in the following table:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Salary and other compensation</th>
<th>Stock options fair value</th>
<th>Stock options expensed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>4,500</td>
<td>0</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>2,000</td>
<td>0</td>
</tr>
</tbody>
</table>

(iv) A material difference in accounting for stock-based compensation (within the meaning of § 1.482-7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of the arm’s length result under paragraph (f) of this section. In evaluating the comparable operating profits of the tested party, the Commissioner includes in total services costs Taxpayer’s total compensation costs of 1,500 (including stock option fair value of 500). In considering whether an adjustment is necessary to improve comparability under §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner recognizes that the total employee compensation (including stock options provided by Taxpayer and Companies A, B, C, and D) provides a reliable basis for comparison. Because Companies A and B expense stock-based compensation for financial accounting purposes, whereas Companies C and D do not, an adjustment to the comparables’ operating profit is necessary. In computing the net cost plus PLI, the Commissioner uses the financial-accounting data of Companies A and B, as reported. The Commissioner increases the total services costs of Companies C and D by amounts equal to the fair value of their respective stock options, and reduces the operating profits of Companies C and D accordingly.

(v) The adjustments described in paragraph (iv) of this Example 6 are depicted in the following table. For purposes of illustration, the unadjusted data of Companies A and B are also included.

<table>
<thead>
<tr>
<th>Salaries and other compensation</th>
<th>Stock options fair value</th>
<th>Total services costs (A)</th>
<th>Operating profit (B)</th>
<th>Net cost plus PLI (B/A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per financial Statements:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company A</td>
<td>7,000</td>
<td>2,000</td>
<td>27,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Company B</td>
<td>4,300</td>
<td>250</td>
<td>12,750</td>
<td>2,250</td>
</tr>
<tr>
<td>As adjusted:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company C</td>
<td>12,000</td>
<td>4,500</td>
<td>40,500</td>
<td>6,500</td>
</tr>
<tr>
<td>Company D</td>
<td>15,000</td>
<td>2,000</td>
<td>29,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

(g) Profit split method.

(1) In general. The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm’s length by reference to the relative value of each controlled taxpayer’s contribution to that combined operating profit or loss. The relative value of each controlled taxpayer’s contribution is determined in a manner that reflects the functions performed, risks assumed and resources employed by such controlled taxpayer in the relevant

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business activity. For application of the profit split method (both the comparable profit split and the residual profit split), see § 1.482-6. The residual profit split method may not be used where only one controlled taxpayer makes significant nonroutine contributions.

(2) Examples. The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Residual profit split. (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A’s database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also take place. Company A has a wholly-owned subsidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A’s interactive database. Company B solicits unrelated companies to auction spare parts on Company A’s database, and solicits customers interested in purchasing spare parts online. Company B owns and maintains a computer server in Country Y, where it receives information on spare parts available for auction. Company B has also designed a specialized communications network that connects its data center to Company A’s data center in Country X. The communications network allows Company B to enter data from uncontrolled companies on Company A’s database located in Country X. Company B’s communications network also allows uncontrolled companies to access Company A’s interactive database and purchase spare parts. Company B bore the risks and cost of developing this specialized communications network. Company B enters into contracts with uncontrolled companies and provides the companies access to Company A’s database through the Company B network.

(ii) Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangible property that they use to conduct the spare parts auction business. Company A bore the economic risks of developing and maintaining software and the interactive database. Company B bore the economic risks of developing the necessary technology to transmit information from its server to Company A’s data center, and to allow uncontrolled companies to access Company A’s database. Company B helped to enhance the value of Company A’s trademark and to establish a network of customers in Country Y. In addition, there are no market comparables for the transactions between Company A and Company B to reliably evaluate them separately. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of an arm’s length result.

(iii) Under the residual profit split method, profits are first allocated based on the routine contributions of each taxpayer. Routine contributions include general sales, marketing or administrative functions performed by Company B for Company A for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions of each taxpayer. Since both Company A and Company B provided nonroutine contributions, the residual profits are allocated based on these contributions.

Example 2. Residual profit split. (i) Company A, a Country 1 corporation, provides specialized services pertaining to the processing and storage of Level 1 hazardous waste (for purposes of this example, the most dangerous type of waste). Under long-term contracts with private companies and governmental entities in Country 1, Company A performs multiple services, including transportation of Level 1 waste, development of handling and storage protocols, recordkeeping, and supervision of waste-storage facilities owned and maintained by the contracting parties. Company A’s research and development unit has also developed new and unique processes for transport and storage of Level 1 waste that minimize environmental and occupational effects. In addition to this novel technology, Company A has substantial know-how and a long-term record of safe operations in Country 1.

