



Securities Industry Association

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January 12, 2004

The Honorable Emily Parker
Acting Chief Counsel
and
The Honorable Donald Lee Korb
Chief Counsel-Designate
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

The Honorable Gregory Jenner
Acting Assistant Secretary (Tax Policy)
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Ms. Parker, Mr. Korb and Mr. Jenner:

I am pleased to submit the comments of the Securities Industry Association (SIA) with respect to proposed regulations addressing the treatment of services under section 482 and the allocation of income and deductions from intangibles (REG-146893-02 and REG-115037-00).

Thank you for your consideration of our views. Please do not hesitate to call me (at 202-216-2031) or Edward Kleinbard of Cleary, Gottlieb, Steen and Hamilton, SIA's outside counsel on this matter, (at 212-225-2480) if we can be of assistance in any way on either of these projects.

Sincerely,

Patricia McClanahan
Vice President and Director for Tax Policy
Securities Industry Association

cc: Barbara Angus
John Breen
Rocco Femia
Douglas Giblen
Harry J.Hicks III



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CC:PA:LPD:PR (REG-146893-02 and REG-115037-02)
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Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

**SUBMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING REGARDING
TREATMENT OF SERVICES UNDER SECTION 482 AND RELATED MATTERS**

I. INTRODUCTION.

A. The Proposed Regulations.

On September 10, 2003, the Internal Revenue Service (the "IRS") published a Notice of Proposed Rulemaking with respect to two regulation projects (REG-146893-02 and REG-115037-02), titled "Treatment of Services Under Section 482" and "Allocation of Income and Deductions From Intangibles."¹ The Notice of Proposed Rulemaking would amend Reg. §§ 1.482-1, 1.482-4, and 1.482-6 and add a new Reg. § 1.482-9,² as well as make certain other conforming changes (collectively, the "Proposed Regulations").

We are pleased to submit the comments of the Securities Industry Association (the "SIA")³ with respect to the Proposed Regulations. This letter was prepared by the SIA's

¹ 68 Federal Register 53447 (Sept. 10, 2003).

² Unless indicated otherwise, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code") or Treasury regulations promulgated thereunder.

³ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate,

Committee on the Federal Taxation of the Securities Industry. While most of the comments that follow focus on the treatment of services under section 482 (*i.e.*, Prop. Reg. § 1.482-9), we also comment briefly on those portions of the Proposed Regulations that would clarify the treatment of certain intangible transfers.

The Proposed Regulations can be viewed as having three objectives:

First, the Proposed Regulations would prescribe six specific transfer pricing methodologies for services, and relate those methodologies to the general rules of Reg.

§ 1.482-1. In this connection, the Proposed Regulations also would revise the rules of Reg.

§ 1.482-6 generally applicable to the profit split method. These provisions form the bulk of the Proposed Regulations.

Second, the Proposed Regulations would require taxpayers to identify more systematically transfers of intangible property bundled with controlled services, and to subject those transfers to the separate rules of Reg. § 1.482-4. That regulation in turn would be amended to revise the rules for determining the ownership of intangibles, and to separate the issue of legal ownership of an intangible from the question of the appropriate arm's-length return on contributions made to enhance the value of that intangible.

Third, the Proposed Regulations would expand greatly the number of intra-group activities to which section 482 applies and for which comparables must be developed, by revising the definition of a “controlled services transaction” and by repealing current law’s cost-only transfer pricing safe harbor for non-integral services.

B. Overview of Our Submission.

The Proposed Regulations are an important development, because they seek to modernize section 482’s guidance for the treatment of intra-group services—an aspect of section 482 that has not been revised in over 30 years. (For convenience, we refer to the current rules of

thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$304 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

Reg. § 1.482-2(b) as the “Current Services Regulations.”) We applaud the IRS and the Treasury Department (“Treasury”) for tackling this important area of the law. In general terms, we agree with much of the specific guidance offered by the Proposed Regulations. We do, however, have significant concerns regarding the scope of the new rules contained in the Proposed Regulations. We therefore identify these concerns below; we also offer some suggestions as to how the Proposed Regulations could be revised (and then republished in proposed form) to strike a better balance between the competing demands of tax policy, administrability, commercial realities and international comity.

We agree in general terms with the Proposed Regulations’ articulation of specific transfer pricing methodologies for services, with the very important exception of the so-called “Simplified Cost-Based Method.” We believe, however, that it is critically important that the Proposed Regulations be limited to their proper context, which means in particular when applied to the financial services industries that the Proposed Regulations ought not to apply to arrangements properly within the scope of Prop. Reg. § 1.482-8 and related proposed regulations⁴ (the “proposed global dealing regulations”). Our belief that the Proposed Regulations must be limited to their appropriate context if they are not to produce distorted results, also leads us to disagree fundamentally with the proposed expansion of the volume of intra-group services for which comparables must be developed and (in many cases) a profit margin charged.

We acknowledge that intra-group services sometimes can function as vehicles for transfers of separately-identifiable intangible property, and that these cases should be distinguished and addressed under the rules for transfers of intangible property. We believe, however, that the Proposed Regulations should be more precisely targeted to address this problem.

⁴ 63 Federal Register 11,177 (Mar. 6, 1998).

In our view, the Proposed Regulations, if promulgated in final form without revision, would lead to unproductive and unnecessary efforts on the part of Revenue Agents to ferret out intangibles that truly are incidental to the services provided. This in turn would lead to unnecessary disputes and compliance burdens for taxpayers. In light of our concerns, both with respect to our principal recommendation and the other recommendations made herein, and the similar concerns expressed by most of the other comment letters submitted to date, we urge that the Proposed Regulations be revised and republished in proposal form, so that taxpayers can have an opportunity to comment on those proposed revisions.

C. Summary of SIA's Principal Recommendation.

We think it critical to recognize that much of Prop. Reg. § 1.482-9 could be read to apply to arrangements that properly are within the scope of the proposed global dealing regulations. The overlap is apparent most directly with respect to assumptions of financial risks, which are brought into the Proposed Regulations by Prop. Reg. § 1.482-9(l)(2), but the overlap exists equally with respect to service functions that are a component of global dealing operations. Prop. Reg. § 1.482-9(m)(5) implicitly acknowledges the issue by providing a placeholder for a coordination rule, but a substantive rule itself is missing from the Proposed Regulations.

Large portions of the transnational intra-group activities of SIA member firms properly fall within the ambit of global dealing, insofar as those activities have at their core the commingling of human ingenuity, technology and financial capital to provide financial services to customers in multiple jurisdictions. Taxpayers, the IRS and Treasury all have worked diligently to develop flexible and commercially reasonable rules for the taxation of global dealing arrangements.⁵ The Proposed Regulations reflect almost none of that dialogue, particularly with respect to the different arm's-length methodologies by which multinational

⁵ See, e.g., the SIA's extensive comments on this topic in Letter from Saul M. Rosen of the SIA to Barbara Angus, International Tax Counsel, and Patricia Brown, Deputy-International Tax Counsel, dated July 27, 2001 *reprinted in* 2001 *Tax Notes Today* 174-20 (Sept. 7, 2001) (the "2001 SIA Global Dealing Letter"). See also our initial submission on the Proposed Regulations on Global Dealing Operations, dated July 21, 1998 *reprinted in* 1998 *Tax Notes Today* 146-8 (July 30, 1998) (the "SIA Global Dealing Comment").

financial services firms today share the risks and rewards arising from the commingling of financial capital and human services in global dealing operations.

As a result, whatever the merits of the Proposed Regulations when applied to simple assumptions of financial risk within a multinational industrial enterprise, the Proposed Regulations would offer incomplete and unsatisfactory guidance were a Revenue Agent to apply these rules to global dealing arrangements. For this reason, we urge the IRS to provide a substantive rule under Prop. Reg. § 1.482-9(m)(5) to the effect that the proposed global dealing regulations, and *not* Prop. Reg. § 1.482-9, will apply to arrangements properly within the scope of the proposed global dealing regulations.⁶

We stand ready to offer whatever assistance we can to the IRS and Treasury in working through any outstanding issues with respect to the proposed global dealing regulations. At the same time, we strongly believe that the application of Prop. Reg. § 1.482-9 to global dealing arrangements could lead to unreasonable results and extensive controversy. It therefore is critically important that Prop. Reg. § 1.482-9 not apply to global dealing operations, even for an interim period, and that the IRS and Treasury publish revised proposed global dealing regulations that reflect the extensive comments that have been made to date.⁷

D. Summary of Other SIA Recommendations.

We believe that the Proposed Regulations expand the range of service activities for which comparables must be developed, and in many cases a profit charged, in ways that are commercially unrealistic, extraordinarily difficult to implement and administer, and inconsistent

⁶ We note that the proposed approach is consistent generally with the approach adopted by the Proposed Regulations. Specifically, the Preamble to the Proposed Regulations states that the broad definition of “activity” was promulgated “to allow transactions that are not subject to existing section 482 regulations applicable to other types of transactions to be analyzed under proposed § 1.482-9.” 68 Federal Register 53448, 53456 (parenthetical omitted). Accordingly, the global dealing regulations, like other section 482 regulations, should have priority in application over the Proposed Regulations.

⁷ For these purposes, we include within the proper scope of the global dealing regulations the principles by which taxpayers should allocate income and expenses from dealing activities between different “desks” or branches of a single enterprise.

both with economic theory and with international norms. We believe that the Proposed Regulations in fact *depart* from international norms as expressed by Organisation for Economic Co-operation and Development (the “OECD”) in its 1995 publication, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*⁸ (the “OECD Guidelines”) when the Proposed Regulations include as controlled services transactions arrangements where the service recipient is said to receive a “benefit,” even in the absence of evidence that the recipient would be willing to pay for that benefit.

Similarly, the Proposed Regulations misapprehend the role of current law’s “cost-only” safe harbor for non-integral services. The safe harbor serves as much more than an administrative convenience; in the absence of the safe harbor, natural synergies of doing business as a multinational enterprise will become subject to transfer pricing disputes, with the result that the income of group members in fact will be distorted. The cost-only safe harbor recognizes that these synergies are difficult to ascribe to one group member or another, and therefore effectively treats intra-group services that give rise to synergistic savings, but that are not part of the businesses that group members pursue with *bona fide* customers (*i.e.*, non-integral services), as transferred at cost, because that is the price which distorts group members’ income the least.

Some observers have expressed concern in recent years about the re-siting of white-collar services jobs (typically, in industries other than the financial services industries) from the United States to foreign locations. We are concerned that the Proposed Regulations might inadvertently accelerate that trend, by encouraging U.S.-based multinational enterprises to locate intra-group service providers in those jurisdictions outside the United States where those enterprises already do business. Multinational enterprises might consider doing so to avoid profit imputation on high-value services that may not be deductible in the service recipient’s jurisdiction and to take advantage of a marked-up deduction that may be available in the United

⁸ “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (OECD Comm. on Fiscal Affairs, 1995) (the “OECD Guidelines”).

States. This in turn could result in the loss of U.S. jobs and reduced investment in the United States.

We believe that the basic goals of the Proposed Regulations could be met at far less cost and with many fewer controversies, if the Proposed Regulations were modified in three respects:

- Prop. Reg. § 1.482-9(l)(1) should be revised to define a “controlled services activity” in a manner that tracks more closely the recommendations made by the OECD Guidelines—namely, as an activity for which the service recipient reasonably could be expected *to pay*, not simply as an activity from which the service recipient receives a more than an indirect or remote “benefit.” Concerns that this approach would reintroduce undesirable inquiries into a service recipient’s subjective intent can be addressed by clarifying explicitly that the test refers to the expected behavior of a hypothetical company in the same economic position as that of the service recipient.
- The “Simplified Cost-Based Method” of Prop. Reg. § 1.482-9(f) should be abandoned, and the Current Services Regulations’ cost-only safe harbor for non-integral services incorporated in the Proposed Regulations, with appropriate further clarifications to exclude from the cost-only safe harbor embedded intangible transfers and other problematic transactions. For the reasons developed in Part V, we recommend that the cost-only safe harbor continue to apply to intra-group guarantees, so long as (i) providing guarantees is not an integral part of the guarantor’s business, and (ii) the guarantees in question arise in cases that fall *outside* the scope of the proposed global dealing regulations.
- The concept of embedded intangibles transfers should be refined further to clarify that, for an intangible to exist and be subject to Reg. § 1.482-4, it must be separable from human skill: that is, the simple relocation of a talented and highly-compensated employee should not be analyzed as a disguised transfer of valuable intangibles.

E. Criteria for Reviewing the Proposed Regulations.

As a final introductory note, we think it helpful to identify the criteria that we applied in evaluating the Proposed Regulations. We believe that there are four such criteria:

First, are the results obtained by the Proposed Regulations commercially reasonable? That is, do the Proposed Regulations produce results that senior executives of a firm would recognize as consistent with the business behavior of rational commercial actors?

Second, are the methodologies contemplated by the Proposed Regulations administrable at reasonable cost by taxpayers and tax administrators alike? Another way of asking this question is whether the benefits of the proposals clearly outweigh any incremental costs?

Third, do the Proposed Regulations treat different forms of business organizations comparably? Some financial services firms rely to a significant extent on branch operations, while others conduct nearly all their business in separate subsidiary form. In addition, intra-group services can be performed through partnerships, or co-operatives, or contractual cost-sharing agreements (or “cost contribution arrangements,” to use the OECD’s term). It is critical that intra-group services should lead to comparable profits in each relevant jurisdiction, regardless of the form of business organization chosen.

Fourth, are the results obtained under the Proposed Regulations consistent with international norms? Both the United States and the OECD endorse the arm’s-length principle, but to answer this question requires drilling down to a greater level of specificity. To that end, we attach a memorandum from Cleary, Gottlieb, Steen & Hamilton summarizing the actual transfer pricing practices of five leading trading partners. Because intercompany pricing is directly relevant to the tax administrations of every jurisdiction in which a multinational enterprise does business, U.S. rules that are out of step with international norms will lead to innumerable (and insoluble) competent authority disputes.

II. INTRODUCTION TO FINANCIAL SERVICES FIRMS.

A. In General.

The financial services sector of the economy comprises many different industries, each with its own dominant business model for delivering a set of financial products to often overlapping bases of customers. The financial services sector includes the activities of securities firms, banks, finance companies and insurance companies. Within these categories in turn are sub-industries that are as different as they are similar: property and casualty insurance, for example, is a very different business from writing life insurance, just as consumer lending is very different from financing an affiliate's equipment sales to its customers. Increasingly, however, financial services firms conduct operations in multiple industries and sub-industries, which often replicate one another's financial products and services and compete for the same base of customers.

Fundamentally, financial services firms apply human ingenuity, technology *and financial capital* to provide specialized financial services to customers. Most core financial operations of these firms are not pure service functions, although there are of course important exceptions (investment advisory services, for example). The fundamental distinction between financial services firms and other service providers is that financial services require the application of extensive amounts of financial capital as well as human labor and technology to provide their specialized customer services.

Industries in the financial services sector of the economy are all tremendously competitive. To be successful, most large financial services firms have concluded that they must be *global*: they serve customers that are located and conduct business in multiple jurisdictions, and they in turn offer these customers a broad range of essential financial products and services that must be sourced from many jurisdictions.⁹ Moreover, certain dealing operations are

⁹ There is an extensive literature that develops in more detail the identified in the text themes of the global scope and close integration of most major financial services firms. *See, e.g.*, "The Taxation of Global Trading of Financial Instruments" (OECD Comm. on Fiscal Affairs, 1998) (the "OECD Global Trading Report"); OECD, "The New Financial Landscape—Forces Shaping the Revolution in Banking, Risk Management and Capital Markets" (1995); Bank for International Settlements, "Triennial Central Bank Survey of Foreign Exchange and Derivatives

conducted globally on a 24-hour basis (*e.g.*, standing ready to buy and sell, or “market making,” in currencies and government securities).

As a result, the dominant financial services firms in most of the world’s major markets generally are multinational enterprises. In the United States, some of the leading financial services firms are U.S.-based multinational enterprises, while many others are U.S. branches or subsidiaries of foreign-based multinational enterprises. All compete vigorously in the world’s financial markets for the same customers and offer similar services.

In order to be successful, it is not sufficient for a financial services firm merely to establish an international presence. A successful financial services firm also must function as a globally *integrated* business, and not as a loose agglomeration of uncoordinated local enterprises, in order to manage the firm’s financial risks and to serve customers effectively. The world’s major financial markets are closely tied to one another, because local currency values, interest rates, commodity prices and equity indices all reflect global developments. A global financial firm’s risk management operations must identify and effectively manage correlated financial risks in multiple jurisdictions. To enhance the customer relationship in a highly competitive marketplace, financial firms must meet customer requirements globally and must stay abreast of global developments to do so.

Financial services firms also must be very large in order to provide the complex financial services that sophisticated customers demand. Financial services firms do not employ only a relative handful of capital risk takers (traders, credit officers or senior actuaries, for example) and a “back office” of administrative staff, as is sometimes believed. On the contrary, financial services firms, precisely because they operate *customer service* businesses, have significant fixed assets and enormous work forces. For example, Citigroup in 2002 employed approximately 255,000 people, over 45 percent of whom—nearly 120,000 employees—were

Market Activity in 2001” (2002); The Joint Forum, “Risk Management Practices and Regulatory Capital: Cross-Sectoral Comparison” (Nov. 2001); Diakonova, Huibregtse & Körner, “Where Do Financial Services Meet Transfer Pricing?” 2 *IBFD Derivatives & Fin. Instruments*, 55 (2000); Samuels & Brown, “Observations on the Taxation of Global Securities Trading,” 45 *Tax L. Rev.* 527 (1990).

located outside the United States;¹⁰ Merrill Lynch & Co. in 2002 employed approximately 51,000 people, with over 20 percent of whom—nearly 11,000 employees—located abroad.¹¹

Because financial services firms are globally integrated, capital intensive, and highly competitive, we believe these firms could be disproportionately burdened by any ambiguities or issues of scope with respect to the application of the Proposed Regulations.

B. Securities Firms.

Fundamentally, securities firms earn profits by successfully anticipating and addressing the needs of capital users and capital suppliers. As with financial firms generally, securities firms operate globally, are highly integrated and employ a complex mix of human ingenuity, technology and financial capital to provide specialized financial services to customers.

One core business of all securities firms is market making, whereby these firms buy and sell securities with their customers on a continuous basis. (Underwriting can be viewed in this regard as a special subset of market making.) By purchasing securities that customers wish to sell, and selling securities that customers wish to buy, securities firms earn a spread on such customer transactions (the bid/ask spread). Effectively, securities firms are compensated for the service of providing liquidity to the marketplace.

Securities firms provide services related to the assumption of financial risks by writing derivative contracts on either side of the market (*e.g.*, long or short positions in prices, interest rates or currencies) and through buying, selling or writing options, swaps or forward contracts. In connection with these transactions, securities firms do not simply enter into offsetting transactions, but rather effectively earn compensation for providing sophisticated

¹⁰ See Citigroup, Inc., 2002 Annual Report, at 28 (2003). In the securities industry, even the Goldman Sachs Group, which generally is thought of as an institutionally-oriented financial services firm (although it, in fact, has an important private client services group), employed roughly 19,800 people in 2002. See Goldman Sachs, 2002 Annual Report, at 2 (2003).

¹¹ See, Merrill Lynch & Co., Inc. 2002 Annual Report, at 12 (2003).

intermediation services, by taking on financial risks (credit risks and market risks, for example), and hedging those risks in the same or other markets.

Securities firms also offer many related financial services, such as securities lending and margin lending. Finally, securities firms offer traditional “pure” services as well, such as mergers and acquisitions or investment advisory services; even those services, however, often are offered in conjunction with other, capital-intensive, services (*e.g.*, subordinated debt financing for M&A transactions).

Because the core services provided by securities firms require the application of capital, securities firms (like other financial services firms) are highly leveraged. Typical debt-to-equity ratios might be on the order of 20:1 to 30:1. Interest expenses (the “cost to carry” securities positions) therefore are a critical component of the profitability of a securities dealer’s individual lines of business.

