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IRS Updates Transfer Pricing Regs on Related Party Service Transactions

The Internal Revenue Service issued temporary and proposed transfer pricing regulations that update the current tax treatment of related party service transactions. The new regulations also address service transactions related to intangible property. A proposed revenue procedure was also issued that outlines support services that qualify for a new method introduced in the temporary regs.

The transfer pricing regs provide guidance on numerous types of cross-border transactions involving companies located in different tax jurisdictions but owned by the same interests. Since the first transfer pricing regs were issued in 1968, the IRS has revised the regs many times, the latest in 2003.

In response to many comments received by the IRS on the 2003 proposed regs, the prescribed transfer pricing methods for service transactions in the new regs have been simplified to reduce the compliance burden for taxpayers, in particular, for taxpayers with low-margin or routine intercompany service transactions. The new regs will allow the IRS to focus its audit resources on transfer pricing of high-margin services, as well as transfer pricing of tangible and intangible property.

Some of the more significant provisions of the new regs:

- Provide transfer pricing methods consistent with existing regs and international standards in the area of transfers of tangible and intangible property.
- Coordinate the transfer pricing rules for services related to intangibles with transfer pricing rules for the transfer of intangible property.
- Suggest transfer pricing methods to use to determine the arm's length price in a services transaction.
- Provide that valuable intangibles cannot be transferred outside the U.S. for less than arm's length consideration.

The Simplified Cost-Based Method ("SCBM"), which was introduced in the 2003 proposed regs, has been eliminated and replaced by with a new Services Cost Method ("SCM"). The SCM is intended for routine back-office services and these services may be charged at cost without a markup, similar to the safe harbor for non-integral services provided in the current transfer pricing regs.

The regs provide for two categories of covered services that qualify for the SCM, provided the other conditions of the application of the method are met. One category includes "low margin covered services" that are eligible for compensation at cost. "Low margin covered services" are defined as services with a median comparable arm's length markup on total costs less than or equal to 7 percent.

The other category includes specific activities as listed by the proposed revenue procedure: accounting, finance, human resources, information technology, and legal support. Consistent with the objective of reducing taxpayer burden, the IRS has stated that

taxpayers may rely upon this listing and need not perform their own independent analysis of comparable service providers.

The SCM approach is much less complicated than the current treatment of integral and non-integral services under the current safe harbor provisions. While the SCM reduces some of the compliance burden of the 2003 proposed regs, a taxpayer may still need a transfer pricing study for non-listed services. This does not eliminate the risk that the IRS may reject the arm's-length range identified in the taxpayer's transfer pricing study.

Other provisions of the regs include guidance on:

- The use of methods to evaluate whether the amount charged in a controlled services transaction is arm's length.
- Shared service arrangements.
- Circumstances in which the profit split method would constitute the best method.
- Cost of service plus method with numerous clarifying changes.

Other provisions not substantially changed from the 2003 regs include:

- Sections on the comparable uncontrolled services price (CUSP) method.
- Sections on the gross service margin method.
- Sections on the comparable profit method (CPM).

The temporary regs update the existing transfer pricing service regs, which have been in effect since 1968. The temporary regs become effective January 1, 2007 and apply to tax years beginning after December 31, 2006. The regs have been issued with a delayed effective date in order to provide taxpayers with an opportunity to modify their transfer pricing policies to conform to the new regs.

Altus Economics' transfer pricing professionals can guide you in assessing the impact of these new regs on your business and oversee the implementation of policies or procedures required to comply with the new regs.

The full text of the proposed transfer pricing service regs is available online at <http://www.ustreas.gov/press/releases/reports/servicesreg0801.pdf>.