(ii) Company A’s subsidiary, Company B, has been in operation continuously for a number of years in Country 2. Company B has successfully completed several projects in Country 2.
involving Level 2 and Level 3 waste, including projects with government-owned entities. Company B has a license in Country 2 to handle Level 2 waste (Level 3 does not require a license). Company B has established a reputation for completing these projects in a responsible manner. Company B has cultivated contacts with procurement officers, regulatory and licensing officials, and other government personnel in Country 2.

(iii) Country 2 government publishes invitations to bid on a project to handle the country’s burgeoning volume of Level 1 waste, all of which is generated in government-owned facilities. Bidding is limited to companies that are domiciled in Country 2 and that possess a license from the government to handle Level 1 or Level 2 waste. In an effort to submit a winning bid to secure the contract, Company B points to its Level 2 license and its record of successful completion of projects, and also demonstrates to Country 2 government that it has access to substantial technical expertise pertaining to processing of Level 1 waste.

(iv) Company A enters into a long-term technical services agreement with Company B. Under this agreement, Company A agrees to supply to Company B project managers and other technical staff who have detailed knowledge of Company A’s proprietary Level 1 remediation techniques. Company A commits to perform under any long-term contracts entered into by Company B. Company B agrees to compensate Company A based on a markup on Company A’s marginal costs (pro rata compensation and current expenses of Company A personnel). In the bid on the Country 2 contract for Level 1 waste remediation, Company B proposes to use a multi-disciplinary team of specialists from Company A and Company B. Project managers from Company A will direct the team, which will also include employees of Company B and will make use of physical assets and facilities owned by Company B. Only Company A and Company B personnel will perform services under the contract. Country 2 grants Company B a license to handle Level 1 waste.

(v) Country 2 grants Company B a five-year, exclusive contract to provide processing services for all Level 1 hazardous waste generated in County 2. Under the contract, Company B is to be paid a fixed price per ton of Level 1 waste that it processes each year. Company B undertakes that all services provided will meet international standards applicable to processing of Level 1 waste. Company B begins performance under the contract.

(vi) Analysis of the facts and circumstances indicates that both Company A and Company B make nonroutine contributions to the Level 1 waste processing activity in Country 2. In addition, it is determined that reliable comparables are not available for the services that Company A provides under the long-term contract, in part because those services incorporate specialized knowledge and process intangible property developed by Company A. It is also determined that reliable comparables are not available for the Level 2 license in Country 2, the successful track record, the government contacts with Country 2 officials, and other intangible property that Company B provided. In view of these facts, the Commissioner determines that the residual profit split method for services in paragraph (g) of this section provides the most reliable means of evaluating the arm’s length results for the transaction. In evaluating the appropriate returns to Company A and Company B for their respective contributions, the Commissioner takes into account that the controlled parties incur different risks, because the contract between the controlled parties provides that Company A will be compensated on the basis of marginal costs incurred, plus a markup, whereas the contract between Company B and the government of Country 2 provides that Company B will be compensated on a fixed-price basis per ton of Level 1 waste processed.

(vii) In the first stage of the residual profit split, an arm’s length return is determined for routine activities performed by Company B in Country 2, such as transportation, recordkeeping, and administration. In addition, an arm’s length return is determined for routine activities performed by Company A (administrative, human resources, etc.) in connection with providing personnel to Company B. After the arm’s length return for these functions is determined, residual profits may be present. In the second stage of the residual profit split, any residual profit is allocated by reference to the relative value of

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the nonroutine contributions made by each taxpayer. Company A’s nonroutine contributions include its commitment to perform under the contract and the specialized technical knowledge made available through the project managers under the services agreement with Company B. Company B’s nonroutine contributions include its licenses to handle Level 1 and Level 2 waste in Country 2, its knowledge of and contacts with procurement, regulatory and licensing officials in the government of Country 2, and its record in Country 2 of successfully handling non-Level 1 waste.

(h) Unspecified methods.

Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm’s length. Any method used under this paragraph (h) must be applied in accordance with the provisions of § 1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm’s length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction (for example, outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm’s length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

Example. (i) Company T, a U.S. corporation, develops computer software programs including a real estate investment program that performs financial analysis of commercial real properties. Companies U, V, and W are owned by Company T. The primary business activity of Companies U, V, and W is commercial real estate development. For business reasons, Company T does not sell the computer program to its customers (on a compact disk or via download from Company T’s server through the Internet). Instead, Company T maintains the software program on its own server and allows customers to access the program through the Internet by using a password. The transactions between Company T and Companies U, V, and W are structured as controlled services transactions whereby Companies U, V, and W obtain access via the Internet to Company T’s software program for financial analysis. Each year, Company T provides a revised version of the computer program including the most recent data on the commercial real estate market, rendering the old version obsolete.