Securities firms can support their high leverage ratios because they systematically *hedge* many of their risks. One key difference, in fact, between securities dealers and other financial services firms is the extent to which securities dealers first assume and then hedge market (*e.g.*, price) risks through market-based hedging transactions. (Dealers also hedge credit and other risks, for example, through the credit derivatives markets.) Hedging is thus a core component of a securities dealer’s business activities, and dealers go to great lengths to ensure, not only that risks are appropriately measured and managed through hedging, but also that those hedging gains and losses are accurately reflected in the results of the relevant business units.

Securities firms invest substantially in proprietary communications and trading technology (including systems and trading platforms) to support their trading and hedging activities on a “real time” basis, as well as to track flows of securities and cash, and provide their customers with accurate information as to their activities. These systems are made available to the group in locations around the world. The development of computer software and data banks can occur at various locations, but usually is centered at the firm’s principal office.

C. Global Dealing.

The integrated global activities of securities firms that involve the commingling of human ingenuity, technology and financial capital usually are described as “global dealing” operations. As a general matter, global dealing operations in turn can be organized under “transactional” and “non-transactional” business models.¹²

Under the transactional model, a securities firm’s global dealing operations can be broken down into a series of discrete transactions among two or more participants within the group. The transactional model is followed, for example, where one participant sells a security from investor to another participant, which then resells the security to an unrelated customer. Another example of the transactional model is where one participant enters into a derivative transaction, such as a swap, with a customer and then transfers the market risk (but not the credit risk of the customer) associated with that derivative to another participant through a back-to-back derivative transaction. Similarly, under the transactional model, one participant may pay a sales commission to another participant that serves as a sales agent for a product originated by the first participant.

By contrast, a security firm’s operations follow a “non-transactional” model where two or more participants within the group combine their resources to plan and sell a financial product to an unrelated customer and hedge any associated risks to the global firm. Under this model, there may be few separately identifiable transactions between the participants. Rather, the participants contribute various elements—such as capital, trading, risk management, information technology and sales services—to provide a product and to manage the associated risks.

As a commercial matter, securities firms typically do not allocate operational profit and loss from the “non-transactional” model on a transaction-by-transaction basis with

¹² The discussion in the text of course is a simplified overview of an important topic that has been developed in great detail elsewhere. See, e.g., 2001 SIA Global Dealing Letter, *supra* note 5; SIA Global Dealing Comment, *supra* note 5; the OECD Global Trading Report; the articles cited in note 9, above; and Faiferlick, Labrum & Rafiq, “Transfer Pricing for Financial Institutions: Global Trading,” 2 *IBFD Derivatives & Fin. Instruments*, 238 (2000).

reference to particular customer transactions. Rather, profit or loss derived by the operation as a whole over some period of time typically is allocated among the participants based on their contributions to the joint effort over that period of time.

D. Form of Business Organization.

In general, multinational enterprises can conduct business activities worldwide through one or more corporate subsidiaries or through branches of the parent company (or of one of its corporate subsidiaries). Most multinational enterprises conduct their large-scale global business activities through subsidiaries organized in the various jurisdictions where the firm operates. Financial services firms are the great exception, because some financial services firms routinely employ branch as well as subsidiary structures to conduct large-scale global operations.¹³

The selection of an organizational form is driven by a variety of legal, regulatory, business and tax considerations. Commercial banks, for example, traditionally operate through branches in order to benefit from the enhanced credit rating and other intangible synergies attributable to a large, diversified, single pool of capital and assets. The synergies inherent in multinational banks have been widely recognized, including in a study prepared by the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System regarding the feasibility of requiring foreign banks to incorporate their U.S. branches. That study concluded:

In fact, a branch of a foreign bank is able to operate more efficiently than a separate subsidiary of a foreign bank, due to a number of factors: (1) the ability to deploy capital flexibly; (2) a lower cost of funding; (3) the ability to compete based on access to the worldwide capital base of its parent; (4) ability to engage in transactions with the home office without significant operational restrictions; and (5) lower transaction costs.¹⁴

¹³ See Reich, "U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives," 2 *Fla. Tax Rev.* 1, 3 (1994).

¹⁴ U.S. Treasury Dep't and Bd. of Governors of the Fed. Reserve Sys., "Subsidiary Requirement Study" (Dec. 1992).

While securities firms may have similar business incentives for operating in branch form, regulatory restrictions generally constrain a securities dealer's ability to conduct operations through branches in multiple jurisdictions. Some jurisdictions simply require that broker-dealer activities involving the public be conducted through a locally-incorporated affiliate. More generally, a securities dealer branch operation can be subject to inconsistent (and sometimes prohibitive) double regulation, in which the host country applies its securities dealer regulatory framework to the branch, and the home jurisdiction does as well. Since broker-dealer regulation is not particularly well coordinated or consistent in approach across different jurisdictions, most securities firms conclude that, in general, the resulting application of two different sets of net capital requirements, for example, is both unadvisable and unaffordable. In particular, the United States would impose much higher net capital requirements on a foreign operation organized in a branch than would almost all non-U.S. rules. Accordingly, in contrast to traditional commercial banking operations, which rely more heavily on branches, securities firms (including securities subsidiaries of commercial banking firms) tend to enter foreign markets by establishing local subsidiaries, each of which (i) maintains its own regulatory capital and (ii) is subject to separate regulation by the authorities in the country in which it operates.¹⁵

Unlike international securities regulation, the bank capital adequacy rules have been harmonized to a significant extent. In addition to being better harmonized in their substantive rules than their securities' counterparts, bank regulators generally have adopted an approach in which a branch jurisdiction's regulatory authority defers on capital adequacy and other major issues to the bank's "home country" regulatory authority, at least when the home

¹⁵ OECD Global Trading Report, ¶ 32. In the United States, for example, the Securities and Exchange Commission subjects all broker-dealers operating within its jurisdiction to the full panoply of its regulations, including its own net capital requirements. See Greene, Beller, et al., "U.S. Regulation of the International Securities and Derivatives Markets," ¶¶ 9.03[3], 9.05, 9.07 (2001).

The principal exception to this observation is the European Union, where, as a result of the "passport" created by the Investment Services Directive, it is now possible (subject to local implementation issues) for a securities firm domiciled in one E.U. Member State (e.g., the United Kingdom) to branch out into other E.U. Member States with limited exposure to multiple regulatory regimes. Within the European Union, therefore, separately incorporated subsidiaries are gradually becoming less necessary as a regulatory matter.

country's regulation meets certain standards. (By contrast, a local bank subsidiary would be more likely to be governed by the host country's banking rules.) This deference of local bank regulators to the home country regulatory authority is a critical difference between integrated banking and securities regulation that effectively makes bank branching practicable.¹⁶

III. APPLICATION OF THE PROPOSED REGULATIONS TO GLOBAL DEALING.

A. The Proposed Global Dealing Regulations.

Responding to the unique aspects of the securities industry described above, the IRS in 1998 issued the proposed global dealing regulations; those proposed regulations attempt comprehensively to address the allocation of profits among participants engaged in a global dealing business. The proposed global dealing regulations provide new methodologies and specialized guidance to securities, derivatives and foreign currency dealers for applying the arm's-length principle to their respective global dealing businesses.

At the outset, it is important to recognize that the IRS and Treasury did not embark on this regulation project unilaterally. Rather, in 1994 the OECD's Committee on Fiscal Affairs convened a special group of tax experts to address the particular challenges associated with appropriately taxing global dealing operations.¹⁷ The United States participated in this effort and helped to forge an international consensus on the project. Moreover, in developing the proposed global dealing regulations the IRS and Treasury tried to gauge the OECD's position on

¹⁶ See, e.g., Claessens & Klingebiel, "Competition and Scope of Activities in Financial Services," 16 World Bank Research Observer, 19-40 (Spring 2001); "Core Principles for Effective Banking Supervision" (Basel Comm. on Banking Supervision, Sept. 1997). In 1988, the Basel Committee on Banking Supervision (the "BCBS"), which consists of banking supervisors from the principal nations whose banking organizations are active internationally, issued its Capital Accord (the "1988 Accord") to achieve convergence in the capital regulations applicable to internationally active banking organizations. The BCBS has amended the 1988 Accord from time to time since it was first introduced. In June 1999, the BCBS released a proposal (hereinafter "Basel II") to revise significantly the 1988 Accord in order to address more precisely various bank risks and to recognize improvement in bank risk measurement and control. The BCBS has issued updated versions of its June 1999 proposal in each of January 2001 and April 2003. The goal of the BCBS is to complete Basel II by mid-year 2004, with implementation to take effect in member countries by year-end 2006.

¹⁷ "The Taxation of Global Trading of Financial Instruments: A Discussion Draft," Preface (OECD Comm. on Fiscal Affairs, 1997). The OECD initiative in turn was preceded by pioneering articles in professional journals. See, e.g., Samuels & Brown, *supra* note 9.

the allocation and sourcing of income and deductions in respect of global dealing operations and attempted to propose regulations generally consistent with the OECD approach.¹⁸

In general, the financial services industries see the proposed global dealing regulations as a promising beginning to the development of appropriate tax regimes for global dealing businesses. Since the release of the proposed global dealing regulations, taxpayers have engaged in a comprehensive ongoing dialogue with the IRS and Treasury to review the proposed regulations' critical conceptual underpinnings and to refine their scope. Taxpayers have submitted extensive comments¹⁹ and participated in hearings and meetings²⁰ with the IRS and Treasury representatives. The general consensus expressed in the submissions and testimony has been that, in order to deal with commercial realities of the global dealing business, the final global dealing regulations must reflect the different sophisticated means by which institutions pool human ingenuity, technology and financial capital in global dealing operations, and allocate the risks and rewards arising from those operations attributable to their different contributors. This discussion has left open several significant issues.

Many taxpayers believe that the scope of the final global dealing regulations should be expanded. As a technical matter, the proposed global dealing regulations would apply only to "participants" in the global dealing operation, and the proposed rules define this term narrowly. The concept of "participants" and "non-participants" loosely relates to the distinction between the core and non-core activities of a financial services firm. Within an integrated global dealing business, however, distinctions between core and non-core activities are elusive and, accordingly, have been difficult to define. The spectrum of activities that broadly comprise a global dealing operation includes pure dealer activities on one side and such functions as credit

¹⁸ "Treasury's Brown Covering Global Dealing Regs at International Bankers' Seminar," 98 *Tax Notes Today* 42-4, (Mar. 4, 1998).

¹⁹ See, e.g., 2001 SIA Global Dealing Letter, *supra* note 5. See also SIA Global Dealing Comment, *supra* note 5.

²⁰ See, e.g., Unofficial Transcript of U.S. IRS Hearing on Global Trading Regs of July 14, 1998 *reprinted in* 98 *Tax Notes Int'l* 139-29 (July 21, 1998).

analysis and accounting and back office services on the other side. A variety of activities, such as marketing, sales, pricing, brokering, risk management, general management and oversight fall in the middle of the spectrum. While all the parties to the proposed global dealing regulations dialogue agree that the ambit of the final global dealing regulations must be limited to activities with sufficient nexus to a global dealing business, taxpayers and the IRS and Treasury have struggled to identify the precise boundaries to delineate which global dealing activities should be covered by the final global dealing regulations.

In their current form, the proposed global dealing regulations do not treat capital providers (acting solely in that capacity) as participants to a transaction, and thus functionally exclude them from the rules. Taxpayers have questioned whether the proposed global dealing regulations' approach is appropriate. Specifically, they question whether *all* capital provided to an affiliate engaged in a global dealing operation should be treated as a "routine" contribution demanding an interest-rate type of return under traditional transfer pricing methods, and whether no allocation of the operation's overall profits to capital providers should be allowed. While "routine" treatment may be appropriate where the capital provider bears only a credit risk that is similar to that of a lender, the capital provider that bears a broader range of risks (*e.g.*, market risks, operational risks or legal risks) should be allowed a return that compensates for these commercial undertakings. The overwhelming consensus within the financial services industry has been that the final global dealing regulations ought to allow for tax allocations that reflect the many ways in which risks and rewards are shared by capital providers as a commercial matter.

Taxpayers and the IRS and Treasury also have discussed ways to improve the sophistication of the methodologies developed within the framework of the proposed global dealing regulations. In particular, the proposed global dealing regulations' bias towards the residual profit split method has provoked significant disagreement. The prevailing opinion within the financial services industry has been that the residual profit split method, as currently defined, captures only one of many actual business models of global dealing operations.

Finally, taxpayers and the IRS and Treasury have debated some important collateral issues raised by the global dealing regulations—in particular, the “deemed branch” issues reflected in Prop. Reg. § 1.863-3(h), *Ex. (3)*.²¹ There appears to be an overwhelming consensus within the financial services industries that the proposed global dealing regulations are too quick to conclude that a participant in a global dealing operation, by virtue of that participation, has branches in multiple other jurisdictions. When that multiplicity of deemed branches in turn is multiplied by the number of participants in a typical global dealing operation, it is easy to see how the result would be global tax administration gridlock.

B. How the Proposed Regulations Could Apply to Core Global Dealing Activities.

As currently drafted, the Proposed Regulations overlap extensively with the proposed global dealing regulations. While the Proposed Regulations implicitly acknowledge this concern by reserving a place for a rule to coordinate the transfer pricing rules for services with the rules for global dealing operations, an actual substantive coordination rule is not included.²²

In view of the significant commitment of time and resources contributed by the parties to the global dealing discussion and the fundamentally sound approach of providing specially tailored rules to address the transfer pricing complexities of global dealing, we are deeply concerned that issues not yet resolved in the context of the proposed global dealing regulations could be addressed in an overly simplistic way—that is, by effectively forcing these issues into the ambit of the Proposed Regulations. Because the Proposed Regulations are designed to cover the gamut of controlled services transactions, and understandably are written

²¹ See Institute of International Bankers’ Comment on the Proposed Regulations Concerning Global Dealing Operations of Dealers in Securities, Derivatives and Foreign Currencies, dated June 4, 1998 *reprinted in 1998 Tax Notes Today* 112-32 (June 11, 1998).

²² Reg. § 1.482-9(m)(5). The approach of the Proposed Regulations differs in this regard from the approach followed for other types of controlled services transactions, where special transfer pricing rules have been promulgated. For example, the Proposed Regulations contain explicit coordination rules for services that effect a transfer of intangible property and services subject to a qualified cost sharing agreement. Prop. Reg. § 1.482-9(m)(3), (4).

from the perspective of industrial and traditional services firms, the Proposed Regulations cannot possibly address in a sophisticated way the complicated global dealing issues faced by the securities industry. Moreover, the application of the Proposed Regulations to global dealing operations would be at odds with the international norms, specifically the OECD's efforts to provide specialized transfer pricing rules for global dealing.

1. Assumptions of Risk and Application of Capital. Because the Proposed Regulations define a "controlled services transaction" to include all "assumptions of risk,"²³ a securities firm's inter-affiliate transactions integral to the firm's core global dealing business (including intra-group hedging and one affiliate's provision of capital and/or capital support to another) technically would be subject to the proposed regime. It is impossible to overstate the impact this would have on our industry, because the Proposed Regulations apply transfer pricing rules that are insensitive to the complexities of the global dealing business described above, particularly with regard to the treatment of providers of capital.

The Proposed Regulations' approach differs substantially from the direction that the proposed global dealing regulations have taken so far. For example, the Proposed Regulations would appear to require affiliates to charge a fee for the use of capital and/or credit support, even where integral to the conduct of a global dealing business. Charges for providing capital and capital support must reflect the type and degree of risk actually borne by the capital provider. In any case, these issues are appropriately within the scope of the proposed global dealing regulations and should be considered in that context. The Proposed Regulations therefore should not apply to capital and capital support provided in connection with the conduct of a global dealing operation.

2. Personal Services. We also are concerned about the potential misapplication of the Proposed Regulations to the personal services component of global

²³ Prop. Reg. § 1.482-9(l)(1), (2).

dealing. Without clear deferral to the final global dealing regulations, these services would fall within the purview of the Proposed Regulations.

Securities firms are globally integrated businesses. Intra-group services such as marketing, sales, pricing, broking, risk management, support, and systems and trading platform development are central to the process of delivering services to customers and cannot be separated in any meaningful way from a firm's core activities. The Proposed Regulations' approach, however, would require that such services be priced piecemeal, at a separately determined arm's-length charge, and without giving any consideration to their nature as a part of an integrated global dealing operation.

For example, the Proposed Regulations would require integrated activities such as the services of the senior manager of a derivatives product desk be charged out at an arm's-length price for services rendered to each affiliate that participated in marketing, trading or hedging that derivative product. There are, of course, no comparables for these sorts of services, and senior traders do not keep time sheets for their dealing activities. The proposed global dealing regulations address these issues systematically and pragmatically; the Proposed Regulations, by contrast, would lead to endless controversies over the proper arm's-length charge for the trader's services provided to different affiliates.

3. Application of the Residual Profit Split Method. As discussed in Section II.A, above, the hallmark of the global dealing operation is the commingling of *human ingenuity, technology and financial capital* to provide specialized financial services to customers. We are concerned that the practical consequence of applying the Proposed Regulations to global dealing operations would be a wholesale application of a simplistic residual profit split method to those activities.

As a practical matter, no other transfer pricing methodology described in the Proposed Regulations could be applied to most global dealing operations. The Simplified Cost

Based Method, of course, does not apply to financial transactions,²⁴ and each of the other methodologies relies on the use of comparables. Reliable comparables generally are not available for global dealing activities that as a commercial matter do not follow a transactional model. Where, for example, does one find comparable data for the strategic advice that a global head of fixed income trading provides to the fixed income trading desks housed in foreign affiliates, or the specialized marketing of highly-customized derivative instruments?

As a result, global dealing businesses almost inevitably would be forced into the Residual Profit Split Method of Prop. Reg. § 1.482-9(g). As the examples provided in Prop. Reg. § 1.482-9(g)(2) demonstrate, the Residual Profit Split Method has been developed for more traditional services, such as pure personal services, the distribution of tangible goods, and manufacturing. The Residual Profit Split Method does not reflect the complexities and commercial realities of global dealing operations and the Proposed Regulations, in any event, do not provide adequate guidance as to how the method could be applied to a global dealing business.

4. Branch and Subsidiary Structures. We believe that all forms of financial services firms should be taxed comparably in respect of the comparable financial services they offer. As nominally different financial services firms and the products they offer converge in the marketplace, this objective assumes increasing importance. In the highly competitive securities industry, where financial services firms organized as banks and as securities firms vie for the same customers and offer many of the same services, the equitable tax treatment of all competitors takes on particular urgency.

Even under the Proposed Regulations, firms organized as branches effectively continue to function as cost sharing arrangements. Not only do branches share pools of capital with the home office (and other branches), they also can draw on shared human resources in conducting both core and non-core operations. There is no indication, however, that the

²⁴ Prop. Reg. § 1.482-9(f)(4)(v)(H).

Proposed Regulations would require intra-corporation profit mark-ups for any transactions between a branch and its home office (or any other branch thereof).²⁵

²⁵ Consistent with the U.S. view that branches are an indivisible part of a single entity that shares its costs and resources, U.S. tax rules generally disregard intra-corporate transactions for purposes of determining the taxable income of a branch and allocate and apportion deductions to income that is “effectively connected” to the branch’s U.S. business. See section 882, Reg. § 1.882-4 and Reg. § 1.861-8. Similarly, a U.S. branch’s deductible interest expense is not based solely on the amount of liabilities booked in the U.S. branch, but instead the entity’s worldwide interest expense is allocated to the branch on a formulary basis that essentially imputes a ratable portion of the entity’s overall equity capital to the branch (taking into account the relative U.S. tax bases of the branch’s U.S. assets). Reg. § 1.882-5.

Thus, whether the issue is a taxpayer’s expenses other than interest, or interest expense, the United States takes the view that branches may deduct their share of the entire corporation’s third-party expenses. Conversely, a branch may not deduct a hypothetical arm’s-length charge that exceeds the branch’s allocable costs for services performed (for example) by the head office.

The same result is reached by many other taxing jurisdictions, especially with respect to expenses other than imputed interest expense. See, e.g., the OECD Global Trading Report, ¶ 242; Donovan & Rafiq, “Charging for Intra-Group Services Within Financial Services Institutions,” 2 *IBFD Derivatives & Fin. Instruments* 174, 180 (2000).

