New IRS Rules for Transfer Pricing of Services Teleconference

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Making the Transition
Shared Services Arrangements
Avoiding Non-US Problems

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Making The Transition

- Must use new rules for years beginning Jan. 1, 2008 or later. (Documentation required by September 15, 2009 or later)

- May elect to use for years beginning after Sept. 10, 2003

- For years beginning Jan. 1, 2007 through Dec. 31, 2007 may use old rules, but must apply “business judgment rule” of the new rules

Making The Transition

An economist's view:

- Any service that fails the business judgment test would also fail the old safe harbor tests
- The new emphasis on the taxpayer's judgment may leave more room for interpretation, although the IRS certainly thinks they have clarified the rules
- More likely just another example of trying to fix an enforcement problem by issuing new rules

Making The Transition

The IRS believes taxpayers use services to transfer valuable intangibles to non-U.S. affiliates

- If this is obviously not a possibility, then do whatever is easiest
- If it is not totally irrational for the IRS to wonder if your inter-company services involve valuable intangibles, then an early transition may be worth the effort

Shared Services Arrangements

- OECD Guidelines recognize services cost sharing as a form of cost contribution arrangement (CCA)
- The IRS version (qualified cost sharing arrangement) is limited to intangible development, but the old services safe harbor allowed U.S. taxpayers to charge cost for services that would have been under a CCA
- The shared services arrangement (SSA) covers the gap left by repeal of the safe harbor
- SSA is an administrative rule, so documentation that requirements were met is absolutely essential

Requirements For SSA

- Only SCM services (specified or low margin)
- 2 or more participants (participant is controlled taxpayer that reasonably anticipates benefits from the SSA)
- Must include <u>all</u> controlled taxpayers that reasonably anticipate a benefit from one or more of the shared services (Examples 20-23 say renderer need not anticipate a benefit)
- Each shared service or reasonable aggregation of services must benefit at least one participant (Example 23 aggregates services even though one participant does not benefit from some services included in the aggregation)

Requirements for SSA

Allocation of costs by reasonably anticipated benefits:

- Reasonably anticipated, whether or not realized
- Most reliable allocation under best method rule
- Aggregation must be reasonable based on facts & circumstances, including effect on allocation of benefits (Example 22 aggregates 2 types of services that required different allocation keys in Examples 20 & 21, then uses 3rd allocation key)
- Annual updating of reasonably anticipated benefits (Each year the allocation basis must be consistent for all participants & services, and must reasonably reflect shares of reasonably anticipated benefits <u>in that year</u>)
- SSA allocations must be made before allocations under qualified cost sharing arrangements

Documentation For SSA

- Statement of intention to apply SCM to evaluate arm's length charge for services under SSA
- List of participants & renderer or renderers
- Description of basis of allocation to participants
- Description of any aggregation of covered services, and consistency with basis of allocation
- If SSA includes aggregation of low margin covered services, description of any difference from the aggregation used for comparables for any low-margin covered services
  - Differences allowed if "such alternative aggregation can be implemented on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary"
  - Probably means they want assurance that comparables do not have high margin services offset by other activities

Suggestions For Documentation

- Be sure documentation addresses every requirement
  - Especially allocation keys
- Be sure SSA services really are covered
  - Explain any public statements about the importance of support functions or systems
- Don’t be afraid to aggregate services, but do try to provide reasonable explanations
- If SSA is not limited to specified services, pay special attention to the comparables

Avoiding Non-U.S. Problems

- Avoid new U.S. terminology in documentation that will be seen by other governments, or at least include the OECD name for the method you use
- Try to ensure your documentation answers the kinds of questions you would ask if you didn’t know much about the company and industry, but needed to decide whether prices were arm’s length
- When comparables are needed, pay special attention to risk
- In a SSA, be wary of having a renderer that does not expect to benefit