(ii) In evaluating whether the consideration paid by Companies U, V, and W to Company T was arm’s length, the Commissioner may consider, subject to the best method rule of § 1.482-1(c), Company T’s alternative of selling the computer program to Companies U, V, and W on a compact disk or via download through the Internet. The Commissioner determines that the controlled services transactions between Company T and Companies U, V, and W are comparable to the transfer of a similar software program on a compact disk or via download through the Internet between uncontrolled parties. Subject to adjustments being made for material differences between the controlled services transactions and the comparable uncontrolled transactions, the uncontrolled transfers of tangible property

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may be used to evaluate the arm’s length results for the controlled services transactions between Company T and Companies U, V, and W.

(i) Contingent-payment contractual terms for services.

(1) Contingent-payment contractual terms recognized In general. In the case of a contingent-payment arrangement, the arm’s length result for the controlled services transaction generally would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm’s length result for the controlled services transaction generally would require payment by the recipient to the renderer on a basis that reflects the recipient’s benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered.

(2) Contingent-payment arrangement. For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in paragraph (i)(2)(i) of this section and is consistent with the economic substance and conduct requirement in paragraph (i)(2)(ii) of this section.

(i) General requirements.

(A) Written contract. The arrangement is set forth in a written contract entered into prior to, or contemporaneous with the start of the activity or group of activities constituting the controlled services transaction.

(B) Specified contingency. The contract states that payment for a controlled services transaction is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of § 1.482-9(l)(3)) for the recipient directly related to the activity or group of activities. For purposes of the preceding sentence, whether the future benefit is directly related to the activity or group of activities is evaluated based on all the facts and circumstances.

(C) Basis for payment. The contract provides for payment on a basis that reflects the recipient’s benefit from the services rendered and the risks borne by the renderer.

(ii) Economic substance and conduct. The arrangement, including the contingency and the basis for payment, is consistent with the economic substance of the controlled transaction and the conduct of the controlled parties. See § 1.482-1(d)(3)(ii)(B).

(3) Commissioner’s authority to impute contingent-payment terms. Consistent with the authority in § 1.482-1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) Evaluation of arm’s length charge. Whether the amount charged in a contingent-payment arrangement is arm’s length will be evaluated in accordance with this section and other applicable regulations under section 482. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm’s length, the charge determined under the rules of §§ 1.482-3 and 1.482-4 for the transfer of similar property may be considered. See § 1.482-1(f)(2)(ii).

(5) Examples. The principles of this paragraph (i) are illustrated by the following examples:

Example 1. (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research
and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, x% of Company Y’s gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in year 4. In year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in years 7 through 9 and Company Y makes the payments to Company X in years 7 through 9 that are required under the agreement.

(iii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the conditions of paragraph (i)(2) of this section are met and whether the arrangement, including the specified contingency and basis of payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient’s benefit and the renderer’s risk. Consistent with § 1.482-1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties’ conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. Based on all these facts, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of years 6 through 9 is arm’s length, the Commissioner evaluates under this section and other applicable rules under section 482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X’s willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating whether the compensation of x% of gross sales that is paid to Company X during the first four years of commercial sales of derivative products is arm’s length, the Commissioner may consider the royalties (or other consideration) charged for

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intangible property that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

Example 2. (i) The facts are the same as in Example 1, except that no commercial sales ever materialize with regard to the patented compound so that, consistent with the agreement, Company Y makes no payments to Company X in years 6 through 9.

(ii) Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance, and the result (no payments in years 6 through 9) is consistent with an arm's length result.

Example 3. (i) The facts are the same as in Example 1, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount equal to x% of such costs, with the payment to be made in the first year in which any such sales occur. The x% markup on costs is within the range, ascertainable in year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the requirements of paragraph (i)(2) of this section were met at the time the written agreement was entered into and whether the arrangement, including the specified contingency and basis for payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus x%, representing the markup for contract research in the absence of any nonpayment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and § 1.482-1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products developed under the agreement in each of years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under this section and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other
consideration) charged for intangible property that are comparable to those incorporated in the derivative products that resulted from Company X’s research and development activities under the contingent-payment arrangement.

(j) Total services costs.
For purposes of this section, total services costs means 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, or reasonably allocated in accordance with the principles of paragraph (k)(2) of this section to, the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but 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 § 1.901-2(a)), or domestic income taxes.

(k) Allocation of costs.
(1) In general. In any case where the renderer’s activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group under this paragraph (k). The principles of this paragraph (k) must also be used whenever it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

(2) Appropriate method of allocation and apportionment.
(i) Reasonable method standard. Any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments’ costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) Use of general practices. The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner. In determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members in apportioning costs among themselves will also be considered if the relationships with the foreign members are comparable to the relationships among the domestic members of the controlled group. For example, if for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a
reasonable and consistent basis, and such officers exercise comparable control over foreign members of the controlled group, such domestic apportionment practice will be considered in determining the allocations to be made to the foreign members.