Certain U.S. income tax treaties, consistent with Article 7(2) of the OECD Model Double Taxation Convention on Income and on Capital (1963) provide that a branch “is attributed the profits that it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.” See, e.g., Article 7 of the Convention for the Avoidance of Double Taxation (Dec. 31, 1975) U.S.-U.K. 31 UST 5668 (the “Former U.S.-U.K. Tax Treaty”). This treaty provision has been held to conflict with the general U.S. approach to branch income taxation, and, in particular, the U.S. treatment of intra-corporation interest expense.

In *National Westminster Bank, PLC v. U.S.* 44 Fed. Cl. 120, 1999-2 USTC 50,654 (Fed. Cl. 1999), the U.S. Court of Claims held that a U.K. bank under the Former U.S.-U.K. Tax Treaty “will be subjected to U.S. taxation only on the profits of its U.S. branch and that such profits should be based on the books of account of such branch maintained as if the branch were a distinct and separate enterprise dealing wholly independently with the remainder of the foreign corporation.” While the Court of Claims agreed that the branch’s financial records could be subject to adjustment in certain circumstances (e.g., where the branch pays a non-market interest rate), the Court rejected the U.S. approach of effectively disregarding intra-branch transactions and allocating capital costs on a formulary basis. In a subsequent decision, the Court of Claims altogether rejected the imputation of non-interest bearing permanent capital to the branch under the Former U.S.-U.K. Tax Treaty, the basis of such imputation was that such capital would have been required if the branch had been organized in the United States. *National Westminster Bank, PLC v. U.S.* 2004-1 USTC 50,105 (Fed. Cl. 2003).

In more recent U.S. treaties, specific language contemplates apportionment of capital costs in connection with determining the profits of a permanent establishment, and generally permits allocations of deductions consistent with the U.S. view of branch structures as cost sharing arrangements. See U.S. Treasury Dep’t, Technical Explanation of the U.S.- U.K. Income Tax Treaty signed July 22, 2002 and Article 7(2) of the U.S.-U.K. Treaty; U.S. Treasury Dep’t, Technical Explanation of the U.S.- Germany Income Tax Treaty signed August 29, 1989 and Article 7(3) of the U.S.-Germany Income Tax Treaty. Moreover, the OECD’s 2003 “Discussion Draft on the Attribution of Profits to Permanent Establishments: Part II (Banks)” and the OECD’s 2001 “Discussion Draft on the Attribution of Profits to Permanent Establishments” generally provide that capital should be attributed to a permanent establishment based on the risk-weighted value of the branch’s assets, which very generally can be viewed as consistent with the U.S. treatment of branches as cost sharing arrangements. In certain limited respects,

In sum, the Proposed Regulations would permit branches of a single financial services firm, such as a bank, effectively to share costs, and to allocate revenues under a variety of flexible and sophisticated methods, including the final global dealing regulations. Corporate affiliates in a common multinational securities firm’s group, by contrast, will not be permitted to share costs in economically similar circumstances (at least in the absence of a valid cost sharing agreement), and will allocate revenues under the Proposed Regulations in ways that will tend to allocate the synergies of the multinational group to those affiliates—in particular, the parent company—that are deemed to be net intra-group service providers.

The application of the Proposed Regulations to the core global dealing operations of multinational securities firms thus would lead to significant differences in the taxation of direct competitors, based solely on their form of business organization. Another principal result would be a tax regime for multinational and tightly-integrated global dealing operations conducted through corporate affiliates that distorts economic reality, by tending in many instances to allocate revenues attributable to the group’s worldwide synergies to the parent company alone.

C. Conclusions.

While the Proposed Regulations would cover similar conceptual ground to the proposed global dealing regulations, the Proposed Regulations would implement the arm’s-length principle from the perspective of typical traditional industrial and “pure” services firms. The Proposed Regulations, however, would poorly govern the complex issues associated with global dealing operations, which at their core involve the commingling of human ingenuity, technology and *financial capital* to deliver specialized financial services to customers.

The appropriate resolution of the transfer pricing issues raised by global dealing operations is difficult. Taxpayers, the IRS and Treasury have worked together diligently to

however, the OECD Discussion Draft respects intra-group transactions (*e.g.*, the interest deduction for inter-branch funding generally would be based on inter-branch interest rate, rather than on third-party borrowing rates).

develop commercially and fiscally reasonable rules that broadly comport with emerging international standards. The Proposed Regulations should not as a practical matter sidestep that dialogue. Such an outcome would be unfair because it would result in the implementation of rules that would be inadequate commercially, difficult to administer equitably and at odds with international norms.

Of at least equal concern, the Proposed Regulations do not adequately consider the disparate impact they would have on the tax treatment of branch and subsidiary forms of organization, an issue uniquely important to financial services firms. While financial firms organized in branch form generally would not be subject to the Proposed Regulations, the rules would apply to financial firms that conduct business predominantly through separate subsidiaries. As a result, firms operating in a subsidiary form, but not firms organized in branch form, could be subject to the simplistic profit split method contained in the Proposed Regulations. Similarly, because the Proposed Regulations veer from international norms (an issue discussed in Part VI, below), the rules in practice would not apply equally to U.S. and foreign-owned multinational enterprises.

For all of these reasons, we believe that it would be inappropriate for the Proposed Regulations to apply to global dealing operations. We would be pleased to continue to work with the IRS and Treasury towards resolving the remaining issues in the development of a comprehensive transfer pricing regime for global dealing. We seek, however, to return that discussion to its proper context—the revision and eventual adoption in final form of the proposed global dealing regulations.

We therefore recommend that global dealing operations should be covered by a substantive carve-out in the Proposed Regulations, either by adopting a substantive special coordination rule where space for one is reserved as Prop. Reg. § 1.482-9(m)(5), or as an exclusion from the definition of “activities” that are subject to the Proposed Regulations under Prop. Reg. § 1.482-9(l)(2). That substantive carve-out should be in place at the time the Proposed Regulations are promulgated in final form.

IV. PROPER SCOPE OF THE TRANSFER PRICING RULES FOR SERVICES.

A. The Limits of the Arm's-Length Principle.

In Part III, above, we explained why the transfer pricing of activities integrally related to the conduct of a global dealing operation should properly fall within the scope of the global dealing regulations, and why the Proposed Regulations should not apply to these activities, even for an interim period pending adoption of the final global dealing regulations. By contrast, it is appropriate for “pure” services transactions within a multinational financial services group that are not integral to the conduct of global dealing operations to be covered by any final section 482 regulations governing services. We believe, of course, that the fundamental line-drawing exercise between these two sets of guidance most appropriately is undertaken in the context of finalizing the proposed global dealing regulations. We therefore comment in this Part IV on the Proposed Regulations’ treatment of those transactions ultimately excluded from the scope of the final global dealing regulations.

The Proposed Regulations conceptualize the typical multinational enterprise as an agglomeration of disconnected independent firms owned by a parent company that functions as a passive investment firm. As applied to financial services firms, we believe that this construct is inappropriate. Multinational enterprises in general (and multinational securities firms in particular) are organized to capture the benefits of organic synergies and economies of scope arising from the coordinated operation of affiliated entities. While affiliates within a multinational enterprise in practice may bargain and occasionally even compete with one another, affiliates relate to one another differently than do independent firms; part of their success derives from the fact that they regularly share information, resources and costs. (Independent firms, of course, from time to time enter into similar co-operative arrangements in order to reduce costs or improve the efficiency of each separate firm.)

There is thus an unavoidable tension between the abstraction of the arm's-length principle (at least in its most overwrought form) and the synergies that multinational enterprises

are designed to capture. The OECD Guidelines acknowledge as much.²⁶ The tension should not be resolved, however, by a dissection of intra-group behavior designed to ferret out more and more rarefied examples of inter-affiliate services for which fees must be charged: that approach simply appropriates for net intra-group service providers the synergies that belong to the group as a whole.

In this regard, it is instructive to compare the results obtained under a transfer pricing system by using a single corporation with multiple branches to that obtained through a more common multiple subsidiaries structure. Most transfer pricing systems—certainly that of the United States—approach the former mode of organization as an organic whole, and (by allocating costs appropriately and sourcing revenues where they are earned) apportion the firm-wide synergies fairly across the enterprise. Commercially, of course, business executives see a multinational enterprise organized in subsidiary form in exactly the same way. We think it fair to ask whether a tax system should be designed to conflict fundamentally with that commercial understanding.

Some sophisticated commentators have addressed explicitly the consequences for the design of transfer pricing methodologies of this unavoidable tension between the abstraction of the arm's-length principle and the efficiency gains which multinational enterprises exist to capture.²⁷ More often, however, the issue is addressed implicitly and pragmatically. The OECD Guidelines, for example, acknowledge the issue, but conclude that “[t]here are no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.”²⁸

²⁶ OECD Guidelines, ¶ 1.9.

²⁷ See Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation,” 15 *Va. Tax Rev.* 89, 147-150 (1995); Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America*, 652 (1998); Berry, Bradford & Hines, “Arm’s-Length Pricing: Some Economic Perspectives,” 54 *Tax Notes* 731, 737 (1992) (discussing “economies of scope”); Durst, “Management vs. Tax Accounting in Intercompany Transfer Pricing,” 31 *Tax Mgmt. Intl. J.* 95, 98 (2002); Pagan & Wilkie, *Transfer Pricing Strategy in a Global Economy*, 99-102 (IBFD, 1993).

²⁸ OECD Guidelines, ¶ 1.9.

Tax administrations deal with the tension pragmatically by concluding that the arm's-length principle need not be applied to redescribe certain commonplace interactions between related entities as "arm's-length" transactions (i) when the actual activities undertaken by the related affiliates are functionally closer to generalized costs of doing business than to *independent* profit-seeking activities, or (ii) where the affiliate receiving the services would not be willing actually to pay for the services provided. In these cases, cost-only allocations can be consistent with the arm's-length principle, because cost-only allocations do not arbitrarily shift the economic returns on group-wide synergies to net service providers within the group.²⁹

Whether consciously or not, tax administrations thus balance the abstraction of the arm's-length principle against the economic synergies that multinational enterprises exist to capture by creating "cost-only" exceptions to the general application of arm's-length comparables. That cost-only exception in turn can be implemented directly, by means of a statutory or regulatory safe-harbor (as the United States does today in the Current Services Regulations), or indirectly, by means of structural solutions (*e.g.*, "cost contribution arrangements," partnerships, branches or co-operatives) that accomplish the same result (the approach preferred by the OECD).³⁰ The choice between the two approaches is largely aesthetic, rather than substantive: the important point is that virtually every tax administration today as a practical matter tempers the rigorous application of the arms's-length principle in a manner designed to reconcile that principle with the economic realities that explain the success of multinational enterprises as a form of business organization.

The Current Services Regulations unquestionably require substantial revision, particularly with respect to the specific transfer pricing methodologies to be employed and their relationship to Reg. § 1.482-1's "best method" and related rules. In undertaking that revision,

²⁹ See the discussion in Section IV.B.2, below; *cf.* American Bar Association, Section of Taxation, Transfer Pricing Committee, "Comments Concerning Transfer Pricing 'Services' Regulations," at 11-16 *reprinted in* 2002 *Tax Notes Today* 17-29 (Jan. 25, 2002) (the "2002 ABA Recommendations").

³⁰ Cost contribution arrangements are discussed in more detail in Part VI, below.

however, we believe that it is important to recognize how the Current Services Regulations have balanced the abstraction of the arm's-length principle against the realities of multinational business enterprise synergies. Notwithstanding the deficiencies of the Current Services Regulations, we believe that in this one fundamental respect, the current rules have achieved a fair and appropriate balance. As described below, the Current Services Regulations do so by permitting a large range of commonplace services performed among affiliates to be charged at cost, and in some cases by concluding that those relationships do not constitute “services” at all.

B. The Current Services Regulations.

1. Intra-Group Services Transactions Defined. The Current Services Regulations define “services” as “marketing, managerial, administrative, technical, or other services [performed] for the benefit of, or on behalf of, another member of the group.”³¹ The transfer pricing rules for services apply only when “services” are undertaken for the “benefit” of a recipient. The test is applied, however, from the perspective of the service provider, which means that the current transfer pricing rules apply only *if an independent service provider would charge the recipient for the services provided*.³²

Effectively, this rule excludes from the scope of transfer pricing rules numerous intra-group transactions where the parties could not imagine either sending or receiving a bill. The definition comports with a business executive’s reasonable expectations as to the sorts of activities that conceivably constitute “services;” indeed, it would be chimerical to apply rules intended to determine the amount of a hypothetical invoice in a situation where no actual bill would be sent or paid by the parties.

Similarly, the Current Services Regulations provide that intra-group activities duplicating activities that a recipient has performed or is performing for itself do not constitute

³¹ Reg. § 1.482-2(b)(1).

³² Reg. § 1.482-2(b)(2), Ex. (1) through (3). *Also* see Reg. § 1.482-2(b)(2) “No allocation shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services.”

the provision of “services.” In this regard, the recipient’s ability to perform the service independently must be taken into account when determining whether the service is duplicative.³³ While the Current Services Regulations do not contain an explicit exception for activities undertaken by a “shareholder” in its shareholder capacity, other guidance³⁴ has allowed taxpayers to determine whether these shareholder activities (including periodic management review, compliance with reporting or other legal requirements arising from the parent-shareholder relationship, and financing of interest in affiliates) and similar “stewardship” activities fall within the ambit of the transfer pricing rules. Generally, under the current regulations, no allocation is made for many parent-shareholder activities that provide general supervision and strategic business direction to subsidiaries.

The Current Services Regulations recognize that, while many intra-group interactions take place in a multinational enterprise, those that relate to coordinating the affairs of the group are not the types of transactions that would have occurred between independent enterprises or for which parties would reasonably expect to charge. Accordingly, these activities properly are excluded from the ambit of the transfer pricing rules.

2. The Cost-Only Safe Harbor. Under the cost-only safe harbor of the Current Services Regulations, a service provider is permitted to charge an affiliated service recipient only the “costs” of *non-integral* services.³⁵ (Because the rule is simply a safe harbor,

³³ The Current Services Regulations emphasize this criterion through two examples. Reg. § 1.482-2(b)(2)(ii), Ex. (1), (2) (comparing the situation where an affiliate performs financial analysis at request of another affiliate that lacks qualified personnel, in which case an arm’s-length charge is appropriate, to a review by an affiliate of the financial analysis performed by the other affiliate’s qualified in-house personnel, in which case a charge is not appropriate).

³⁴ Tech. Adv. Memo. 8806002 (Sept. 24, 1987) (applying “proximate and direct” standard to allocate to the parent stewardship expenses, defined as expenses in connection with the consolidated tax return, information report filings with appropriate agencies, periodic review of the subsidiary, and financing the parent’s ownership in the subsidiary); *Young & Rubicam, Inc. v. U.S.*, 410 F. 2d 1233 (Ct. Cl. 1969) (charging to the parent corporation expenses for salaries paid to the parent’s employees for the time spent at foreign subsidiary corporations while performing supervisory functions). These authorities are discussed at length in Giannattasio, “Provision of Services under the US Transfer Pricing Rules,” 6 *IBFD Int’l Transfer Pricing J.*, 110, 110-113 (1999).

³⁵ Reg. § 1.482-2(b)(3). The safe harbor is summarized in Giannattasio, *supra* note 34, at 113-14.

taxpayers may, however, at their election charge a higher arm's-length rate, if they can develop sufficient evidence to sustain that charge.³⁶) To ensure that the shared costs of doing business as a multinational group are not marked-up, the Current Services Regulations permit taxpayers to presume that for “non-integral” services “the arm's-length charge shall be deemed equal to [the service provider's] costs or deductions incurred with respect to such services.”³⁷ Services transactions that are an integral part of the business activity of either the service provider or the service recipient fall outside this cost-only safe harbor.

In effect, the cost-only safe harbor covers activities that fall outside the core profit-making activities of the group but are nonetheless services for which a related party would charge (in contrast with intra-group activities that, as a commercial matter, would not ordinarily be charged, and which therefore are not treated as “services” under the Current Services Regulations).

Far from serving as an exercise in administrative oversimplification, the cost-only safe harbor for non-integral services is a critical conceptual component of the current regime.³⁸ The cost-only safe harbor covers a large range of commonplace relationships and intra-group services that business people view as simply *the shared costs of doing business within a multinational group*, rather than as independent profit-seeking activities. Accordingly, the cost-only safe harbor can best be seen as an informal cost sharing arrangement.

The conceptual basis for the cost-only safe harbor is that the benefits that accrue from the sort of saved costs arising from the provision of non-integral services most fairly relate to the organic synergies and economies of scope inherent in multinational enterprise structures. These synergies allow the group as a whole to earn higher profits than the sum of the profits that could be harvested by each affiliate acting as a single entity. By definition, these benefits cannot

³⁶ Reg. § 1.482-2(b)(3); Feinschreiber, ed., *Transfer Pricing Handbook* ¶ 44.3(a) (3rd ed. 2001).

³⁷ Reg. § 1.482-2(b)(3).

³⁸ 2002 ABA Recommendations at 11-16.

be obtained from an unrelated service provider, any “arm’s-length” pricing of such benefits accordingly would lead to a distortion of income, and, in the case of classic economies of scope, the over-taxation of intra-group net service providers.³⁹ The cost-only safe harbor also brings the taxation of a multinational enterprise that relies on separate subsidiaries closer to the tax liabilities that would result if the group operated in branch form.

It has been suggested that the cost-only safe harbor is inconsistent with economic norms:

Every function performed within a group (law, accounting, data processing, *etc.*) should, as an economic matter, earn a return. These functions can be outsourced to firms that operate for profit, and such functions are brought in-house to enhance profitability of the enterprise. The concept of these functions being “cost centers” is an accounting and managerial convention, not a valid economic concept.⁴⁰

We respectfully disagree. In fact, every function performed within a group *adds value* to the group as a whole, but that fact does not answer the question of what prices constitute correct *transfer prices* for intra-group sales or services as a matter of economic theory.⁴¹

Economists in fact consider the determination of the intra-group transfer pricing methodology that will maximize a multinational group’s revenues (without regard to taxes) to be a difficult question, the answer to which is affected at least in part by the nature of the markets in which different group members compete (*i.e.*, perfectly competitive, or not), and by the organization of the group in question (*i.e.*, tightly integrated or highly decentralized). One leading study has gone so far as to argue that abstract economic theory can give misleading answers to how multinational groups should behave (without regard to tax considerations), because the theories tend to ignore fundamental strategic issues (what business should a group

³⁹ Berry, Bradford & Hines, *supra* note 27, at 737.

⁴⁰ Zollo, Bowers & Cowan, Jr., “Transfer Pricing for Services: The Next Wave,” 81 *Taxes* 17, 29 (2003).

⁴¹ The literature is briefly summarized in Eccles, *The Transfer Pricing Problem: A Theory for Practice*, 16-27 (1985).

pursue in the first place?) and the implications of transfer pricing policies for the behavior of individual managers (through performance evaluations, *etc.*).⁴² That study in turn concluded that, without regard to tax considerations, the profit-maximizing transfer pricing strategy for an integrated multinational group in general is to set intra-group transfer prices at full cost.⁴³

It thus does not follow that the cost-only safe harbor must be rejected as fundamentally non-economic, or defended solely on the basis of administrative convenience. Instead, the cost-only safe harbor can be seen as an exercise in principled pragmatism. The cost-only safe harbor recognizes that the synergies of an integrated multinational enterprise are difficult to ascribe to one group member as opposed to another, and therefore effectively treats intra-group services that give rise to synergistic savings, but that are not part of the businesses that group members pursue with *bona fide* customers (*i.e.*, non-integral services), as transferred at the groupwide profit-maximizing price, which is cost.

The Current Services Regulations describe four specific situations in which services are considered to be an integral part of the business activity and therefore cannot be charged at only cost:⁴⁴ (1) where either the renderer or the recipient is engaged in the trade or business of providing similar services to one or more unrelated persons; (2) where one of the renderer's principal activities is providing intra-group services;⁴⁵ (3) where the renderer is peculiarly capable of rendering the services and such services are a principal element of the recipient's operations; and (4) where the recipient received a substantial amount of services from

⁴² *Id.*, at 24-25.

⁴³ *Id.*, at 8-9.

⁴⁴ Reg. § 1.482-2(c)(7).

⁴⁵ It is presumed that the provision of intra-group services is not a principal activity of the renderer if the costs of the renderer's services attributable to such intra-group services for the taxable year do not exceed 25 percent of the total costs of the renderer for that taxable year. This presumption is not available to renderers of manufacturing, production, extraction, or construction services. Reg. § 1.482-2(b)(7)(ii)(A).

one or more related parties during its taxable year.⁴⁶ In these situations, separate methodologies must be applied to determine arm's-length prices for intra-group service transactions.

C. The Proposed Regulations.

The Proposed Regulations would expand substantially the range of intra-group activities that the controlled services transfer pricing rules would cover. Because the new regime eliminates the cost-only safe harbor described above, the new regime would require taxpayers to produce comparables for many non-material non-core business transactions, and in many cases could require taxpayers to impute profit charges for these transactions, if for no other reason than to reduce audit disputes. In combination, these changes would require application of the arm's-length principle in a manner that fundamentally disregards the way in which related parties (and in some cases, unrelated parties) interact to share costs and otherwise take advantage of economies of scope and organic synergies. The changes also would be extremely burdensome to apply.

1. Definition of Services. The Proposed Regulations define “controlled services transaction” as any intra-group *activity*⁴⁷ that directly results in a *benefit* to one or more other members of the group.⁴⁸ An “activity” for these purposes 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.”⁴⁹ This provision covers intra-group

⁴⁶ Services received are considered substantial in amount if the costs of such intra-group services exceed 25 percent of the total costs of the recipient for that taxable year. Reg. § 1.482-2(b)(7)(iv).

⁴⁷ Prop. Reg. § 1.482-9(l)(1).

⁴⁸ It has been suggested that the use of the word “directly” is intended to confirm the rejection by the Proposed Regulations of the “general benefit” test of the Current Services Regulations. See Zollo, Bowers & Cowan, Jr., “Transfer Pricing for Services: The New Wave Hits,” 82 *Taxes* 29, 31 (2004).

⁴⁹ Prop. Reg. § 1.482-9(l)(2). The proposed definition of “activity” arguably would change the outcome of *Hosp. Corp. of Am. v. Comm’r*, 81 T.C. 520 (1983) (herein, *HCA*). In *HCA*, the Tax Court held that the U.S. parent company did not transfer an intangible to its foreign subsidiary by allowing that subsidiary to enter into a contract with a foreign unrelated customer that had initially been discussed and negotiated by the U.S. parent. The Tax Court reasoned that the definition of intangibles under the general principles of tax law did not encompass an unexecuted

transactions that would not necessarily be considered services in a commercial sense. For example, this definition would include a wide range of formal and informal transfers of financial risk. In effect, by virtue of this broad definition, the Proposed Regulations' rules for services will become the default rules for all transactions within the scope of section 482 that are not expressly carved out by a more specific provision.⁵⁰

A "benefit" under the Proposed Regulations may be provided, 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" (emphasis added).⁵¹ The Proposed Regulations go on to provide that, as a general matter, an activity will confer a "benefit" if a similarly situated uncontrolled taxpayer would be willing to pay an unrelated party to perform the same or similar activity (on fixed or contingent payment basis) or would perform the same or similar activity itself. We believe, however, that a close reading of the Proposed Regulations leads to the conclusion that this second thought merely acts as a *presumption* of when a "benefit" can be said to exist, not a limitation on the meaning of a "reasonably identifiable increment" of value.⁵² As many of the examples in the Proposed Regulations demonstrate, the first sentence of Prop. Reg. § 1.482-2(l)(3) alone appears to set out the test for determining the existence of a controlled services transaction subject to the transfer pricing rules.⁵³

contract or business opportunity. The Tax Court, however, did not consider such contract negotiation to have constituted a service rendered to the foreign subsidiary by the U.S. parent. Under the Proposed Regulations, a similar transfer of value from a parent to subsidiary would fall under the definition of an activity that may give rise to a controlled services transaction, because it represents "use by a renderer of ... intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances."

⁵⁰ Zollo, Bowers & Cowan, Jr., *supra* note 48 at 31.

⁵¹ Prop. Reg. § 1.482-9(l)(3)(i).

⁵² See, e.g., Prop. Reg. § 1.482-9(l)(4), Ex. (6) and (13).

⁵³ The Preamble to Proposed Regulations also states that "the benefit analysis ... focuses on whether one or more controlled parties receive an identifiable benefit from an activity performed by another member of the group." See also Prop. Reg. § 1.482-9(l)(3)(ii) discussed in the text below, which defines an "indirect and remote" benefit as

The Preamble to the Proposed Regulations states that the “benefit” test was rewritten to examine a controlled services transaction from the perspective of service recipients rather than service providers in order better to comport with international norms—meaning, presumably, the OECD Guidelines.⁵⁴ As described in Part VI, however, the Proposed Regulations in fact depart from international norms to the extent that they treat the “willingness to pay” standard simply as presumptive evidence that a benefit has been received, rather than as a necessary component of the definition of a “benefit.”

One explanation for the IRS’s ambivalence towards the “willingness to pay” standard is that, as the Preamble to the Proposed Regulations suggests, the IRS sees the revised benefit standard as more objective, and therefore as easier to administer, than the definition of a controlled services transaction under the Current Services Regulations, which is said to require an inquiry into the subjective intent of the service provider. We believe that a definition of “benefit” that does *not* explicitly include the “willingness to pay” standard as part of the definition will be extraordinarily difficult to administer, but for reasons related to the definition’s overbreadth, rather than its evidentiary requirements. We suggest that a straightforward solution would be to include “willingness to pay” as part of the definition of a “benefit,” but then to

one that is substantively indirect and remote, *and* for which the recipient must not have been willing to pay. The second thought would not be necessary if the “willingness to pay” test were a part of the basic standard.

We note that Prop. Reg. § 1.482-9(l)(4), *Ex. (14)* is the only example that applies the “willingness to pay” test in order to determine if the benefit has been conferred on the recipient. We believe that “willingness to pay” is the proper test to determine whether a benefit exists in *all* circumstances and therefore agree with the application of the test in this instance. Other commentators have expressed the same opinion. The example, however, is inconsistent with the substantive rule as expressed by the Prop. Reg. § 1.482-9(l)(3) in that, as explained above, the “willingness to pay” is not a prerequisite to finding the existence of a benefit. The “willingness to pay” test is only a part of the incidental and remote exception. Prop. Reg. § 1.482-9(l)(4), *Ex. (14)* by contrast, is intended to explain the “shareholder activities” exception.

Zollo, Bowers and Cowan, Jr. express the view that the “willingness to pay” test is in fact part of the Proposed Regulations’ definition of “benefit.” See Zollo, Bowers & Cowan, Jr., *supra* note 48 at 31. We agree that this *should* be true, but respectfully disagree that the Proposed Regulations, as currently drafted, are so limited.

⁵⁴ Terr, “The Proposed Transfer Pricing Services Regulations,” 101 *Tax Notes* 1439, 1443 n. 32 (Dec. 22, 2003). Another collateral consequence of the revised standard is that it enables the IRS to reverse the “general benefit” rule of the Current Services Regulations. Reg. § 1.482-2(b)(2); Prop. Reg. § 1.482-9(l)(3).

clarify more forcefully that “willingness to pay” refers to a *hypothetical* company in the same economic position as that of the service recipient.⁵⁵

The Proposed Regulations establish four categories of activities that are excepted from the benefit rule in that they do not result in a benefit sufficient to subject the services activity to the transfer pricing rules:

- indirect and remote benefits;⁵⁶
- duplicative services;⁵⁷
- shareholder activities;⁵⁸ and
- passive association.⁵⁹

In general, the exceptions to the “benefit” rule are to be construed narrowly, thereby expanding the types of intra-group activities that would be deemed to confer a benefit on the recipient.⁶⁰ Under this framework, transactions that would occur only between related parties and for which the parties would be unwilling to pay could become subject to the transfer pricing rules (and perhaps charged with a profit mark-up comparable to that paid to a third-party services provider).

For example, compare Prop. Reg. § 1.482-9(l)(4), *Ex. (6)*⁶¹ to Reg. § 1.482-2(b)(2)(ii), *Ex. (2)*. Under Example (2) in the Current Services Regulations, a

⁵⁵ Zollo, Bowers and Cowan, Jr. argue that the Proposed Regulations in fact already adopt an objective standard. *See* Zollo, Bowers & Cowan, Jr., *supra* note 48 at 31. We do not disagree that the “willingness to pay” standard is an objective test, but we recommend that the point be made more directly in the course of revising the Proposed Regulations to make the “willingness to pay” test a formal part of the definition of “benefit.”

⁵⁶ Prop. Reg. § 1.482-9(l)(3)(ii). The existence of Prop. Reg. § 1.482-9(l)(3)(ii) as an exception to the general rule implies that the general definition of benefit provided in Prop. Reg. § 1.482-9(l)(3)(i) includes services resulting in only indirect and/or remote “benefits.”

⁵⁷ Prop. Reg. § 1.482-9(l)(3)(iii).

⁵⁸ Prop. Reg. § 1.482-9(l)(3)(iv).

⁵⁹ Prop. Reg. § 1.482-9(l)(3)(v).

⁶⁰ Prop. Reg. § 1.482-9(l)(4).

⁶¹ At one level, Prop. Reg. § 1.482-9(l)(4), *Ex. (4)* and (5) appear to parallel current Reg. § 1.482-2(b)(2)(ii), *Ex. (1)* and (2), in that both the examples in the Proposed Regulations and the current examples deal with treasury

corporation's treasury department prepares an analysis of its funding needs and recommends that the corporation borrow from a bank. The report is submitted to the financial staff of an affiliate that reviews the report to determine whether the plan should be reconsidered. The Current Services Regulations do not require that the company be charged for the affiliate's review. This result does not appear to turn on whether the affiliate makes any recommendations, the company takes any advice, or whether the affiliate's review in fact reduces any business risk or would be likely to do so.

An entirely different result is obtained under Prop. Reg. § 1.482-9(l)(4), *Ex. (6)*. In that example, a subsidiary is involved in negotiating a complex joint venture that raises sophisticated legal issues. The subsidiary's outside law firm, which possesses the relevant specialized expertise, reviews the transactions and opines on key issues. The parent company's in-house legal staff (which also specializes in these issues) reviews the same contracts, and though its review substantially duplicates the law firm's services, the parent's efforts also reduce the commercial risk of the transaction. The example concludes that the subsidiary obtains a benefit from the duplicative review. No inquiry appears necessary as to whether the parent would have charged for the transaction or whether the recipient of this "additional benefit" would have been willing to pay an unrelated party for this second opinion—or even whether the subsidiary requested the second opinion (or, alternatively, and more probably, whether the parent required the review for its own purposes). Similarly, there is no discussion as to whether a second opinion is typically obtained under the circumstances.

functions and duplicative services. The similarity, however, is misleading. Prop. Reg. § 1.482-9(l)(4), *Ex. (4)* and (5) illustrate the determination of whether the activity duplicates functions performed by the potential "recipient." The proposed examples draw a distinction between the facts where (i) only the parent performs the subsidiary's treasury function and (ii) where the parent company performs certain treasury functions independently of the subsidiary's performance of the same functions. In Prop. Reg. § 1.482-9(l)(4), *Ex. (5)*, the subsidiary does not take advantage of the parent's activities. The subsidiary does not submit its decisions to the parent for review; rather, the parent and subsidiary perform the treasury functions independently of each other and do not share the results. Such duplication of functions does not offer any potential of reducing the risk of a wrong business decision. By contrast, the type of review by the parent and subsequent communication of the recommendations to the subsidiary envisioned in Reg. § 1.482-2(b)(2)(ii), *Ex. (2)* can reduce the subsidiary's risk of making a wrong business decision. That is precisely the thrust of Prop. Reg. § 1.482-9(l)(4), *Ex. (6)*. Consequently, we believe that the sharper contrast is between Reg. § 1.482-2(b)(2)(ii), *Ex. (2)* and Prop. Reg. § 1.482-9(l)(4), *Ex. (6)*.

The Proposed Regulations' example displays a basic misapprehension of how related parties interact. First, Example (6) fails to clarify why the second opinion was procured, a question critical to determining how the transaction should be taxed. If, in fact, the parent directed the review as a basic control activity and no independent entity would have regularly obtained a second opinion (or have been willing to pay for one), this transaction properly should be viewed as primarily for the benefit of the parent, and should not be subject to the transfer pricing rules (which are fundamentally aimed at clearly reflecting income and preventing tax evasion).

If as a factual matter (and in contrast to the facts assumed in Example (2) of the Current Services Regulations), the parent's review substitutes for procuring a second opinion from an independent firm or is the type of service for which the parent would expect to charge and the subsidiary would be willing to pay, the transfer pricing rules should cover the transaction. To the extent legal services are non-integral services (*i.e.*, neither party is involved in the trade or business of providing legal services to third parties), it would not be appropriate to charge this transaction with a profit mark-up as if the arrangement had been entered into with an independent firm. Imputing profit on non-integral transactions is at odds with the rationale for the economies of scope that justifies bringing together otherwise independent entities within the multinational enterprise. In this situation, the proper "arm's-length" comparable would be a cost charge-out or other co-operative arrangement where all subsidiaries shoulder their applicable shares of costs related to retaining the group's specialized legal staff, as opposed to retaining an outside law firm. This would comport with the reality that the legal department services the enterprise as a whole, and is not properly analogized to an independent law firm developing a stable of clients, which in turn are free to hire other law firms.

Prop. Reg. § 1.482-9(l)(4), *Ex. (13)*, dealing with the "shareholder activities" exception, raises similar concerns. Under Example (13), a subsidiary is treated as deriving a benefit where the parent establishes detailed personnel policies for its subsidiaries, reviews and approves performance appraisals of executives, monitors compensation levels, and participates in

the hiring and firing decisions involving senior executives. Example (13) concludes that each subsidiary is treated as obtaining a benefit from its parent, even if the subsidiary would be unwilling as a factual matter to (i) pay the parent for its involvement on compensation issues, (ii) otherwise hire a third party to perform these or similar services or (iii) undertake any additional internal human resource activities for its own account. Treating these transactions as if they were commissioned from a third party fundamentally disregards the way affiliates within a multinational enterprise interact and would not appear necessary to clearly reflect the income of the parent or to prevent tax avoidance.

2. “Simplified Cost-Based Method.” The Proposed Regulations would eliminate the cost-only safe harbor of the Current Services Regulations and establish instead the “Simplified Cost-Based Method,” which taxpayers may be able to apply to certain routine, low-value transactions (including transactions that from a commercial perspective might be considered remote or incidental). The Simplified Cost-Based Method reads as a more convoluted version of the Cost of Services Plus Method that would allow qualifying service providers to “undercharge” by a small amount on what the IRS and Treasury could assert would be an appropriate mark-up for these services.

We believe that the thinking underlying the Simplified Cost-Based Method fundamentally misapprehends the point of the current cost-only safe harbor. The safe harbor is not simply a rule of administrative convenience, but rather embodies the fundamental principle that many centralized back office activities are performed, not for independent profit, but to reduce the generalized cost of doing business. In this regard, we agree with many of the comments made by the U.S. Council for International Business and the Tax Executives Institute in their submissions on the Proposed Regulations as to the technical infirmities of the Simplified Cost-Based Method.⁶²

⁶² U.S. Council for International Business, Comments on Proposed Regulations §§ 1.482-9, 1.482-1(d) and 1.482-4, dated Dec. 23, 2003 *reprinted in* 2004 *Tax Notes Today* 6-25 (Jan. 9, 2004); Comments of Tax Executives Institute, Inc. on The Proposed Regulations Relating to the Treatment of Services Under Section 482 and The Allocation of Income and Deductions From Intangibles, dated Dec. 22, 2003 *reprinted in* 2003 *Tax Notes Today* 247-23 (Dec. 24, 2003).

The Preamble to the Proposed Regulations states that the Simplified Cost-Based Method is intended to provide “appropriately reduced administrative and compliance burdens for low-margin services,” while ensuring the broad application of the arm’s-length standard to the controlled services transactions and remedying what is perceived as a failure of the existing regulations to prevent pricing of high-value services at cost. According to the Preamble, the Simplified Cost-Based Method also is intended to “provide certainty concerning the pricing of low-margin controlled services, and to reduce the number of disputes where taxpayers make a good faith effort to price qualifying services under this method.” Even under this standard the Simplified Cost-Based Method is a poor substitute for the existing cost-only safe harbor.

It has been suggested that the IRS felt compelled to eliminate the cost safe harbor of the Current Services Regulation because the IRS believed that safe harbor to be inconsistent with the OECD Guidelines.⁶³ It is true that the OECD does not favor safe harbors, but by the same token this generalization has fairly been described as an overstatement.⁶⁴ More directly, and as Part VI and Appendix A demonstrate, the issue is not whether the OECD favors safe harbors, but rather whether the OECD Guidelines and the practices of other tax administrations contemplate the same *results* as those obtained today by the cost-only safe harbor. The answer is that they do, both by acknowledging the necessity of safe harbors and simplified cost allocation methodologies as a matter of sound administration,⁶⁵ and by contemplating the use of *structural* solutions, such as cost contribution arrangements covering services.⁶⁶ (In this regard, the Current

⁶³ 2002 ABA Recommendations at 11. The IRS clearly found this to be a difficult issue to resolve, as early indications were that the safe harbor would be retained. *See, e.g.*, “IRS’s Beck Discusses Transfer Pricing Regulation Project,” 2001 *Tax Notes Today* 242-4 (Dec. 14, 2001) (“The current thinking is not to toss out the cost safe harbor rule,” Beck said.); “It’s time to Revisit Transfer Pricing Safe Harbors, Former APA Director Says,” 2002 *Tax Notes Today* 27-5 (Feb. 7, 2002); Bell, “Treasury Official Previews Intercompany Services Regs,” 2003 *Tax Notes Today* 19-7 (Jan. 28, 2003).

⁶⁴ Bell, “Treasury Official Previews Intercompany Services Regs,” 2003 *Tax Notes Today* 19-7 (Jan. 28, 2003).

⁶⁵ OECD Guidelines, ¶ 7.22-7.24, 7.37.

⁶⁶ OECD Guidelines, ¶ 8.7. For the question of whether the OECD Guidelines contemplate charging out services described in a cost contribution arrangement at actual cost or at a mark-up, see note 92, below.

Services Regulations' cost-only safe harbor can be seen as simply a species of cost sharing arrangement.) Other tax administrations follow just these sorts of pragmatic approaches to limiting the quest for comparables for every conceivable intra-group service.

The Proposed Regulations essentially transform common cost centers into profit centers. By requiring arm's-length pricing and the imputation of profit for such centralized services as back office, accounting, legal services, and support, the Proposed Regulations would disregard the economic substance of the arrangement and would distort taxable income (where an offsetting deduction is not available under law applicable to the affiliate).

We therefore are concerned that the Proposed Regulations could encourage multinational enterprises to locate certain intra-group service providers outside the United States. Moving intra-group service units off-shore could avoid pricing high-value (but non-integral) intra-group services at a profit mark-up (as the Proposed Regulations would require), and generally would ensure that a service recipient could fully deduct the intra-group service fees and payments. Moreover, to the extent that high-value intra-group services are provided to U.S. recipients, marked-up deductions may be available in the United States even where the mark-up is not fully taxable in the service provider's jurisdiction. Transfer pricing rules that favor non-U.S. intra-group service providers in this way could result in the loss of U.S. jobs and reduced investment in the United States.

It is true that the Simplified Cost-Based Method would permit taxpayers to charge certain intra-group services at cost. To do so, however, a taxpayer would be required to do all the work developing comparables that would be required outside of the Simplified Cost-Based Method, and then would be permitted to charge at cost only if the taxpayer could demonstrate that the median of the interquartile range of third-party comparables is less than cost plus 6 percent.⁶⁷ For all the reasons developed earlier relating to multinational group synergies and

⁶⁷ See Wolosoff, Ryan & Eisenhauer, "The New Proposed Section 482 Regulations—A Path to Confusion, Uncertainty and Endless Controversy," 4 *BNA Tax Plan. Int'l Transfer Pricing* No. 12, at 14 (Dec. 1, 2003), for a discussion of the volatility associated with the median of an interquartile range of a relatively small sample population.

economies of scope, third-party comparables in fact are very difficult to develop for precisely the sorts of services that today fall within the cost-only safe harbor. We therefore believe it inaccurate to suggest that taxpayers will find the Simplified Cost-Based Method to be a useful substitute for the cost-only safe harbor with respect to many common intra-group services.