(3) Examples. The principles of this paragraph (k) are illustrated by the following examples:

Example 1. Company A pays an annual license fee of $500x to an uncontrolled taxpayer for unlimited use of a database within the corporate group. Under the terms of the license with the uncontrolled taxpayer, Company A is permitted to use the database for its own use and in rendering research services to its subsidiary, Company B. Company B obtains benefits from the database that are similar to those that it would obtain if it had independently licensed the database from the uncontrolled taxpayer. Evaluation of the arm’s length charge (under a method in which costs are relevant) to Company B for the controlled services that incorporate use of the database must take into account the full amount of the license fee of $500x paid by Company A, as reasonably allocated and apportioned to the relevant benefits, although the incremental use of the database for the benefit of Company B did not result in an increase in the license fee paid by Company A.

Example 2. (i) Company A is a consumer products company located in the United States. Companies B and C are wholly-owned subsidiaries of Company A and are located in Countries B and C, respectively. Company A and its subsidiaries manufacture products for sale in their respective markets. Company A hires a consultant who has expertise regarding a manufacturing process used by Company A and its subsidiary, Company B. Company C, the Country C subsidiary, uses a different manufacturing process, and accordingly will not receive any benefit from the outside consultant hired by Company A. In allocating and apportioning the cost of hiring the outside consultant ($100), Company A determines that sales constitute the most appropriate allocation key.

(ii) Company A and its subsidiaries have the following sales:

<table>
<thead>
<tr>
<th>Company</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>400</td>
<td>100</td>
<td>200</td>
<td>700</td>
</tr>
</tbody>
</table>

(iii) Because Company C does not obtain any benefit from the consultant, none of the costs are allocated to it. Rather, the costs of $100 are allocated and apportioned ratably to Company A and Company B as the entities that obtain a benefit from the campaign, based on the total sales of those entities ($500). An appropriate allocation of the costs of the consultant is as follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>A</th>
<th>B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation</td>
<td>400/500</td>
<td>100/500</td>
<td>.......</td>
</tr>
<tr>
<td>Amount</td>
<td>80</td>
<td>20</td>
<td>100</td>
</tr>
</tbody>
</table>

(l) Controlled services transaction.

(1) In general. A controlled services transaction includes any activity (as defined in paragraph (l)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (l)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

(2) Activity. An activity includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.

(3) Benefit.
(i) In general. An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, 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 on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to the owner of intangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property. Paragraphs (l)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

(ii) Indirect or remote benefit. An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose. The determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) Duplicative activities. If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.

(iv) Shareholder activities. An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer’s capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer’s capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers.

(v) Passive association. A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer’s status as a member of a controlled group. A controlled taxpayer’s status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(4) Disaggregation of transactions. A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm’s length consideration, if that analysis is the most reliable means of determining the arm’s length consideration for the controlled services transaction. See the best method rule under § 1.482-1(c).

(5) Examples. The principles of this paragraph (l) are illustrated by the following examples. In each example, assume that Company X is a U.S. corporation and Company Y is a wholly-owned subsidiary of Company X in Country B.

Example 1. In general. In developing a worldwide advertising and promotional campaign for a consumer product, Company X pays for and obtains designation as an official sponsor of the Olympics. This designation allows Company X and all its subsidiaries, including Company Y, to identify themselves as sponsors and to use the Olympic logo in advertising and promotional campaigns. The Olympic sponsorship campaign generates benefits to Company X, Company Y, and other subsidiaries of Company X.
Example 2. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X implements certain changes in its management structure and the compensation of managers of divisions located in the United States. No changes were recommended or considered for Company Y in Country B. The internal study and the resultant changes in its management may increase the competitiveness and overall efficiency of Company X. Any benefits to Company Y as a result of the study are, however, indirect or remote. Consequently, Company Y is not considered to obtain a benefit from the study.

Example 3. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X decides to make changes to the management structure and management compensation of its subsidiaries, in order to increase their profitability. As a result of the recommendations in the study, Company X implements substantial changes in the management structure and management compensation scheme of Company Y. The study and the changes implemented as a result of the recommendations are anticipated to increase the profitability of Company X and its subsidiaries. The increased management efficiency of Company Y that results from these changes is considered to be a specific and identifiable benefit, rather than remote or speculative.

Example 4. Duplicative activities. At its corporate headquarters in the United States, Company X performs certain treasury functions for Company X and for its subsidiaries, including Company Y. These treasury functions include raising capital, arranging medium and long-term financing for general corporate needs, including cash management. Under these circumstances, the treasury functions performed by Company X do not duplicate the functions performed by Company Y’s staff. Accordingly, Company Y is considered to obtain a benefit from the functions performed by Company X.

Example 5. Duplicative activities. The facts are the same as in Example 4, except that Company Y’s functions include ensuring that the financing requirements of its own operations are met. Analysis of the facts and circumstances indicates that Company Y independently administers all financing and cash-management functions necessary to support its operations, and does not utilize financing obtained by Company X. Under the circumstances, the treasury functions performed by Company X are duplicative of similar functions performed by Company Y’s staff, and the duplicative functions do not enhance Company Y’s position. Accordingly, Company Y is not considered to obtain a benefit from the duplicative activities performed by Company X.