In-house legal services provide an instructive example in this regard.

Multinational enterprises have established internal legal departments to save costs and to develop specialized expertise about the regulatory and legal environment in which the multinational operates. The activities of these departments are only roughly comparable to the services outside lawyers provide, and often focus on providing an institutional continuity of approach to legal issues of concern to the group as a whole. Moreover, affiliates typically are not given a choice about using the resources of the group's legal department, because the legal department exists, in some respects, to supervise and coordinate as well as to serve. Outside law firms typically operate at significant margins over their costs, which cover the risks and returns to the firm's partners, as the owners of the enterprise, as well as the different specialized services these firms provide (*e.g.*, 24-hour support staff and legal staff available to work around the clock). Does the IRS really expect multinational enterprises to use these outside providers as comparables? If so, how could one usefully adjust for these profound differences in the risk/reward profile of inside and outside providers?

This points to our fundamental concern that many taxpayers will be precluded from using the Simplified Cost-Based Method. For financial services firms, certain financial services transactions (*e.g.*, "financial transactions, including guarantees") would be ineligible for application of the Simplified Cost-Based Method, even where such transactions are, in fact, low-margin and routine.⁶⁸ Many other types of "services" that currently are included in the cost-only safe harbor would lack quality comparables, thereby making it difficult for taxpayers to establish or justify an arm's-length mark-up that taxpayers could use with certainty.

⁶⁸ Prop. Reg. § 1.482-9(f)(4).

As a practical matter, the use of the Simplified Cost-Based Method in all cases will require more detailed analysis and documentation of inter-affiliate services transactions (as compared to the current cost-only safe harbor) and in certain situations will require extensive transfer pricing studies. Significantly, the Simplified Cost-Based Method rules do not override the general best method rule under the transfer pricing regulations, which generally requires analysis of the facts and circumstances surrounding a transaction in order to determine which transfer pricing method provides the most reliable measure of an arm's-length result.

Under Prop. Reg. § 1.6662-6(d)(2)(ii)(b), for the taxpayer's selection of the Simplified Cost-Based Method to be reasonable, a taxpayer must (1) satisfy itself of the reasonableness of the method for allocating and apportioning total services costs to the controlled service; (2) confirm that the specific requirements of the Simplified Cost-Based Method (*i.e.*, limitations, conditions, and eligibility of transactions) have been met; (3) determine the arm's-length mark-up that would apply if the requirements of the Simplified Cost-Based Method were not met; and (4) choose and document a net cost mark-up pursuant to the requirements of the Simplified Cost-Based Method. Further, if the taxpayer were inadvertently to fail the requirements of the Simplified Cost-Based Method under the Proposed Regulations, the best method rule and penalty rules would apply.

Before using the Simplified Cost-Based Method, a taxpayer must evaluate whether the amount charged for the controlled services transaction falls within an acceptable range of a mark-up percentage charged in a comparable uncontrolled transaction.⁶⁹ As examples to the Proposed Regulations illustrate, minimal disagreements about the ranges of arm's-length

⁶⁹ The range of the acceptable deviation decreases proportionately with the increase in the mark-up actually charged by the taxpayer. In this regard, the Simplified Cost-Based Method completely phases out and is not available for pricing high-margin transactions, that is, transactions with an arm's-length mark-up exceeding 10 percent. Prop. Reg. § 1.482-9(f)(2)(ii), (iii). Additionally, the Simplified Cost-Based Method does not restrict the ability of the IRS to make allocations if the charge is less than cost, or if the charge exceeds the arm's-length mark-up. Prop. Reg. § 1.482-9(f)(5), *Ex. 7*. In addition, the IRS can make allocations based on the taxpayer's use of an inappropriate method to allocate and apportion total services costs to the controlled services transaction. Prop. Reg. § 1.482-9(f)(1)(v)(A).

mark-up or the total costs of service could eliminate the benefits of the Simplified Cost-Based Method for the taxpayer.⁷⁰

Finally, as a condition to using the Simplified Cost-Based Method, Prop. Reg. § 1.482-9(f)(3) requires that taxpayers maintain records regarding the determination and allocation of total costs and document in written contracts the charges for the provision of services. For multinational enterprises covered by these rules, there is no rule that excludes transactions of only limited value, which will impose substantial costs on taxpayers.

D. Conclusion.

The Current Services Regulations appropriately take account of the fact that affiliates within a multinational enterprise interact in a manner that fundamentally differs from relations between unrelated parties acting at arm's length. The Current Services Regulations do not lose sight of the fact that multinational enterprises are purposefully arranged to benefit from organic synergies and economies of scope. To balance these concerns against the concerns of tax avoidance that animate the arm's-length principle, the current regime permits a large range of commonplace services performed among affiliates to be charged at cost, or in some cases, does not treat those relationships as constituting "services" at all.

The Proposed Regulations, as discussed above, would dramatically expand the scope of the transfer pricing rules applicable to services. More disconcertingly, they would disregard the organic synergies inherent in multinational enterprises, treat inter-affiliate services and inter-branch services differently, and, as discussed in Part VI, below, create inconsistency with international norms of transfer pricing that would disparately affect U.S. and foreign-based firms. While many of these problems would affect a wide range of taxpayers, the consequences would be felt acutely by the securities industry.

⁷⁰ Prop. Reg. § 1.482-9(f)(5), *Ex.* (2)-(4), (6)-(10).

For the reasons discussed above and more fully developed in Part VI, below, Prop. Reg. § 1.482-9(l)(1) should be revised to define a “controlled services activity” in a manner that tracks more closely the recommendations made by the OECD in its OECD Guidelines—that is, as an activity for which the service recipient reasonably could be expected *to pay*, not as an activity from which the service recipient merely receives a “benefit.”

Similarly, the “Simplified Cost-Based Method” of Prop. Reg. § 1.482-9(f) should be abandoned, and the Current Services Regulations’ cost-only safe harbor for non-integral services should be re-adopted within the Proposed Regulations, with appropriate further clarifications to exclude from the cost-only safe harbor embedded intangible transfers and other problematic transactions.⁷¹

V. PRICING ROUTINE CAPITAL.

As developed in Part III, we are concerned that the Proposed Regulations could apply to activities related to the conduct of a global dealing business that are more appropriately within the scope of the final global dealing regulations, and that should be addressed in that context. As discussed in Part IV, above, we believe that the Proposed Regulations should not apply the arm’s-length principle to increase significantly the number of intra-group transactions for which comparables must be developed and mark-ups charged. Each of these concerns is illustrated by the treatment of financial guarantees under the Proposed Regulations.

Under the Current Services Regulations, financial guarantees can be charged at cost, except in cases where a financial guarantee is provided as an integral part of the guarantor’s business activities. The Proposed Regulations in all cases would require an arm’s-length charge for providing capital and/or credit support to affiliates. The absence of a continuing safe harbor for guarantees in appropriate cases raises several difficult conceptual and practical issues and could produce economically inappropriate results.

⁷¹ See in this regard the 2002 ABA Recommendations for a number of suggested improvements for the cost-only safe harbor.

A. Current Law on Guarantees.

The Current Services Regulations do not provide a specific rule for pricing intra-group financial guarantees.⁷² In addition, no rule exists for determining the source (as U.S. or foreign) of guarantee fee income, or the character of that income for withholding tax or foreign tax credit purposes.

In a 1978 technical advice memorandum,⁷³ the IRS concluded that by providing a financial guarantee, a parent corporation enabled its affiliate to secure needed funds. The IRS reasoned that, because Reg. § 1.482-2(b)(7), *Ex.* (9) specifically referred to the arranging of financing as a service performed by one party for another, a financial guarantee could be treated as a service within the meaning of Reg. § 1.482-2(b). The provision of a financial guarantee is not excluded from current law's cost-only safe harbor of Reg. § 1.482-2(b)(7).

In the 1978 technical advice memorandum, the IRS considered the nature of the costs incurred by the parent corporation and concluded that no allocation was necessary to reflect the costs associated with the assumption of contingent risks. Consequently, the IRS required that the parent corporation charge only for its "out of pocket" costs. Because typically there are no incremental out of pocket costs for providing a financial guarantee, the net result of the technical advice memorandum was to contemplate a guarantee fee essentially of zero.

In a later general counsel memorandum,⁷⁴ the IRS closely followed the reasoning laid out in the 1978 technical advice memorandum and arrived at an identical conclusion. In addition, the IRS addressed the issue of sourcing the allocated service income (in the unlikely case an allocation for providing a financial guarantee were to be made).⁷⁵ This issue has yet to

⁷² For a general discussion of the tax issues raised by financial guarantees, see Miller, "Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis," 48 *Tax Law.* 103, 130-31 (1994).

⁷³ Tech. Adv. Memo. 7822005 (Mar. 5, 1978).

⁷⁴ Gen. Counsel Memo. 38499 (Sept. 19, 1980).

⁷⁵ The IRS acknowledged that because the classification of the payment was not free from doubt, valid arguments existed for treating the income as either sourced outside the United States (because the guarantee enabled a foreign subsidiary to secure financing abroad and because the risk undertaken was linked to a foreign obligation) or within the United States (pursuant to section 861(a)(3), because the performance of services took place in the

be resolved definitively.⁷⁶ As a result, the sourcing and character of financial guarantee fees for purposes of foreign tax credit computation and income tax withholding has remained unclear.

B. The Proposed Regulations' Treatment of Guarantees.

Financial guarantees clearly would fall under the expanded definition of services under the Proposed Regulations,⁷⁷ but would not qualify for the new Simplified Cost-Based Method that permits cost-only treatment for certain low-margin transactions.⁷⁸ As a result, income from the provision of financial guarantees must be determined under one of the arm's-length methodologies provided in the Proposed Regulations.

While the Proposed Regulations require that providers of financial guarantees receive arm's-length fees for their service, the Proposed Regulations do not address the current vacuum of guidance on the source and character of guarantee fees, for withholding tax, foreign tax credit and other purposes. Taxpayers would urgently require resolution of these questions if final regulations were adopted that effectively require payments to be made for these transactions.

As discussed in Part III, the delineation between "routine" and "non-routine" contributions of capital remains a significant unresolved concern to all taxpayers engaged in

United States). The IRS, however, suspended further consideration of this source of income issue until completion of the then-pending litigation of *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl., 1982).

⁷⁶ In *Bank of America*, the Court of Claims held that commissions received by a bank for acceptance of letters of credit (activity similar to the provision of financial guarantees) related to the bank's assumption of credit risk and, therefore, should be treated as interest sourced by the residence of the obligor under sections 861(a)(1) and 862(a)(1) rather than as personal services under sections 861(a)(3), 862(a)(3). In Priv. Ltr. Rul. 8508003 (Nov. 9, 1984), in a context unrelated to transfer pricing or international taxation, the IRS addressed the issue of whether payments for financial guarantees constituted interest income for purposes of the investment income rules of section 163(d)(3)(B). The IRS reasoned that guarantee fees were not received for the use or forbearance of money, because no indebtedness existed between the payor and the guarantor. The IRS therefore concluded that the guarantee fee income was compensation for serving as guarantor of a loan. *But see Centel Communications Co. v. Comm'r*, 920 F.2d 1335 (7th Cir. 1990) (shareholder guarantees did not constitute the performance of personal services taxable under section 83, but were more closely analogous to a loan transaction).

⁷⁷ Prop. Reg. § 1.482-9(l)(1) - (3) (described in more detail above in Part IV).

⁷⁸ Prop. Reg. § 1.482-9(f)(4)(v)(H).

global dealing. Consequently, we are troubled by the fact that the scope of the Proposed Regulations presumably includes *all* financial guarantees.

Proposing that all financial guarantees be treated under the controlled services transfer pricing rules creates an undesirable background to any future discussion about the treatment of capital within global dealing operations. In particular, the pricing of financial guarantees under the Proposed Regulations implies that inter-affiliate guarantors would not be treated as “participants” in the global dealing operation and labels all financial guarantees as “routine” contributions.

We believe that this line-drawing between “routine” and “non-routine” capital contributions is not appropriate when applied to financial services firms and would complicate the global dealing guidance project. In this regard, we reiterate our concern that the efforts to refine and finalize the proposed global dealing regulations should not be sidestepped through the implementation of the Proposed Regulations. We therefore urge the IRS and Treasury not only to provide in the Proposed Regulations an explicit substantive “carve-out” rule for capital activities related to global dealing operations, but also to state explicitly that no inference should be made from the Proposed Regulations about the nature of capital as a “routine” or “non-routine” contribution.

C. Current Law Provides Appropriate Results for Routine Capital.

While we believe that the final global dealing regulations rather than the Proposed Regulations should address the treatment of capital provided to a global dealing operation, we recognize that the provision of financial guarantees outside a global dealing operation would fall under the purview of the Proposed Regulations. The current safe harbor for guarantees generally has been acceptable commercially and administratively. The Proposed Regulations’ approach to pricing financial guarantees, by contrast, raises several conceptual and practical issues that would need to be addressed if the safe harbor were removed.

1. Circularity of Cost of Capital. By providing a guarantee, the parent company of a multinational enterprise extends the benefit of a publicly available measure of the entire controlled group's creditworthiness to a specific subsidiary. Rating agency credit ratings or regulatory approval of capital adequacy are examples of such credit measures. In receiving these ratings, the parent company is not evaluated on a stand-alone basis (*i.e.*, taking account of only the directly-held assets and direct income sources). Rather, the parent's credit rating takes into account the assets, income and liabilities of all of the group's members, as indirect assets of the parent. Consequently, all affiliates contribute to the parent's rating, and it is very difficult to determine the size of each affiliate's relative contribution to a multinational group's overall credit rating, or the incremental credit benefit conferred upon the subsidiary from the parent guarantee.

A parent guarantee thus is different as an economic matter from a guarantee obtained from (for example) an unrelated financial insurer. The parent guarantee has value, at least in part, because of the value of the subsidiary that is the beneficiary of the guarantee. Requiring that the subsidiary pay the parent for the guarantee at the arm's-length price that a financial insurer might charge effectively can be said to result in the subsidiary paying twice for the use of the same capital—first, in the form of its own cost of equity, and second, in the form of the parent's guarantee fee (the value of which guarantee in turn reflects the value of the subsidiary's equity). Admittedly, the magnitude of this circularity problem depends on the value of a particular subsidiary relative to the value of the parent company's other assets.

Current law permits taxpayers and the IRS alike to avoid these difficult inquiries into the relative creditworthiness of each subsidiary on a stand-alone basis. A rule requiring arm's-length charges in every case, by contrast, would require taxpayers in effect to determine separate shadow credit ratings for every substantial subsidiary that is a beneficiary of a parent guarantee, and then to determine a shadow credit rating for the group, *ex-that* substantial subsidiary, as preliminary steps to calculating the value to each such subsidiary of the parent's guarantee. This process would be very difficult to perform.

2. Limited Economic Benefit from Guarantee. In many transactions a parent guarantee may be required as a matter of market practice, regulatory requirements or the requirements imposed on the lender by *its* rating agency. Nonetheless, a parent guarantee does not always confer a substantial economic benefit on the subsidiary.

Because a multinational group's reputation and credit rating depends on each subsidiary's performance of its obligations, most large multinationals view each subsidiary as having an implicit financial "keepwell" from the parent company.⁷⁹ Because the Proposed Regulations would appear to treat the benefit arising from this type of implicit support as a form of "passive association," as a commercial matter, a formal parent guarantee would not substantively change the economic arrangement. The parent, however, would be required to charge for any *explicit* credit support.

In practice, a lender to a subsidiary in a multinational group often demands a guarantee from the parent company of the group simply to eliminate the legal and business complications associated with negotiating and monitoring numerous financial and negative covenants on the finances and activities of the subsidiary, as well as to simplify the due diligence process in making the loan in the first instance. Financial and negative covenants in a loan agreement are difficult and costly to negotiate and can significantly burden the entire controlled group's ability to conduct business; a parent guarantee obviates the need for these negotiations, even where the subsidiary assets and earnings would support the loan. The arm's-length value of a parent guarantee in this situation should be determined by reference to the costs of negotiating and complying with the foregone covenants, not by postulating that the affiliate could not otherwise have obtained financing. Again, the actual calculation of the appropriate fee in this circumstance would be very difficult.

⁷⁹ Some multinational companies even have board resolutions in place stating that the parent company will ensure that all financial obligations of all of its subsidiaries are met.

3. Lack of Comparables. Parent companies often guarantee their subsidiaries' performance on various derivative transactions. In these transactions, a subsidiary hedging a particular risk may enter into a swap with an unrelated party. The parent typically guarantees the subsidiary's *potential* obligation represented by the swap transaction. Because the potential liability under the swap is limitless, there generally are no markets in which unrelated parties are willing to assume credit risk on such transactions.⁸⁰ Accordingly, comparable uncontrolled transaction data often is unavailable.

In addition, because the Proposed Regulations contemplate a spectrum of financial support with the formal financial guarantee to be charged out at an arm's-length price at one end, and the benefit of passive association not requiring a charge on the other, the treatment of intermediate forms of financial support remains unclear. Controlled groups commonly use forms of financial and credit support that vary both in terms of legal enforceability and the degree of reliance that lenders place on them. Forms of credit support such as a binding "keepwell" or a soft "declaration of backing" (*i.e.*, a letter indicating that the parent's policy is not to permit its subsidiaries to become insolvent) would fall in the middle of the spectrum established in the Proposed Regulations. To the likely confusion of both taxpayers and Revenue Agents, the Proposed Regulations do not provide any guidance for determining on which side of the spectrum a specific form of credit support would fall and do not exempt affirmative non-guarantee forms of credit support from the transfer pricing rules.

Significantly, these types of support never would be provided outside a controlled group and no comparables would be available to price them. While keepwells give general comfort to business people who do not specialize in credit analysis, rating agencies and other third-party credit specialists do not treat keepwells as equivalent to financial guarantees.

⁸⁰ For this reason, credit issues in the over-the-counter derivatives market generally are addressed by periodically marking the derivative to market and posting collateral as needed.

Accordingly, we think it clear that keepwells (or soft “declarations of backing”) are not undertakings of the type that should constitute controlled services transactions.

4. Difference in Result Between Subsidiary and Branch Structures. The Proposed Regulations would apply only to inter-affiliate and not to inter-branch charges for capital. Consequently, the absence of a continuing safe harbor for financial guarantees under the Proposed Regulations would drive a further wedge between the comparability of tax treatment of firms operating through the subsidiary structure and firms operating through branches. While the IRS takes the view that branches and the home office of a single corporation may not charge each other for the use of capital, effectively resulting in a “cost sharing” treatment of capital,⁸¹ corporate affiliates in all circumstances would have to charge the use of capital at arm’s-length prices. We do not see any valid tax policy being served when a rule veers away from neutrality in application across these two modes of doing business.

5. Conclusion. For all the above reasons, we believe that a compelling case can be made for the preservation of current law’s safe harbor for intra-group guarantees. That safe harbor, however, should not apply to cases governed by the proposed global dealing regulations, or to cases where the guarantor in fact regularly provides financial guarantees or other forms of credit support to third-party customers as an integral part of the guarantor’s business. As under current law, the safe harbor should remain just that—a safe harbor, not a mandatory prescription. Finally, we urge the IRS to address through regulations the outstanding source, withholding tax and similar issues outside the transfer pricing arena associated with guarantees.

VI. CONFLICT WITH INTERNATIONAL NORMS.

According to their Preamble, the Proposed Regulations are intended to “provide updated guidance consistent with international standards in this area on the threshold issue of

⁸¹ Prop. Reg. § 1.482-8(a)(2)(ii).

whether activities constitute the rendering of services for the benefit of another member of a controlled group.”⁸² Notwithstanding the superficial similarities between some aspects of the Proposed Regulations and the OECD Guidelines, we believe that the Proposed Regulations in fact significantly depart from the treatment of controlled services transactions advanced by the OECD Guidelines, as interpreted by other tax administrations. As a result, if the Proposed Regulations were to be adopted in final form without significant modifications, the result would be substantial discontinuities between the U.S. transfer pricing regime and international norms. These concerns are addressed in further detail below and in the Cleary, Gottlieb, Steen & Hamilton memorandum dated January 12, 2004, outlining arm’s-length transfer pricing rules under the laws of Belgium, France, Germany, Italy and the United Kingdom, attached as Appendix A.⁸³

A. OECD Guidelines Treatment of Non-Integral Services Generally.

Since 1963, the OECD has been the most influential force in forging uniform international standards in transfer pricing.⁸⁴ The OECD Guidelines reflect the OECD’s ongoing effort to articulate a comprehensive position on transfer pricing of intra-group services that is both conceptually consistent and easy to administer.⁸⁵

⁸² 68 Federal Register 53449.

⁸³ See also Boekhoudt & van der Vliet, “The Recharging of Netherlands Head Office Expenses,” 9 *IBFD Int’l Transfer Pricing J.* 3 (2002) for a discussion of similar issues under Netherlands law. The authors of that article criticize the Netherlands tax administration for what the authors conclude is an overbroad application of transfer pricing principles to ‘services’ that a Netherlands company is deemed to perform for its subsidiaries—in contravention (according to the authors) of the principle of the OECD Guidelines discussed below.

⁸⁴ Although OECD is a consultative body, and its decisions and pronouncements are not mandatory, it enjoys a high level of prestige among its members. All of its positions evolve out of multinational dialogue and deliberations and represent a consensus on the particular topic under study.

⁸⁵ Chapter VII, Special Considerations for Intra-group Services, OECD Guidelines, ¶¶ 7.1 through 7.42 (adopted in March 1996). Although specific rules concerning the controlled services transactions are contained in Chapter VII, such rules must be read within the overall context of the OECD Guidelines.

The arm’s-length principle has been fundamental to the OECD transfer pricing positions since it was first articulated in the OECD’s Model Tax Convention, which was originally published in 1963, substantially revised in 1977, and reissued in 1992. The OECD Committee on Fiscal Affairs (the OECD functional committee with jurisdiction over tax policy) also has issued a number of reports on transfer pricing and related tax issues. The first

The OECD Guidelines substantively address the two fundamental tasks of a transfer pricing regime for services: (i) determining what intra-group activities should be within the scope of the transfer pricing regime (*i.e.*, determining when intra-group services have been rendered) and (ii) determining what costs should be allocated or profits imputed with respect to the intra-group services that have been rendered, (*i.e.*, determining the appropriate arm's-length charge).

The OECD Guidelines only generally describe the range of activities that could possibly be treated as “services.”⁸⁶ Primarily, the OECD Guidelines focus on how the arm's-length principle⁸⁷ should be applied to determine whether intra-group services have been rendered. Under the OECD Guidelines, services are rendered if:

the activity provides [recipient] with economic or commercial value to enhance its commercial position [such that] an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.⁸⁸

major report, issued in 1979, was “Transfer Pricing and Multinational Enterprises,” which elaborated on the arm's-length standard. “Transfer Pricing and Multinational Enterprises” (OECD Comm. on Fiscal Affairs, 1979) (hereinafter 1979 OECD Report). Subsequent OECD reports addressed specific transfer pricing issues. A task force of the OECD also published two reports in 1992 that reviewed the then-proposed U.S. section 482 regulations. The first five chapters of the OECD Guidelines emerged from a revision of 1979 OECD report and were approved by the OECD Council in 1995 and released to the public. The OECD Council adopted two more chapters of the OECD Guidelines in 1996.

⁸⁶ OECD Guidelines, ¶ 7.2. The OECD Guidelines in their general description of intra-group activities observe that multinational enterprises provide affiliates with a wide range of services and, in particular, identify administrative, technical, financial, and commercial services. OECD Guidelines, ¶ 7.2, 7.14.

⁸⁷ *Id.*, ¶¶ 1.6-1.14. The arm's-length principle is stated in the OECD Model Tax Convention: “[When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” OECD Model Tax Convention, Art. 9, § 1.

⁸⁸ OECD Guidelines, ¶ 7.6.

The OECD’s views this determination as factual in nature, and therefore states that “it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intra-group services.”⁸⁹

The theme running throughout the OECD Guidelines is that no receipt of services can occur *unless* “an independent enterprise in comparable circumstances would have been willing to pay” for the services rendered or to have undertaken the activities itself.⁹⁰ As discussed in Part IV, this type of standard appropriately applies the arm’s-length principle within the context of multinational enterprise by excluding from the scope of transfer pricing rules intra-group interactions that would not have occurred between unrelated parties and that do not result in income shifting between related parties. It also avoids inquiries into the subjective intent of the service recipient by evaluating whether a “comparably situated independent enterprise” “would have been willing to pay.”

Where intra-group services have been rendered, the OECD Guidelines apply the arm’s-length principle to determine whether profit imputation to the service provider is necessary in order to reflect the arm’s-length price, or if cost allocation would better reflect the charge that “would have been made and accepted between independent enterprises in comparable circumstances.” While the OECD Guidelines generally underscore the importance of assessing the comparability of intra-group transactions with third-party transactions, they acknowledge that cost-only allocations may be appropriate when the intra-group service is a generalized cost of doing business.⁹¹ This approach thus contemplates the possibility of cost-only allocations for

⁸⁹ *Id.*, ¶ 7.7.

⁹⁰ *Id.*, ¶ 7.6. *Cf.* Boekhoudt & van der Vliet, *supra* note 83, at 8. The “willingness to pay” test is invoked in ¶¶ 7.8 and 7.14 as an indispensable part of the determination of whether a benefit has been conferred upon an affiliate. The “willingness to pay” test also is illustrated by applying it to the four categories of intra-group activities explicitly described as not constituting services: shareholder activities (¶¶ 7.9-7.10), duplicative activities (¶ 7.11), activities conferring incidental and remote benefit (¶ 7.12) and passive association (¶ 7.13).

⁹¹ *Id.*, ¶ 7.37. The OECD Guidelines apply an administrative rationale for deviating from the arm’s-length principle by “allowing a taxpayer in appropriate circumstances to merely allocate the cost of providing those services.”

many centralized activities that create the synergies of successful multinational enterprise (*e.g.*, management, accounting, computer support, logistics and other back office functions), but are not the core services provided to third parties.

As described earlier, the OECD Guidelines do not favor safe harbors (although they do acknowledge the practical inevitability of some). The OECD Guidelines do, however, implicitly endorse *structural* cost-only solutions, such as cost contribution arrangements.⁹² Other structural solutions can include partnerships, co-operatives and, of course, branch operations. By contrast, the United States does not permit cost sharing agreements for services, instead limiting the scope of those agreements to the development of intangibles.⁹³ In this respect, the U.S. transfer pricing regime is inconsistent with international norms—although, so long as a viable cost-only safe harbor continues to exist, that inconsistency today has little immediate consequence.

B. The Proposed Regulations as Compared to the OECD Guidelines.

In contrast to the OECD Guidelines, we believe that the Proposed Regulations' scope generally is not in fact limited by the "willingness to pay" standard. While under the

⁹² The OECD Guidelines contemplate that multinational enterprises enter into cost contribution arrangements "for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services." *Id.*, ¶ 8.7. In this regard, the OECD specifically notes that "business enterprises may decide to pool resources for acquiring centralised management services or for development of advertising campaigns common to participants' markets." The OECD Guidelines do not explicitly address whether a service provider in a cost contribution arrangement must include a profit component in pricing the services it performs for other group members. Tax administrations, however, have taken view that the OECD does not require profit imputation in every cost sharing arrangement. *See, e.g.*, U.S. Dep't of Treasury, "A Study Of Intercompany Pricing," 1988-2 C.B. 458, 500 n.233 (July, 1988) (hereinafter, "1988 White Paper"); Anderson & Graham "Comparative Survey, Cost Contribution Arrangements: Australia," 8 *IBFD Int'l Transfer Pricing J.* 46 (2001); Casley & Taylor "Comparative Survey, Cost Contribution Arrangements: United Kingdom," 8 *IBFD Int'l Transfer Pricing J.* 65 (2001); Pistone, "Short Report on the Proceedings of the 54th IFA Congress, Munich 2000," 55 *Bull. for Int'l Fiscal Documentation* 35, 39 (2001); Bernstein, "Transfer Pricing in Canada," 53 *Bull. for Int'l Fiscal Documentation* 570, 576 (1999). Some commentators believe that the OECD Guidelines "leave open" the question of when to require mark-ups for services generally, while implicitly approving of cost-only treatment for services performed under cost contribution arrangements. Durst, *supra* note 25, at 98.

⁹³ Even in the environment contemplated by the Proposed Regulations, however, the United States plainly would require cost-only allocations for branch operations, and taxpayers could replicate similar results through partnerships and co-operative corporations. Prop. Reg. § 1.482-8(a)(2)(ii).

OECD Guidelines this standard is essential to determining whether intra-group services should be subject to transfer pricing rules under the OECD Guidelines, in the Proposed Regulations a taxpayer's "willingness to pay" is simply probative evidence (but not a necessary condition to concluding) that a benefit has been provided.⁹⁴ As a result, many relationships that are not subject to transfer pricing inquiry at all under the OECD Guidelines would fall squarely within the scope of the Proposed Regulations.

To demonstrate, consider Prop. Reg. § 1.482-9(l)(4), *Ex. (6)*, discussed in detail in Part IV, above, which describes a situation where the recipient arguably derives *some incremental* benefit from a duplicative review of a contract and a second legal opinion by the parent's in-house counsel. The Proposed Regulations do not indicate whether, as a factual matter, the affiliate would have been willing to pay to obtain the second legal opinion. Instead, the Proposed Regulations summarily conclude that the review reduces the commercial risk associated with the transaction and, therefore, the affiliate has obtained a benefit.

The OECD Guidelines refer to second legal opinions as an example of duplicative services that result in a benefit to the recipient.⁹⁵ The crucial difference, however, is the OECD's reasoning behind the seemingly similar outcome. The OECD finding is explicitly conditioned on the duplicative activity being undertaken *in order to* reduce the risk of a wrong business decision (*i.e.*, reduction in risk is not merely a collateral consequence of the duplicative activity) and therefore must be based on an assumption that the OECD's general "willingness to pay" standard has been satisfied. Absent the conclusive factual determination that the affiliate would have

⁹⁴ Prop. Reg. § 1.482-9(l)(3)(i). The one place where "willingness to pay" is directly relevant, rather than simply probative evidence, is in the exception for remote and incidental benefits: willingness to pay serves as conclusive proof that a benefit is *not* remote or incidental. Accordingly, an activity that confers a remote or incidental benefit on the "recipient" will only be covered by the transfer pricing rules for services if the recipient of services is willing to pay or perform the activity itself. Prop. Reg. § 1.482-9(l)(3)(ii). Under this exception, the determination of whether the benefit from the 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. All of the other exceptions to the definition of "benefit" under the Proposed Regulations require taxpayers to demonstrate that no incremental benefit has been received (in contrast to the OECD Guidelines, which do not ask whether a taxpayer has received value, but whether the taxpayer would be willing to pay for it). Prop. Reg. § 1.482-9(l)(3)(iii)-(v).

⁹⁵ OECD Guidelines, ¶ 7.11.

been willing to pay for the second legal opinion, this transaction would be excluded from the scope of the transfer pricing framework of the OECD Guidelines.

The general conflict between the Proposed Regulations and the OECD Guidelines is all the more troubling, because the OECD Guidelines specifically require that the service must, in fact, be rendered before the affiliate charged for the service can deduct that charge from its income.⁹⁶ Consequently, we are concerned that these differences in approach could result in systematic global over-taxation of U.S.-based parent companies that would be required under the Proposed Regulations to charge subsidiaries for services for which the subsidiaries could not claim deductions in taxing jurisdictions that follow the OECD Guidelines. At the same time, foreign-based multinational enterprises could benefit from the U.S. subsidiaries' receiving additional U.S. tax deductions for "services" even if the "mark-up" would not need to be included in taxable income in the parent companies' jurisdictions.

In many cases, the Proposed Regulations' insistence on imputing a profit element, in the absence of reliable comparables (which, in our experience, would be common for synergistic functions), would force multinational enterprises to apply some form of a residual profit split.⁹⁷ The OECD Guidelines generally disapprove of the residual profit split method and recommend its use only in cases of last resort.⁹⁸ Therefore, we believe that jurisdictions that follow OECD Guidelines would reject the residual profit split allocations for many routine functions that multinational enterprises for U.S. tax purposes and require allocations more consistent with the OECD Guidelines. In addition, those jurisdictions simply would not allow the deductions from the recipients' taxable income for the "mark-up" on such routine services, because under the OECD Guidelines such charges would be considered inflated and not at arm's length. Again, as a practical matter, this conflict between the Proposed Regulations and the

⁹⁶ OECD Guidelines, ¶ 7.32.

⁹⁷ See *Terr supra* note 54.

⁹⁸ OECD Guidelines, ¶ 3.52.

OECD Guidelines could result in systematic global over-taxation of the U.S.-based enterprises whose foreign affiliates operating in jurisdictions that follow the OECD Guidelines and could provide benefits to certain foreign-based multinational enterprises.

VII. TREATMENT OF “EMBEDDED” INTANGIBLES.

The Proposed Regulations would revise the rules generally applicable to intra-group intangibles transfers (Reg. § 1.482-4), and would develop more explicit coordination rules between the section 482 intangible transfer regulations and the section 482 regulations governing intra-group services transactions.⁹⁹ Our comments in this Part VII do not relate to these revisions, but instead focus on the “embedded” intangibles rule of Prop. Reg. § 1.482-9(m)(2). In general, we concur with the observation of a recent commentator that this rule “seems an unnecessarily broad remedy for a problem that could be adequately addressed with a more narrowly drawn antiabuse rule.”¹⁰⁰

We acknowledge that intra-group services sometimes can function as vehicles for transfers of separately-identifiable intangible property, and that such cases should be distinguished and addressed under the rules for transfers of intangible property. We believe, however, that the Proposed Regulations, as currently drafted, would not accomplish this goal, but simply would impose additional compliance burdens on taxpayers, and would send wrong signals to Revenue Agents. We also believe that the goals of the Proposed Regulations as stated in the Preamble would be much better served by providing long-overdue substantive guidance on the issue of distinguishing embedded intangibles from high-value services under the standard of Reg. § 1.482-4(b).

As described above in Part III, the securities industry commingles human ingenuity, technology and financial capital to provide financial services to customers in multiple

⁹⁹ These aspects of the Proposed Regulations are comprehensively summarized in Terr, “The Proposed Transfer Pricing Services Regulations,” 101 *Tax Notes* 1439, 1443 n. 32 (Dec. 22, 2003).

¹⁰⁰ *Id.*, at 1456.

jurisdictions. Correspondingly, we believe that unproductive taxpayer disputes resulting from indiscriminate attempts by Revenue Agents to misclassify many high-value personal services as transfers of intangibles would affect the securities industry in an especially detrimental way. We therefore recommend that the IRS and Treasury develop a set of precise criteria to assist taxpayers and Revenue Agents in identifying embedded intangibles.

A. Proposed Regulations Do Not Change Current Rules Substantively.

The Preamble to the Proposed Regulations states that the primary reason for its provisions relating to “embedded intangibles” is to “mitigate the extent to which the form or characterization of a transfer of intangibles as the rendering of services can lead to inappropriate results”¹⁰¹ and to ensure that the transfer pricing rules “reach similar results in case of economically similar transactions, regardless of the characterization or structuring of such transactions”¹⁰² and that “economically similar transactions, in particular transactions that effect the transfer of intangible property, be evaluated consistently under the transfer pricing regulations.”¹⁰³

In order to accomplish this goal, Prop. Reg. § 1.482-9(m)(2) would identify as potentially containing an intangible element any intra-group services that (i) result in a transfer, in whole or in part, of intangible property; (ii) have an effect similar to the transfer of intangible property; or (iii) include an element that constitutes the transfer of intangible property. If an intra-group service falls within one of the above categories, the Proposed Regulations would require an inquiry into whether the intangible element (if any) is material to the valuation of the entire transaction. And if such intangible element is material, then the Proposed Regulations would require that it be analyzed further under the rules of Reg. § 1.482-4.

¹⁰¹ 68 Federal Register 53449.

¹⁰² *Id.*

¹⁰³ 68 Federal Register 53457.

Under Reg. § 1.482-4(b), which would apply in the second round of analysis, transactions treated as transfers of intangibles are limited to the transfers of assets (*e.g.*, know-how) that have “substantial value independent of the services of any individual.” No case law or administrative guidance exists on the interpretation of this standard.¹⁰⁴ Where the intangible property has value independent of the services provided, the element of the transaction that involves intangible property would be characterized under the rules of Reg. § 1.482-4, and the services component presumably would be subject to the transfer pricing rules for controlled services transactions under the Proposed Regulations.¹⁰⁵

Because current Reg. § 1.482-4(b) already subjects separately-identifiable intangibles to the rules for intangible transfers, it is difficult to determine the precise purpose of Prop. Reg. § 1.482-9(m)(2), except to express general dissatisfaction with how the IRS itself currently is administering the intangibles transfer pricing regulations. The Proposed Regulations by their terms do not modify Reg. § 1.482-4(b) to remove the “value independent of the services of any individual” standard.

B. Practical Effect of the Proposed Regulations.

The fundamental practical problem raised by Prop. Reg. § 1.482-9(m)(2) is that it can be read by aggressive Revenue Agents as authorizing a quest for any scrap of paper that might be viewed as an embodiment of an intangible asset that is separate from services of any individual. In the normal performance of their duties, service providers leave a trail of documentation behind them—presentations, memoranda, emails, and the like. We believe that Prop. Reg. § 1.482-9(m)(2) will be read to suggest that these sorts of ordinary workproducts can constitute separate intangibles transfers.¹⁰⁶

¹⁰⁴ In its 1988 White Paper, the IRS and Treasury cited experience of international examiners and acknowledged the detrimental effect of the lack of guidance as to the criteria for determining whether a service transfers an intangible that has a distinct value from the services performed. 1988 White Paper, at 463 n.58 (July, 1988).

¹⁰⁵ Prop. Reg. § 1.482-9(m)(2).

¹⁰⁶ *Cf.* Prop. Reg. § 1.482-9(m)(6), *Ex.* (4).

We are particularly concerned about this sort of reading of the Proposed Regulations because securities firms employ individuals who (i) are highly trained, (ii) possess substantial business expertise, and (iii) are very valuable to the business. We believe that the primary consequence of the Proposed Regulations would be wide-scale and unproductive efforts on the part of Revenue Agents to ferret out intangibles that truly are incidental to the services these individuals provided, by searching for scraps of paper on which those individuals record their insights, and which no reasonable businessperson would perceive as involving independent intangible transfers. For example, under the Proposed Regulations, a securities firm that sends a highly qualified trader from New York to become an employee of a foreign affiliate, for the purpose of leading that affiliate's efforts to implement a new trading desk in the local market, could be challenged as transferring valuable know-how that must be priced under the "commensurate with income" standard applicable to transfers of intangibles, by virtue of the transferee's emails and memoranda to subordinates.

As a starting point, we recommend that the Proposed Regulations clarify that for purposes of Reg. § 1.482-4(b), an employee's knowledge and skills will not constitute an intangible unless (i) such know-how or similar intangible has been formally documented or otherwise separated from the individual other than through ordinary course of business correspondence, (ii) the firm claims ownership of the intangible, and (iii) the firm protects the intangible and keeps it confidential. The point should be illustrated with examples that make clear that the special expertise of a highly-compensated individual is not in fact an intangible asset for purposes of section 482.

NEW YORK

January 12, 2004

MEMORANDUM FOR THE SECURITIES INDUSTRY ASSOCIATION

Re: Transfer Pricing Rules for Intra-Group Services Transactions under the Laws of Belgium, France, Germany, Italy and the United Kingdom.

I. INTRODUCTION.

In connection with the Securities Industry Association's "Submission in Response to Notice of Proposed Rulemaking Regarding Treatment of Services under Section 482 and Related Matters," we have prepared a survey of certain aspects of the transfer pricing rules for services under the laws of Belgium, France, Germany, Italy and the United Kingdom.

The proposed amendments to Treasury regulation sections 1.482-1, 1.482-4, and 1.482-6 together with the proposed addition of Treasury regulation section 1.482-9, and certain other conforming changes (collectively, the "Proposed Regulations") would revise and expand significantly the scope of the U.S. transfer pricing rules applicable to services. The current U.S. transfer pricing regime for services permits a large range of commonplace "services" transactions among affiliates to be charged at cost, or excludes those interactions from the transfer pricing rules altogether. In contrast, the Proposed Regulations contemplate that the substantive transfer pricing rules would apply to interactions among affiliates in most cases where the service recipient is deemed to receive a direct "benefit" (*i.e.*, any identifiable increment of economic or commercial value that enhances the recipient's commercial position).