Example 6. Duplicative activities. Company X’s in-house legal staff has specialized expertise in several areas, including intellectual property. The intellectual property legal staff specializes in technology licensing, patents, copyrights, and negotiating and drafting intellectual property agreements. Company Y is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. Company Y retains outside counsel that specializes in intellectual property law to review the transaction documents. Company Y does not have in-house counsel of its own to review intellectual property transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to Company Y and that the contracts are valid and fully enforceable. Company X’s intellectual property legal staff possess valuable knowledge of Company Y’s patents and technological achievements. They are capable of identifying particular scientific attributes protected under patent that strengthen Company Y’s negotiating position, and of discovering flaws in the patents offered by the unrelated party. To reduce risk associated with the transaction, Company X’s intellectual property legal staff reviews the transaction documents before Company Y executes the contracts. Company X’s intellectual property legal staff also separately evaluates the patents and copyrights with respect to the licensing arrangements and concurs in the opinion provided by outside counsel. The activities performed by Company X substantially duplicate the legal services obtained by Company Y, but they also reduce risk associated with the transaction in a way that confers an additional benefit on Company Y.

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Example 7. Shareholder activities. Company X is a publicly held corporation. U.S. laws and regulations applicable to publicly held corporations such as Company X require the preparation and filing of periodic reports that show, among other things, profit and loss statements, balance sheets, and other material financial information concerning the company's operations. Company X, Company Y and each of the other subsidiaries maintain their own separate accounting departments that record individual transactions and prepare financial statements in accordance with their local accounting practices. Company Y, and the other subsidiaries, forward the results of their financial performance to Company X, which analyzes and compiles these data into periodic reports in accordance with U.S. laws and regulations. Because Company X's preparation and filing of the reports relate solely to its role as an investor of capital or shareholder in Company Y or to its compliance with reporting, legal, or regulatory requirements, or both, these activities constitute shareholder activities and therefore Company Y is not considered to obtain a benefit from the preparation and filing of the reports.

Example 8. Shareholder activities. The facts are the same as in Example 7, except that Company Y's accounting department maintains a general ledger recording individual transactions, but does not prepare any financial statements (such as profit and loss statements and balance sheets). Instead, Company Y forwards the general ledger data to Company X, and Company X analyzes and compiles financial statements for Company Y, as well as for Company X's overall operations, for purposes of complying with U.S. reporting requirements. Company Y is subject to reporting requirements in Country B similar to those applicable to Company X in the United States. Much of the data that Company X analyzes and compiles regarding Company Y's operations for purposes of complying with the U.S. reporting requirements are made available to Company Y for its use in preparing reports that must be filed in Country B. Company Y incorporates these data, after minor adjustments for differences in local accounting practices, into the reports that it files in Country B. Under these circumstances, because Company X's analysis and compilation of Company Y's financial data does not relate solely to its role as an investor of capital or shareholder in Company Y, or to its compliance with reporting, legal, or regulatory requirements, or both, these activities do not constitute shareholder activities.

Example 9. Shareholder activities. Members of Company X's internal audit staff visit Company Y on a semiannual basis in order to review the subsidiary's adherence to internal operating procedures issued by Company X and its compliance with U.S. anti-bribery laws, which apply to Company Y on account of its ownership by a U.S. corporation. Because the sole effect of the reviews by Company X's audit staff is to protect Company X's investment in Company Y, or to facilitate Company X's compliance with U.S. anti-bribery laws, or both, the visits are shareholder activities and therefore Company Y is not considered to obtain a benefit from the visits.

Example 10. Shareholder activities. Country B recently enacted legislation that changed the foreign currency exchange controls applicable to foreign shareholders of Country B corporations. Company X concludes that it may benefit from changing the capital structure of Company Y, thus taking advantage of the new foreign currency exchange control laws in Country B. Company X engages an investment banking firm and a law firm to review the Country B legislation and to propose possible changes to the capital structure of Company Y. Because Company X's retention of the firms facilitates Company Y's ability to pay dividends and other amounts and has the sole effect of protecting Company X's investment in Company Y, these activities constitute shareholder activities and Company Y is not considered to obtain a benefit from the activities.

Example 11. Shareholder activities. The facts are the same as in Example 10, except that Company Y bears the full cost of retaining the firms to evaluate the new foreign currency control laws in Country B and to make appropriate changes to its stock ownership by Company X. Company X is considered to obtain a benefit from the rendering by Company Y of these activities, which would be shareholder activities if conducted by Company X (see Example 10).
Example 12. Shareholder activities. The facts are the same as in Example 10, except that the new laws relate solely to corporate governance in Country B, and Company X retains the law firm and investment banking firm in order to evaluate whether restructuring would increase Company Y's profitability, reduce the number of legal entities in Country B, and increase Company Y's ability to introduce new products more quickly in Country B. Because Company X retained the law firm and the investment banking firm primarily to enhance Company Y's profitability and the efficiency of its operations, and not solely to protect Company X's investment in Company Y or to facilitate Company X's compliance with Country B's corporate laws, or to both, these activities do not constitute shareholder activities.