Additionally, by eliminating the current regime’s cost-only safe harbor, the Proposed Regulations would require taxpayers to produce comparables for many non-core business transactions, and in many cases would require taxpayers to impute profit charges for these transactions.

According to their Preamble, the Proposed Regulations “provide updated guidance with international standards in this area on the threshold issue of whether activities constitute the rendering of services for the benefit of another member of a controlled group.”¹ The Preamble further states that “[t]he guidance regarding transfer pricing methods provided for in the proposed regulations generally is consistent with the current regulatory guidance regarding the transfer pricing methods applicable to transfers of tangible or intangible property *and is consistent with international standards in this area*” (emphasis added).² To evaluate these claims, we surveyed the laws of Belgium, France, Germany, Italy, and the United Kingdom to determine (i) when intra-group services activities are subject to the transfer pricing regimes in these countries; (ii) whether cost-only allocations can be made for non-integral services; and (iii) whether under the laws of each jurisdiction, a deduction would be available to a non-U.S. subsidiary that “benefits” from potentially duplicative “services” provided by its U.S. parent corporation in circumstances similar to those under Proposed Treasury regulation section 1.482-9(l)(4), *Ex. (6)* (“Example (6)”) as described in detail in Part IV, below).

We offer the following summary of our findings:

- Most (but not all) of the European transfer pricing regimes we reviewed generally follow Organisation for Economic Co-operation and Development (the “OECD”) guidance to identify the types of intra-group “services” activities covered by transfer pricing rules. Accordingly, to determine when intra-group services have been rendered, most of these

¹ 68 Federal Register 53447 (Sept. 10, 2003).

² *Id.* at 53449.

jurisdictions focus on whether the recipient or a similarly situated third party would have been “willing to pay” for services and not merely whether “any identifiable increment of economic or commercial value” has been received.

- Many (but not all) jurisdictions allow cost-only allocations for certain non-integral services, either by concluding that the provider’s costs can be deemed to equal (or reasonably approximate) the true arm’s-length price or by permitting cost sharing arrangements;
- Most tax authorities in the jurisdictions we surveyed (i) would scrutinize the facts and circumstances described in Example (6) (discussed in detail in Part IV, below), (ii) would not allow a deduction unless it could be demonstrated that the second opinion was primarily for the benefit of the subsidiary (*i.e.*, that the subsidiary would have procured the second opinion from a third party, or at a minimum, had asked the parent to provide the advice), and (iii) probably would not sustain a full deduction that includes a substantial profit margin for the parent under a range of theories (*e.g.*, that the parent also benefits and allocation is therefore appropriate, that no comparables are available, or that cost allocation is most appropriate for an activity not undertaken for independent profit).

II. DEFINITION OF SERVICES.

In this Part II we briefly survey the rules that apply to determine when intra-group services activities are subject to the transfer pricing regimes in each of Belgium, France Germany, Italy and the United Kingdom. The summaries below note the relationship between domestic law and OECD guidance, particularly the positions expressed in the OECD’s 1995 publication, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the “OECD Guidelines”) because domestic rules are often based on or explicitly follow the OECD Guidelines.³

A. Belgium.

Although the Belgian Income Tax Code (“ITC”) does not include a specialized international transfer pricing regime, it contains several provisions designed to prevent inappropriate profit shifting among affiliated enterprises.⁴ With respect to intra-group services transactions, a key provision allows the Belgian tax authorities to adjust the profits of a Belgian taxpayer that grants “abnormal or gratuitous advantages” to an affiliate, without regard to the

³ *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Comm. on Fiscal Affairs, 1995).

⁴ *See, e.g.*, Articles 26, 54, 79, 207 and 344, par. 2 ITC.

form of those advantages.⁵ For example, this provision would prevent a Belgian taxpayer from deducting excessive amounts charged by an affiliate for intra-group services provided to the Belgian taxpayer. Case law generally defines “abnormal advantages” as those advantages “not consistent with common practice” and “gratuitous advantages” as those granted without consideration.⁶ An “advantage” for these purposes arises when one party obtains a benefit, and the other party does not receive adequate consideration for the benefit it provides.⁷

The Belgian tax authorities generally interpret the concept of “abnormal or gratuitous advantages” in accordance with the OECD Guidelines,⁸ including the arm’s-length principle. Arguably, then, the OECD “benefit test” would apply to determine whether an intra-group service has been rendered. Under this test a service is rendered and an arm’s-length charge would be required if a similarly situated independent enterprise acting at arm’s length would have been willing to pay for the intra-group service or to perform the activity itself.⁹

It also is possible for the Belgian tax authorities to deny a Belgian taxpayer’s expense deductions claimed in respect of intra-group transactions under the general requirements for deducting business expenses.¹⁰ For example, expenses under Belgian tax law can be deducted only if expenditures are made in order to realize (or maintain) the taxpayer’s taxable income.

B. France.

French Tax Authorities have issued several regulations and comments that provide detailed guidance on intra-group transfer pricing.¹¹ In the absence of adequate domestic

⁵ Article 26 ITC.

⁶ Commentary to the ITC, n° 26/16; Supreme Court, October 31, 1979, Bull. Bel., 1980, nr. 590, 2353; Mons, March 1, 1978, J.D.F., 1978, 227; Antwerpen, June 30, 1981, A.F.T., 1981, 274; Antwerpen, May 10, 1994, A.F.T., 1994, 292.

⁷ These definitions are accepted by the Belgian tax authorities. See, e.g., ruling Ci COM/020 of September 21, 1993, Bull. Bel., n° 736/3.94, p. 636.

⁸ In June 1999, the Belgian tax authorities published general guidelines for the application of transfer pricing rules. These guidelines include an annex with a summary translation of the OECD Guidelines and implicitly refer to them for purposes of evaluating whether intra-group transactions are at arm’s length. Circular Letter n° AFZ/98-0003 of June 28, 1999, “Transfer pricing guidelines”, Bull. Bel. September 1999, n° 799. Belgian courts, however, have not always strictly applied the arm’s-length principle embraced by the OECD Guidelines and, therefore, Article 26 ITC should not be interpreted as identical to the arm’s-length principle.

⁹ OECD Guidelines ¶7.6.

¹⁰ See ITC Article 49.

¹¹ “*Documentation Administrative*” (hereinafter, “D. Adm.”).

guidance, the French Tax Authorities¹² and the French Tax Courts¹³ generally can be expected to follow the OECD Guidelines.

The French tax regulations do not specifically define “services,” but provide several examples of service transactions between a French company and its foreign affiliate that are then analyzed from the service recipient’s standpoint. Whether an intra-group activity constitutes the provision of a service subject to the French transfer pricing rules depends principally on whether the “recipient” of the activity, in fact, needed the services rendered (*i.e.*, whether the subsidiary requested or arranged to receive the intra-group services).¹⁴

C. Germany.

The German tax law provides several conceptual approaches for properly reflecting the taxable income of related parties, including constructive profit distributions,¹⁵ constructive capital contributions and¹⁶ transfer pricing rules.¹⁷ The German statutory transfer pricing rules and the related Federal Ministry of Finance guidelines generally follow the OECD Guidelines.¹⁸

¹² D. Adm. 4 A 1214, n° 55, March 9, 2001.

¹³ *Tribunal Administratif de Lyon*, April 25, 1990, n°s 86-9508 and 86-10150, Laboratoires Frisons.

¹⁴ D. Adm. 4 A 1214, n° 19 to 21, March 9, 2001.

¹⁵ Certain transactions that arise because of shareholder’s relationship to its subsidiary and that decrease the profits or property of the subsidiary and benefit the parent (and are not regular profit distributions undertaken pursuant to principles of corporate law) are treated as constructive profit distributions. Federal Tax Court of January 21, 1970, BStBl. II 1970, p. 470; Federal Tax Court of July 3, 1968, BStBl. II 1969, p. 15 and Section 31(3) of the German Corporate Tax Regulations, *Körperschaftsteuerrichtlinien* – KStR. Any act, whether legally significant or otherwise, can give rise to a constructive profit distribution. Thus, the provision of services can give rise to a constructive profit distribution if, for example, a subsidiary provides services to its parent company at an inadequately low price or pays an excessively high price for services received from its parent company. The standard applied to determine the adequacy of the price is that of a careful and conscientious managing director. A constructive dividend distribution does not arise if the corporation, applying this diligence standard, would have accepted the decrease, or would not have insisted on obtaining the prevented increase, in its property under otherwise identical circumstances vis-à-vis a non-shareholder.

¹⁶ Only property that can be recorded as an asset on the balance sheet of a corporation, however, can result in a constructive capital contribution. *Geiger/Klingebiel/Wochinger* in Dötsch/Eversberg/Jost/Witt, *Die Körperschaftsteuer*, Section 8(1) of the Corporate Tax Act (*Körperschaftsteuergesetz*, KStG) at 113 with further references. Accordingly, the services provided by a shareholder to its subsidiary generally cannot be characterized as a constructive capital contribution.

¹⁷ Section 1 of the German Foreign Tax Act (*Außensteuergesetz*, AStG) provides the relevant transfer pricing rules for allocating income and deductions arising out of cross-border commercial dealings of related parties. Section 1 AStG grants the German tax authorities the right in the cross-border context, to adjust a taxpayer’s income in respect of related party transactions with terms that deviate from the terms that unrelated parties would have agreed to under identical or similar circumstances.

¹⁸ *See, e.g.*, the revised segment on cost sharing agreements issued by Federal Ministry of Finance on December 30, 1999.

Income adjustments under the transfer pricing rules require that the German taxpayer and its related party have a “business relationship,” which German courts have described broadly as any commercial exchange of goods *or services*, exclusive of shareholder activities.¹⁹ Statute generally defines the term “business relationship” as any relationship under commercial or contract law (but not the corporate statute) that is part of an activity that would be subject to German income tax provisions, assuming the activity was undertaken in Germany.²⁰ Practically, this definition does not limit the application of the German transfer pricing rules. Similarly, there is no definition of “services” that limits the scope of the transfer pricing rules. (The rules, however, distinguish between commercial, research and development and administrative services).²¹

A German entity must charge for the intra-group administrative services it performs and can deduct payments for the intra-group administrative services it receives, if unrelated parties would have paid for the services. The rules assume that unrelated parties would pay only for services that are clearly definable and measurable and are rendered in the recipient’s own interest (*i.e.*, provide an expected benefit and reduce the recipient’s costs).²² No charge is allowed for services that a subsidiary receives as part of a multinational enterprise, if it would not have acquired and used these services for its own purposes if it had been an independent business.²³ The requirements for deducting payments made to affiliates for intra-group administrative services (and for recognizing income for services provided) echo the OECD’s “willingness to pay” standard.

The German transfer pricing rules also define a set of administrative functions that qualify as shareholder activities. These shareholder activities generally do not constitute “services” within the meaning of the transfer pricing rules and, therefore, need not be charged. Administration, management, control, advisory, and similar activities performed by a shareholder (in its shareholder capacity) for the benefit of the entire enterprise would qualify for this exception.

D. Italy.

Italian transfer pricing rules provide that any intra-group cross-border transactions, including the provision of services, must be priced at fair market value as determined under

¹⁹ BFH, judgment of May 30, 1990, BStBl. II 1990, p.875; BFH, judgment of November 29, 2000, BStBl. II 2002, p. 720.

²⁰ Section 1(4) AStG. The current version is based on an amendment introduced in 2003. The purpose of this amendment was to clarify that Section 1 AStG applies to any relationship based on a contractual agreement, irrespective of whether the relationship is the result of business or shareholder considerations.

²¹ Transfer Pricing Guidelines, *supra*, at 3.2., 3.2.2.

²² Transfer Pricing Guidelines, *supra*, at 6.2.2. Sentence 1.

²³ Transfer Pricing Guidelines, *supra*, at 6.2.2. Sentence 2.

pricing methodologies described in comprehensive regulations.²⁴ The transfer pricing regulations adopt the contents of the OECD’s transfer pricing report issued in 1979²⁵ (but have not implemented the OECD Guidelines).²⁶

Neither the statute nor regulations define “services,” but the tax authorities and taxpayers broadly interpret the term to encompass any provision of economic value not specifically identified in the regulations, (*i.e.*, any provision other than a transfer of tangible or intangible goods, or use of money). In order for an intra-group activity to result in the provision of services to an affiliate member that would be subject to Italian transfer pricing rules, the activity must provide the affiliate with an actual (not merely a potential) benefit. In this regard, when a parent, in its shareholder capacity undertakes activities that relate to its subsidiary, these activities must be evaluated on a case-by-case basis in order to ascertain whether the recipient is effectively benefiting from the service.

In evaluating whether a benefit has been received by the affiliate, Italian tax authorities consider whether the activity is duplicative, whether the affiliate has qualified personnel to perform similar functions, whether the service provider discloses the results to the affiliate; whether the activity is performed as a control function in accordance with the parent’s policies; and whether the results of the activity actually affect or are used by the affiliate.²⁷

E. United Kingdom.

The United Kingdom’s transfer pricing rules were revised in 1998 to require corporate taxpayers undertaking intra-group transactions to comply with the “arm’s-length principle” in accordance with the OECD Guidelines. The transfer pricing rules do not formally define “services,” but consistent with the approach of the OECD Guidelines, the rules²⁸ focus on whether a “provision” has been made or imposed between any two affiliated persons by means of a transaction or a series of transactions. Transactions are defined as “arrangements, understandings and mutual practices (whether or not they are, or are intended to be, legally

²⁴ Article 111, paragraph 7, of Presidential Decree of December 22, 1986, no. 917, as amended and Ministerial Circular of September 22, 1980 no. 32/9/2267, subsequently confirmed by Ministerial Circular of December 12, 1981, no. 42/12/1587.

²⁵ OECD, Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs (1979).

²⁶ Nonetheless, because international law trumps domestic law under Italian constitutional principles, a number of commentators rightly have concluded that taxpayers may rely on commentary in the OECD Guidelines for dealings with affiliates located in countries with which Italy has entered into a tax treaty that follows the OECD Model Taxation Convention. When domestic tax rules are more advantageous, however, taxpayers can apply the domestic rules.

²⁷ An affiliate can “effectively benefit” from an intra-group activity even if it, or a similarly situated third party would not have been willing to pay for the services. This interpretation could prevail even if it conflicts with a treaty provision, if domestic Italian tax rules are more favorable to the taxpayer (*i.e.*, allow it a deduction).

²⁸ Contained in Schedule 28AA Income and Corporation Tax Act 1988 (as amended).

enforceable).²⁹ If the terms of a provision differ from an arm's-length provision, then Inland Revenue may make an adjustment. The statute expressly states that the rules should be interpreted in a manner that best secures consistency with the OECD Model Treaty and the OECD Guidelines.³⁰

The Inland Revenue has published extensive guidance on its approach to these rules, and so far as services are concerned has indicated that “[a] common sense approach, based on a complete review of the facts, is necessary in deciding whether a service has been performed and what the arm's-length price for the services would have been.”³¹ In this regard, the Inland Revenue accepts that not all intra-group dealings give rise to “an actual provision” of services that are subject to the transfer pricing rules. In keeping with the OECD Guidelines, the Inland Revenue considers the economic or commercial value of the services to the recipients, and the extent to which comparable services might be paid for in a transaction between independent parties.³² Determinations regarding whether an “actual provision” has been made (and whether transfer pricing rules should apply), then, implicitly include the “willingness to pay” standard.

Certain activities undertaken in the group context are excluded from the scope of the transfer pricing rules. For example, entity-related activities in a shareholder capacity are excluded (*e.g.*, shareholder meetings, share issues, financing costs related to the acquisition of new subsidiaries, financial reporting requirements including maintaining consolidated accounts). Similarly, the transfer pricing rules do not apply where a subsidiary receives incidental benefits from belonging to a multinational enterprise (*e.g.*, financial reporting information and data) or in certain cases where duplicative activities are provided.

In practice, however, it is fair to say that Inland Revenue excludes very few intra-group activities from the scope of the transfer pricing rules.³³

III. PRICING NON-INTEGRAL INTRA-GROUP SERVICES AT COST.

When intra-group activities are within the scope of the transfer pricing rules of a taxing jurisdiction, the substantive transfer pricing rules of that jurisdiction apply to ascertain

²⁹ Schedule 28AA, para.3(1).

³⁰ Schedule 28AA, paragraph 2.

³¹ Inland Revenue International Manual, paragraph 464050.

³² A relevant example provided by the Inland Revenue is as follows: “A UK subsidiary uses the services of senior personnel from its US parent to provide expertise on general market direction. The subsidiary is unlikely to be able to point to a particular outcome and say ‘that is where they added value.’ Any review would need to ascertain the facts and to ask whether an independent [firm] would have paid for what was actually received. There is the possibility that the facts might indicate that such a general service forms part of general shareholder activity.” International Manual, paragraph 464050.

³³ The Inland Revenue applies these rules in an even-handed manner to require profit imputation for intra-group services performed by a UK affiliate and to allow cost-plus deductions for cross-border payments for intra-group services claimed by a UK company.

whether the pricing of the intra-group transaction is appropriate and does not result in improper income shifting or tax evasion. The current U.S. transfer pricing rules permit an affiliated service provider to charge only the “costs” of non-integral services (*i.e.*, services that are not part of the core business activity of either the service provider or the recipient—but rather are viewed as simply the shared costs of doing business within a multinational group). In this Part III, we survey the rules for pricing non-integral intra-group services transactions in the key European jurisdictions discussed above.

A. Belgium.

As a general rule, Belgium follows the OECD Guidelines in pricing intra-group services, including non-integral services.³⁴ Many multinational enterprises perform headquarters-type support activities in Belgium and therefore Belgium has developed a set of transfer pricing rules for intra-group services.

In particular, the Belgian rules on coordination centers allow for the provision of a wide spectrum of intra-group financial and support services. There are no binding rules that require a coordination center use a particular methodology for charging costs to group members. For intra-group services, coordination centers therefore may apply the OECD Guidelines to determine an appropriate transfer pricing methodology. In practice, coordination centers generally charge their costs to group members, either directly or through an indirect method such as a “cost-sharing”³⁵ or “cost-funding”³⁶ arrangement. A profit margin (typically in a range of 8 to 10 percent) is common for services charged directly to the relevant affiliates (*i.e.*, where the related party is charged for specific services).³⁷ Inclusion of a profit mark-up is much more controversial when the costs of intra-group services are charged through indirect methods. In

³⁴ See discussion in Section II.A, above.

³⁵ Under the cost-sharing method, costs incurred by the coordination center are allocated to each of the group members in accordance with their estimated share of the expected benefits arising from the services.

³⁶ Under a cost-funding method, the coordination center is compensated by contributions from affiliates where each affiliate’s contribution is determined based on broad commercially relevant criteria (*e.g.*, the affiliate’s percentage of the group’s aggregate revenue).

³⁷ This outcome is not necessarily undesirable for a multinational enterprise because coordination centers are low tax vehicles and the affiliate may be subject to a higher tax rate in the tax jurisdiction where it operates (and where it will claim a deduction for the marked-up charge).

these cases, a profit margin would be charged only in accordance with the OECD Guidelines (e.g., if the provision of services is one of the main activities of the enterprise).³⁸

More recently, the Belgian tax authorities have established a framework for obtaining advance pricing agreements that establish the tax base of intra-group service centers.³⁹ In broad outline, service centers are support group units reporting to headquarters offices.⁴⁰ The service center's profit margin agreed in an advance pricing agreement is determined on a cost-plus basis varying between 5 to 15 percent (except for active sales operations). These safe-harbors are non-binding indications of an appropriate arm's-length charge. Significantly, salary and all other personnel-related expenses as well as certain arm's-length third-party disbursements may be recharged at cost by the service center to its affiliates. Belgian service center rules, however, do not allow other costs or expenses to be charged without a mark-up.