Example 13. Shareholder activities. Company X establishes detailed personnel policies for its subsidiaries, including Company Y. Company X also reviews and approves the performance appraisals of Company Y's executives, monitors levels of compensation paid to all Company Y personnel, and is involved in hiring and firing decisions regarding the senior executives of Company Y. Because this personnel-related activity by Company X involves day-to-day management of Company Y, this activity does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, and therefore does not constitute a shareholder activity.

Example 14. Shareholder activities. Each year, Company X conducts a two-day retreat for its senior executives. The purpose of the retreat is to refine the long-term business strategy of Company X and its subsidiaries, including Company Y, and to produce a confidential strategy statement. The strategy statement identifies several potential growth initiatives for Company X and its subsidiaries and lists general means of increasing the profitability of the company as a whole. The strategy statement is made available without charge to Company Y and the other subsidiaries of Company X. Company Y independently evaluates whether to implement some, all, or none of the initiatives contained in the strategy statement. Because the preparation of the strategy statement does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, the expense of preparing the document is not a shareholder expense.

Example 15. Passive association/benefit. Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken to date by Company Y. Company Y did not use Company X's marketing intangible property to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this section, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Example 16. Passive association/benefit. The facts are the same as in Example 15, except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain milestones. This performance guarantee allowed Company Y to obtain the contract on materially more favorable terms than otherwise would have been possible. Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.

Example 17. Passive association/benefit. The facts are the same as in Example 15, except that Company X began the process of negotiating the contract with the financial institution in Country B before acquiring Company Y. Once Company Y was acquired by Company X, the contract with the
financial institution was entered into by Company Y. Company Y is considered to obtain a benefit from Company X's negotiation of the contract.

**Example 18. Passive association/benefit.** The facts are the same as in Example 15, except that Company X sent a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y and that Company X would maintain that same percentage ownership interest in Company Y until the contract was completed. This letter allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Since this letter from Company X to the financial institution simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed, Company Y is not considered to obtain a benefit from Company X's furnishing of the letter.

**Example 19. Passive association/benefit.** (i) S is a company that supplies plastic containers to companies in various industries. S establishes the prices for its containers through a price list that offers customers discounts based solely on the volume of containers purchased.

(ii) Company X is the parent corporation of a large controlled group in the information technology sector. Company Y is a wholly-owned subsidiary of Company X located in Country B. Company X and Company Y both purchase plastic containers from unrelated supplier S. In year 1, Company X purchases 1 million units and Company Y purchases 100,000 units. S, basing its prices on purchases by the entire group, completes the order for 1.1 million units at a price of $0.95 per unit, and separately bills and ships the orders to each company. Companies X and Y undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iii) R1 and its wholly-owned subsidiary R2 are a controlled group of taxpayers (unrelated to Company X or Company Y) each of which carries out functions comparable to those of Companies X and Y and undertakes purchases of plastic containers from supplier S, identical to those purchased from S by Company X and Company Y, respectively. S, basing its prices on purchases by the entire group, charges R1 and R2 $0.95 per unit for the 1.1 million units ordered. R1 and R2 undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iv) U is an uncontrolled taxpayer that carries out comparable functions and undertakes purchases of plastic containers from supplier S identical to Company Y. U is not a member of a controlled group, undertakes no bargaining with supplier S with respect to the price charged, and purchases no other products from supplier S. U purchases 100,000 plastic containers from S at the price of $1.00 per unit.

(v) Company X charges Company Y a fee of $5,000, or $0.05 per unit of plastic containers purchased by Company Y, reflecting the fact that Company Y receives the volume discount from supplier S.

(vi) In evaluating the fee charged by Company X to Company Y, the Commissioner considers whether the transactions between R1, R2, and S or the transactions between U and S provide a more reliable measure of the transactions between Company X, Company Y and S. The Commissioner determines that Company Y’s status as a member of a controlled group should be taken into account for purposes of evaluating comparability of the transactions, and concludes that the transactions between R1, R2, and S are more reliably comparable to the transactions between Company X, Company Y, and S. The comparable charge for the purchase was $0.95 per unit. Therefore, obtaining the plastic containers at a favorable rate (and the resulting $5,000 savings) is entirely due to Company Y’s status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group. Consequently, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group.

**Example 20. Disaggregation of transactions.** (i) X, a domestic corporation, is a pharmaceutical company that develops and manufactures ethical pharmaceutical products. Y, a Country B corporation, is a distribution and marketing company that also performs clinical trials for X in Country B.