European Economic Interest Groupings (*Groupement européen d'intérêt économique/europees economisch samenwerkingsverband*, "EEIG,"⁴¹ a form of business entity organized under the laws of the European Union and roughly analogous to a U.S. partnership), and Belgian Economic Interest Groupings (*Groupement d'intérêt économique/economisch samenwerkingsverband*, "BEIG") also can be used in Belgium to provide intra-group services. The EEIG and BEIG are treated as tax transparent entities for Belgian tax purposes. Because these entities are not organized for the purpose of making profits, the EEIG's and BEIG's expenses are allocated to their members without a profit mark-up for services rendered.

B. France.

French transfer pricing regulations require that the charges for intra-group services be commensurate with the services rendered.⁴² In the case of "common expenses" incurred for the benefit of a group of companies where each company's specific benefit cannot be determined, French tax regulations allow for a straightforward cost allocation.⁴³ This category includes

³⁸ We understand that non-Belgian tax authorities often have disallowed deductions for Belgian coordination centers marked-up charges where indirect methods are used on the theory that these arrangements do not involve any entrepreneurial risk for the coordination center.

³⁹ See Circular Letter Ci.RH.421/486.766 of July 26, 1996, *Bull. Bel.* n° 763. It should be noted that the Belgian service center rules have been blacklisted as a "harmful tax regime" within the meaning of the EU Code of Conduct (see Annex to the Code of Conduct Group Report, November 17, 2003, 14361/03, FISC 173, p. 7).

⁴⁰ Belgian service centers can engage in more than "preparatory and auxiliary" activities within the meaning of Article 5(4) of the OECD Model Treaty. Thus, a service center may provide assistance and information to group customers, function as a central order processing unit and also can engage in sales operations by accepting orders on pre-established conditions.

⁴¹ Council Regulation (EEC) No 2137/85 of 25 July 1985. EEIGs are recognized by other European Union members, although in practice they are relatively uncommon.

⁴² D. Adm. 4 A 1214, n° 19 to 21, March 9, 2001.

⁴³ D. Adm. 4 A 1214, n° 25, March 9, 2001.

certain holding company expenses that benefit other group members,⁴⁴ such as management expenses (including managers' compensation),⁴⁵ financial expenses, (e.g., interest accrued on bonds issued to finance the shared activities of the entire group),⁴⁶ and merger expenses.⁴⁷ Under the French transfer pricing regulations and applicable case law, costs would be allocated by comparing the French enterprise's revenues and the revenues of the entire group.⁴⁸

Other vehicles, such as Economic Interest Groupings ("*Groupements d'Intérêt Economique*," "GIE") or European Economic Interest Groupings (EEIGs), are financed with member contributions to provide in certain circumstances ancillary services to the members. French tax authorities recognize that those entities are not operated to earn independent profits⁴⁹ and therefore, the GIE's expenses can be allocated among the beneficiaries without imputing a profit mark-up.

As a general matter, services provided to a specific subsidiary or branch that do not benefit the entire group and are not provided through a GIE must be charged on a "*cost-plus*" basis. These services need to be provided for the benefit of the recipient and be commensurate with the compensation paid. A multinational enterprise that sets up headquarters ("*quartiers généraux*") in France generally can obtain a ruling from the French tax authorities that requires the headquarters to include income on a cost-plus basis in respect of its activities.⁵⁰ This headquarters arrangement only may be used to provide services that do not have a readily ascertainable market value (e.g., information technology, research and development, and financial analysis).⁵¹

⁴⁴ D. Adm. 4 H 1414, n° 42 and 43.

⁴⁵ *Conseil d'Etat* (French Administrative Supreme Court), May 8, 1944, n°s 66.968 and 68.362 cited in D. Adm. 4 H 1414, n° 43-1°.

⁴⁶ D. Adm. 4 H 1414, n° 43-2°.

⁴⁷ D. Adm. 4 H 1414, n° 43-3°.

⁴⁸ Other acceptable methods would compare the profits or the assets of the French enterprise to the profits or assets of the whole group, but the regulations emphasize that these methods have more drawbacks than the method based on revenues.

⁴⁹ For example, the French Tax Authorities' regulations for the tax treatment of Economic Interest Groupings explain: "the purpose of a grouping shall be to facilitate or develop the economic activities of its members and to improve or increase the results of those activities; its purpose is not to make profits for itself. This principle does not prohibit the GIE to earn profits, but means that the profits arising from the GIE's activity must not be kept by the GIE but pass to its members" (D. Adm. 4 H 1211, n° 2, March 1, 1995).

⁵⁰ The mark-up of the headquarters services traditionally has varied from 8 to 10 percent. The *quartiers généraux* treatment does not differ substantially from the direct provision of services that generally must be charged at cost plus. Because of the type of services provided, even if the benefit of these headquarter services cannot be identified specifically, cost-only allocations are not permitted.

⁵¹ According to Revenue Ruling ("*Instruction*") 13 G-1-97 of January 21, 1997, n°s 13 and 14, such services may include direction, management, coordination and supervision services in the following areas: administration, information technology, strategy, human resources, communication, research and

C. Germany.

The German transfer pricing guidelines do not provide a safe harbor under which non-integral services may be charged at cost. The transfer pricing guidelines distinguish administrative services from other services (which distinction is similar, but not identical to, the distinction between integral and non-integral services), and require an arm's-length charge for administrative services (other than shareholder activities excepted from the transfer pricing rules). The guidelines explicitly provide that the cost-plus method should be used if comparable market prices are not available.⁵² Accordingly, the direct provision of administrative services (*i.e.*, without a cost contribution arrangement) may not be charged at cost.

German law, however, provides for a variety of indirect approaches for charging non-integral services at cost. For example, cost sharing agreements are contracts concluded between affiliated enterprises located in different jurisdictions to render or receive services for the benefit of all the parties on a long-term basis through a jointly operated pool.⁵³ All direct and indirect expenses that are connected with the pool's services may be included in the amount to be allocated among the pool members. Because the pool is not operated for independent profit, for German tax purposes no profits are imputed to the pool and only the pool's connected expenses must be allocated to the pool members.⁵⁴

Similar arrangements also allow cost-only charges. When a cross-border commercial partnership performs services for a partner, the remuneration may be charged at cost.⁵⁵ This rule also would apply to a German resident European Economic Interest Grouping (*Europäische Wirtschaftliche Interessenvereinigung*), which under German commercial law qualifies as a commercial partnership.⁵⁶ Finally, we note that German resident co-operatives (*Genossenschaften*) also may charge their members at cost for all services performed.⁵⁷ We are not aware of examples, however, where German resident co-operatives have been used in international tax planning.

development, back-office and some financial analysis functions. Logistics centers also can get a ruling from the French Tax Authorities to be taxed on a "cost-plus" basis for their storage, packaging, labeling and distribution activities.

⁵² Transfer Pricing Guidelines, *supra*, at 6.4.1.

⁵³ Letter of the Federal Ministry of Finance of December 30, 1999 (BStBl. I 1999, p. 1122).

⁵⁴ Federal Ministry of Finance of December 30, 1999, *supra*, at 2.2.

⁵⁵ See Federal Tax Court, judgment of March 24, 1983, BStBl. II 1983, p. 598 (599).

⁵⁶ See Section 1 of the EWIV Execution Act and Letter of the Federal Ministry of Finance of November 15, 1988, DB 1989, p. 354.

⁵⁷ See Federal Tax Court, judgment of October 11, 1989, BStBl. II 1990, p. 88 and Section 31(3) Sentence 19 KStR).

D. Italy.

The Italian transfer pricing regulations apply either a direct or an indirect pricing methodology to determine the appropriate transfer price for intra-group services, depending on whether market comparables are available for the related party transaction at issue and on other related facts and circumstances.⁵⁸ The transfer pricing rules, however, provide that a mark-up may be charged only if the intra-group services are rendered as part of the principal activity of the provider. Otherwise, the services must be charged at cost. In particular, the transfer pricing regulations state that no mark-up may be applied for services that are:

- (i) strictly related to the group's structure, are not part of the provider's principal activity, and do not have a specific market value;
- (ii) rendered by an independent party to the affiliate that charges back the expense; or
- (iii) related to the ordinary management and administration activities of the parent company.

Cost sharing agreements generally are permitted although the regulations impose certain restrictions on the use of these agreements to prevent inappropriate income shifting. In particular, the regulations require certain adjustments when cost allocations among group members are based on each group member's revenue. In addition, the regulations deny a deduction for (i) cost contributions made by an affiliate that only sells goods produced by the parent on the assumption that expenses incurred would be embedded in the price of the goods, or (ii) any portion of a cost contribution including a mark-up for the parent company on the theory that these costs are not related to the parent's main activity.

E. United Kingdom.

The Inland Revenue, in keeping with the OECD Guidelines, accepts that different pricing methodologies are appropriate for different types of services, including the cost-plus basis. In certain limited circumstances, recharge at cost also may be appropriate. In determining the proper intra-group price for a "provision," Inland Revenue examines a number of factors, including:

- (i) the costs of providing the service;
- (ii) the costs of obtaining an alternative service;
- (iii) the expected benefit;
- (iv) the state of the market at the relevant time; and

⁵⁸ In addition, the regulations describe certain criteria to be taken into account when applying indirect pricing methods, such as the cost incurred by the service provider, the time incurred to complete the service, recurrence of the service, the independent or ancillary nature of the service, and the business risk borne. The cost is to be charged separately, and not embedded in the consideration agreed upon in other transactions entered into by the same related parties.

(v) the financial position of the provider and the recipient.⁵⁹

The above list is not comprehensive. There are no special rules for non-integral intra-group services, nor are there any available cost-only safe harbors that allow taxpayers to automatically pass through amounts charged by affiliates or third parties.

While Inland Revenue permits cost contribution arrangements, UK domestic law does not expressly authorize their use. Rather, conservatively structured cost contribution arrangements are accepted because Inland Revenue follows the OECD Guidelines.⁶⁰ In some cases, these arrangements can include headquarters and other administrative expenses. The Inland Revenue, however, can closely scrutinize any arrangement to ensure that it does not abuse the arm's-length principle.

IV. DEDUCTIONS FOR POTENTIALLY DUPLICATIVE SERVICES.

In this Part IV we consider for each jurisdiction whether (and to what extent) a subsidiary could deduct payments to its U.S. parent for the duplicative legal services the parent provides to the subsidiary in the factual scenario described in Proposed Treasury regulation section 1.482-9(l)(4), *Example (6)* (defined above as “Example (6)”). In Example (6), a subsidiary is involved in negotiating a complex joint venture that raises sophisticated legal issues. The subsidiary's outside law firm, which possesses the relevant specialized expertise, reviews the transactions and opines on key issues. The parent company's in-house legal staff (which also specializes in these issues) reviews the same contracts, and though its review substantially duplicates the law firm's services, the parent's efforts also reduce the commercial risk of the transaction.

Example (6) concludes that the subsidiary obtains a “benefit” from the duplicative legal review (because the second legal opinion reduces the commercial risk of the transaction), and the services provided by the parent are thus subject to the substantive transfer pricing rules. No inquiry appears necessary as to whether the parent would have charged for the transaction or

⁵⁹ International Manual, paragraph 464050.

⁶⁰ Income and Corporation Taxes Act 1988, Schedule 28AA, paragraph 2.

whether the recipient of this “additional benefit” would have been willing to pay an unrelated party for this second opinion—or even whether the subsidiary requested the second opinion (or, alternatively, and more probably, whether the parent required the review for its own purposes). Similarly, there is no discussion as to whether a second opinion is typically obtained under the circumstances.

A. Belgium.

To deduct payments for services provided by an affiliate, a Belgian company must demonstrate that the services were “effectively provided” for its benefit and that the payments were made to obtain or maintain the Belgian entity’s taxable income.⁶¹ Although there is no published guidance on this issue, services arguably are provided for the benefit of the Belgian company if the Belgian company would pay a third company to obtain the same service (as discussed in Section II.A, above). Expenses paid for purely duplicative activities may not be deductible, therefore, because these payments ordinarily are not made to obtain or maintain taxable income. Nonetheless, the Belgian tax authorities would have considerable discretion in interpreting and applying these standards to the facts of Example (6).

It is doubtful that the Belgian tax authority generally would accept that a theoretical reduction in the Belgian subsidiary’s commercial risk (as in Example (6)) effectively provides the Belgian subsidiary with a benefit. Specifically, if the tax authorities prove that the subsidiary ordinarily would not be expected to pay a third party to obtain this benefit, the deduction of the expense most likely would be disallowed (because it would not have been made for the benefit of the Belgian subsidiary).

If, depending on the specific facts, the Belgian subsidiary obtained a benefit for which a third party ordinarily would be expected to pay and that the expense is made to obtain or maintain taxable income (*e.g.*, the subsidiary doubts that the advice of outside counsel is complete and correct, and therefore asks legal staff of the parent to review the transaction documents), this expense should be deductible. In the event the tax authorities can prove that both the U.S. parent and the Belgian subsidiary benefited from the service provided, a cost allocation might be required, resulting in only a partial deduction of the expense by the Belgian subsidiary.

B. France.

In general, the French tax authorities would deny a deduction for payments to a related party to procure duplicative services unless the French subsidiary can demonstrate that (i) it

⁶¹ See ITC Article 49.

needed the additional services, and (ii) the compensation paid is commensurate with the service rendered.⁶²

Under the facts described in Example (6), there is significant risk that the French tax authorities would view the advice of an outside counsel as sufficient, and, accordingly treat the second opinion as unnecessary.⁶³ Moreover, it would be very difficult for the French subsidiary to demonstrate that the compensation it pays is commensurate with the services rendered because the French tax authorities may not view the affiliate provided services in Example (6) as comparable to services provided by third parties. Sustaining a deduction for more than cost-plus would be particularly difficult in this regard.

C. Germany.

If the situation described in Example (6) involved a German subsidiary, the German tax authorities would apply the constructive profit distributions rules and transfer pricing rules to determine whether the income of the German subsidiary must be adjusted.⁶⁴

A payment would not be deemed a constructive profit distribution if the subsidiary, applying the standard of a careful and conscientious managing director, would have instructed an unrelated third party expert to provide a second legal opinion for a fee.⁶⁵ This would be the case if the subsidiary reasonably believed that the expected benefit from obtaining the second legal

⁶² At the outset French tax authorities would have the burden of proof on transfer pricing matters, but this burden then shifts to the taxpayer. Specifically, the French tax authorities must produce evidence to establish a *prima facie* case that the challenged transactions are abnormal. If this evidence is produced, the taxpayer must produce accurate information with respect to these transactions demonstrating compliance with the appropriate transfer pricing methodology.

⁶³ If the services were rendered by an affiliate without the prior request of the French subsidiary, it is doubtful that the French tax authorities would agree to the deduction of the compensation paid. A French company would be entitled to a deduction for services provided at its request or at least with its previous consent (*e.g.*, by virtue of a “master” agreement with an affiliate company to “subscribe” to such services for a certain period of time).

⁶⁴ Where a constructive profit distribution arises, German withholding tax would be imposed.

⁶⁵ The German tax authorities, in general, would have the burden of proving that a careful and conscientious managing director would not have procured a second legal opinion from an independent law firm for a fee. In this regard, the tax authorities generally bear the burden of proof for the existence of a constructive profit distribution (Section 31(8a) Sentence 1 of the German Corporate Tax Regulations and *Wochinger* in *Dötsch/Eversberg/Jost/Witt*, Die Körperschaftsteuer, Section 8(3) of the Corporate Income Tax Act at 124 et seq.). The taxpayer, however, must clarify the facts of the case to enable the tax authorities to determine whether the conditions for a constructive profit distribution are fulfilled. At the beginning of 2003 the German legislature adopted new statutory provisions that require taxpayers to provide detailed documentation on cross-border business transactions with related persons within a reasonable period of time. This documentation must establish the adequacy of transfer prices by expressly describing the *economic and the legal* basis for the pricing as well as all other relevant business circumstances. The form and the type of the documentary requirements are described in an ordinance (*Rechtsverordnung*) published by the German Ministry of Finance on October 28, 2003. If the taxpayer cannot provide such documentation, the burden of proof on the requirements of constructive profit distributions or of the German transfer pricing provision (Section 1 AStG) may shift from the tax authorities to the taxpayer.

opinion would justify the additional cost. If a careful and conscientious managing director would not have incurred this expense, the intra-group payment would be treated as a constructive profit distribution (*i.e.*, a dividend subject to German withholding tax).

The German transfer pricing rules would follow the same basic analysis. The subsidiary could deduct a payment for the legal services provided by the parent company if the services are rendered in the subsidiary's own interest (*i.e.*, the services provide an expected benefit and reduce the subsidiary's costs).⁶⁶ Even if the subsidiary obtains a "benefit" from the duplicated service, the subsidiary could not deduct the payments if it ordinarily would not have been expected to pay a third party to obtain a second opinion.⁶⁷ If, however the subsidiary would have paid a third party, it would be entitled to deduct the amount paid, which could include a substantial mark-up if this amount was comparable to what an independent party would have paid (and the services were comparable). As a practical matter, however, it would be difficult to convince the tax authorities that the in-house legal services were in fact comparable to independent services and that a substantial mark-up on the services is justified.

D. Italy.

In practice, it would be difficult for an Italian subsidiary to sustain a deduction for payments made to the parent for the second legal opinion described in Example (6) even if the parent only charged for its costs in providing the legal services.⁶⁸ First, it is not clear that the Italian subsidiary would be treated as receiving an "effective benefit" under Italian tax principles (*i.e.*, merely reducing the theoretical risk of incorrect legal advice may not be sufficient to satisfy this standard). Second, the Italian tax authorities could argue that the parent's in-house legal department had reviewed the documentation in exercising its ordinary control and supervision activities.

If, however, the subsidiary can demonstrate that the parent's review, in fact, reduced commercial risk (which would be difficult to prove because in-house counsel simply concurred with the outside counsel's opinion), then the parent's charge for providing the services (which generally cannot exceed the parent's cost of providing these services) would be deductible by the

⁶⁶ The Transfer Pricing Guidelines do not expressly address the provision of duplicative services.

⁶⁷ *But see* Baumhoff in Flick/Wassermeyer/Baumhoff, *Außensteuerrecht*, Section 1 AStG at 635.5 with reference to the OECD Guidelines, ¶ 7.11, which expresses the opinion that, even if the service recipient does not reduce the subsidiary's costs because the same service is duplicated, this may not generally lead to the prohibition of a charge for the respective service. In Baumhoff's view, the duplication of advisory services in exceptional circumstances can produce increased certainty for the recipient's decision and thus provide a benefit. Baumhoff concludes that in this case, the advisory services are rendered in the recipient's own interest so that a charge can be made for such services.

⁶⁸ This conclusion is based on our interpretation of applicable regulations. Apart from these regulations, there is very little administrative practice and case law. In this regard Italian tax authorities only recently (generally, within the last decade) began conducting comprehensive transfer pricing audits because of the sophistication and resources these audits require.

subsidiary. A profit mark-up could be charged to the extent that supplying legal services within the group is one of the parent's main activities.⁶⁹

E. United Kingdom.

A UK subsidiary would be unlikely to sustain a deduction for the duplicative legal services provided by the parent. The basic UK tax rule for deducting business expenditures is that no deduction may be made in respect of expenditures, "not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."⁷⁰ If there is a duality of purpose (*i.e.*, the expenditure benefits both the subsidiary and the parent), then it would fail the "wholly and exclusively" test.

The UK subsidiary's position would be improved in Example (6) if the UK subsidiary could show that the parent provided in-house legal advice at the subsidiary's request and that the UK subsidiary otherwise would have obtained a second opinion from outside lawyers to protect its own commercial position. In that case, it would be easier for the UK subsidiary to demonstrate that it had obtained the second legal opinion solely for its own benefit and that the parent as shareholder was only incidentally benefited. Assuming the UK subsidiary could overcome this initial hurdle, it could then seek a deduction for the arm's-length price paid for the legal services. Bearing in mind the differences in the circumstances, the Inland Revenue, however, may not view third-party law firm fees as an appropriate comparable for determining the arm's-length price.

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⁶⁹ There is no explicit regulatory or case law authority in the transfer pricing area on the question of what constitutes a main activity. Among other factors that may indicate a service provider's main activity is the corporate mission as reflected in the corporate documents and the type and volume of actual activities performed. The Italian tax authorities would generally consider third-party legal fees as a reasonable comparable, but may require that a portion of the charges be allocated to the parent to the extent that the parent benefits from the services.

⁷⁰ Section 74(1)(a) Income and Corporation Taxes Act 1988.