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Because Y does not possess the capability to conduct the trials, it contracts with a third party to undertake the trials at a cost of $100. Y also incurs $25 in expenses related to the third-party contract (for example, in hiring and working with the third party).

(ii) Based on a detailed functional analysis, the Commissioner determines that Y performed functions beyond merely facilitating the clinical trials for X, such as audit controls of the third party performing those trials. In determining the arm’s length price, the Commissioner may consider a number of alternatives. For example, for purposes of determining the arm’s length price, the Commissioner may determine that the intercompany service is most reliably analyzed on a disaggregated basis as two separate transactions: in this case, the contract between Y and the third party could constitute an internal CUSP with a price of $100. Y would be further entitled to an arm’s length remuneration for its facilitating services. If the most reliable method is one that provides a markup on Y’s costs, then “total services cost” in this context would be $25. Alternatively, the Commissioner may determine that the intercompany service is most reliably analyzed as a single transaction, based on comparable uncontrolled transactions involving the facilitation of similar clinical trial services performed by third parties. If the most reliable method is one that provides a markup on all of Y’s costs, and the base of the markup determined by the comparable companies includes the third-party clinical trial costs, then such a markup would be applied to Y’s total services cost of $125.

**Example 21. Disaggregation of transactions.** (i) X performs a number of administrative functions for its subsidiaries, including Y, a distributor of widgets in Country B. These services include those relating to working capital (inventory and accounts receivable/payable) management. To facilitate provision of these services, X purchases an ERP system specifically dedicated to optimizing working capital management. The system, which entails significant third-party costs and which includes substantial intellectual property relating to its software, costs $1000.

(ii) Based on a detailed functional analysis, the Commissioner determines that in providing administrative services for Y, X performed functions beyond merely operating the ERP system itself, since X was effectively using the ERP as an input to the administrative services it was providing to Y. In determining arm’s length price for the services, the Commissioner may consider a number of alternatives. For example, if the most reliable uncontrolled data is derived from companies that use similar ERP systems purchased from third parties to perform similar administrative functions for uncontrolled parties, the Commissioner may determine that a CPM is the best method for measuring the functions performed by X, and, in addition, that a markup on total services costs, based on the markup from the comparable companies, is the most reliable PLI. In this case, total services cost, and the basis for the markup, would include appropriate reflection of the ERP costs of $1000. Alternatively, X’s functions may be most reliably measured based on comparable uncontrolled companies that perform similar administrative functions using their customers’ own ERP systems. Under these circumstances, the total services cost would equal X’s costs of providing the administrative services excluding the ERP cost of $1000.

(m) **Coordination with transfer pricing rules for other transactions.**

(1) **Services transactions that include other types of transactions.** A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. See §§ 1.482-1(b)(2) and 1.482-2(a), (c), and (d). Whether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm’s length result. Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately, provided that
each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm’s length result in the controlled transaction. See § 1.482-1(d)(3).

(2) Services transactions that effect a transfer of intangible property. A transaction structured as a controlled services transaction may in certain cases include an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property. Notwithstanding paragraph (m)(1) of this section, if such element relating to intangible property is material to the evaluation, the arm’s length result for the element of the transaction that involves intangible property must be corroborated or determined by an analysis under § 1.482-4.

(3) [Reserved]. For further guidance, see § 1.482-9T(m)(3).

(4) Other types of transactions that include controlled services transactions. A transaction structured other than as a controlled services transaction may include one or more elements for which separate pricing methods are provided in this section. Whether such an integrated transaction is evaluated under another section of the section 482 regulations or whether one or more elements should be evaluated separately under this section depends on which approach will provide the most reliable measure of an arm’s length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this section, provided that the controlled services may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm’s length results in the controlled transaction. See § 1.482-1(d)(3).

(5) Examples. The principles of this paragraph (m) are illustrated by the following examples:

**Example 1.** (i) U.S. parent corporation Company X enters into an agreement to maintain equipment of Company Y, a foreign subsidiary. The maintenance of the equipment requires the use of spare parts. The cost of the spare parts necessary to maintain the equipment amounts to approximately 25 percent of the total costs of maintaining the equipment. Company Y pays a fee that includes a charge for labor and parts.

(ii) Whether this integrated transaction is evaluated as a controlled services transaction or is evaluated as a controlled services transaction and the transfer of tangible property depends on which approach will provide the most reliable measure of an arm’s length result. If it is not possible to find comparable uncontrolled services transactions that involve similar services and tangible property transfers as the controlled transaction between Company X and Company Y, it will be necessary to determine the arm’s length charge for the controlled services, and then to evaluate separately the arm’s length charge for the tangible property transfers under § 1.482-1 and §§ 1.482-3 through 1.482-6. Alternatively, it may be possible to apply the comparable profits method of § 1.482-5 to evaluate the arm’s length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm’s length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment.

**Example 2.** (i) U.S. parent corporation Company X sells industrial equipment to its foreign subsidiary, Company Y. In connection with this sale, Company X renders to Company Y services that consist of demonstrating the use of the equipment and assisting in the effective start-up of the equipment. Company X structures the integrated transaction as a sale of tangible property and determines the transfer price under the comparable uncontrolled price method of § 1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm’s length result. In this case, the controlled services may be similar to services rendered in the transactions used to determine the comparable

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uncontrolled price, or they may appropriately be considered a difference between the controlled transaction and comparable transactions with a definite and reasonably ascertainable effect on price for which appropriate adjustments can be made. See § 1.482-1(d)(3)(ii)(A)(6). In either case, application of the comparable uncontrolled price method to evaluate the integrated transaction may provide a reliable measure of an arm’s length result, and application of a separate transfer pricing method for the controlled services element of the transaction is not necessary.

Example 3. (i) The facts are the same as in Example 2 except that, after assisting Company Y in start-up, Company X also renders ongoing services, including instruction and supervision regarding Company Y’s ongoing use of the equipment. Company X structures the entire transaction, including the incremental ongoing services, as a sale of tangible property, and determines the transfer price under the comparable uncontrolled price method of § 1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm’s length result. It may not be possible to identify comparable uncontrolled transactions in which a seller of merchandise renders services similar to the ongoing services rendered by Company X to Company Y. In such a case, the incremental services in connection with ongoing use of the equipment could not be taken into account as a comparability factor because they are not similar to the services rendered in connection with sales of similar tangible property. Accordingly, it may be necessary to evaluate separately the transfer price for such services under this section in order to produce the most reliable measure of an arm’s length result. Alternatively, it may be possible to apply the comparable profits method of § 1.482-5 to evaluate the arm’s length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm’s length result if uncontrolled parties are identified that perform the combined functions of selling equipment and rendering ongoing after-sale services associated with such equipment. In that case, it would not be necessary to separately evaluate the transfer price for the controlled services under this section.

Example 4. (i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both companies perform research and development activities relating to integrated circuits. In addition, Company Y manufactures integrated circuits. In years 1 through 3, Company X engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report. In years 1 through 3, Company X generates overall net operating losses as a result of the expenditures associated with this research and development effort. At the beginning of year 4, Company X enters into a technical assistance agreement with Company Y. As part of this agreement, the researchers from Company X responsible for this project meet with the researchers from Company Y and provide them with a copy of the written report. Three months later, the researchers from Company Y apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researchers from Company X.

(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (such as, know-how). Because the element relating to the intangible property is material to the arm’s length evaluation, the arm’s length result for that element must be corroborated or determined by an analysis under § 1.482-4.

(6) *Global dealing operations.* [Reserved].

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(n) **Effective/applicability date.**

(1) **In general.** This section is generally applicable for taxable years beginning after July 31, 2009. In addition, a person may elect to apply the provisions of this section to earlier taxable years. See paragraph (n)(2) of this section.

(2) **Election to apply regulations to earlier taxable years.**

   (i) **Scope of election.** A taxpayer may elect to apply § 1.482-1(a)(1), (b)(2)(i), (d)(3)(ii)(C) Examples 3 through 6, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(ii)(B), (g)(4)(i), (g)(4)(ii) Example 1, (i), (j)(6)(i) and (j)(6)(ii), § 1.482-2(b), (f)(1) and (2), § 1.482-4(f)(3)(i)(A), (f)(3)(ii) Examples 1 and 2, (f)(4), (h)(1) and (2), § 1.482-6(c)(2)(ii)(B)(1), (c)(2)(ii)(D), (c)(3)(i)(A), (c)(3)(i)(B), (c)(3)(ii)(D), and (d), § 1.482-8(b) Examples 10 through 12, (c)(1) and (c)(2), § 1.482-9(a) through (m)(2), and (m)(4) through (n)(2), § 1.861-8(a)(5)(ii), (b)(3), (c)(4), (f)(4)(l), (g) Examples 17, 18, and 30, § 1.6038A-3(a)(3) Example 4 and (i), § 1.6662-6(d)(2)(ii)(B), (d)(2)(ii)(B)(4), (d)(2)(ii)(B)(6), and (g), and § 31.3121(s)-1(c)(2)(iii) and (d) of this chapter to any taxable year beginning after September 10, 2003. Such election requires that all of the provisions of such sections be applied to such taxable year and all subsequent taxable years (earlier taxable years) of the taxpayer making the election.

   (ii) **Effect of election.** An election to apply the regulations to earlier taxable years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see Chapter 66 of the Internal Revenue Code).

   (iii) **Time and manner of making election.** An election to apply the regulations to earlier taxable years must be made by attaching a statement to the taxpayer’s timely filed U.S. tax return (including extensions) for its first taxable year beginning after July 31, 2009.

   (iv) **Revocation of election.** An election to apply the regulations to earlier taxable years may not be revoked without the consent of the Commissioner.