

### **Beware the New Transfer Pricing Regulations for Shared Services**

Since 1994, U.S. companies have been allowed to calculate the intercompany prices for providing services to affiliated companies by simply allocating the costs of such services amongst the users, i.e., no profit element was required. In a dramatic shift, the IRS has released final regulations regarding the treatment of controlled services transactions for tax years beginning after July 31, 2009. The most important feature of the new regulations is that intercompany charges for services by U.S. taxpayers to their foreign affiliates can no longer be priced on an “allocation of cost” basis unless the services are of specified types and/or specific conditions are met. These new regulations replace the “safe harbor” cost allocation rules of the 1994 regulations and require that the amount charged for services in a controlled transaction be determined using one of the seven methods set forth in the regulations:

- > The services cost method;
- > The comparable uncontrolled services price method;
- > The gross services margin method;
- > The cost of services plus method;
- > The comparable profits method;
- > The profit split method; or
- > An unspecified method.

The Services Cost Method (“SCM”) is now the only choice that allows the price for certain covered services to be the total service costs with no markup. But in order to qualify for no markup, the services involved must:

- > (A) meet certain narrow conditions and
- > (B) be “covered services.”

Further, the SCM will apply only if the taxpayer elects to use it.

The aforementioned conditions include four elements:

1. Services may be covered by the SCM only if the taxpayer reasonably concludes that the covered services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both.
2. The service renderer must keep adequate books and records relating to the services.
3. The taxpayer must place in those books and records a statement showing that the taxpayer intends to apply the SCM to these services.
4. The following types of transactions, in whole or part, are not covered services:
  - > Manufacturing
  - > Production
  - > Extraction, exploration, or processing of natural resources
  - > Construction
  - > Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement
  - > Research, development, or experimentation
  - > Engineering or scientific activities
  - > Financial transactions, including guarantees
  - > Insurance or reinsurance (For these types of services, allocation on a cost basis is not permitted, and a mark-up has to be computed based on a method other than the service cost method.)

(continued)

# Baker Tilly Tax Alert

## July 1, 2010



Candor. Insight. Results.

Covered services are controlled services that qualify as either:

- > Specified controlled services
- > Low-margin covered services

Specified controlled services are controlled services transactions that the Service specifies as such from time to time. In fact, Revenue Procedure 2007-13 specifies 101 types of services that may be covered services and that fall into the following general categories: Payroll services; handling premiums for unemployment, disability, and workers compensation; handling accounts payable and receivable; general administrative services; corporate and public relations; meeting coordination and travel planning; accounting and auditing; tax services; handling health, safety, environmental, and regulatory affairs; budgeting; treasury activities; statistical assistance; staffing and recruiting; training and employee development; information technology services; legal services; insurance claims management; and purchasing.

Low-margin covered services are controlled services transactions for which the median comparable mark-up on total services costs is less than or equal to seven percent.

In the event that the SCM does not apply, then the taxpayer must use the alternative method that is most appropriate for the particular service being rendered. This requirement creates the possibility that a taxpayer might have to employ a number of pricing approaches depending upon the type(s) of services at issue.

All taxpayers to which the regulations apply should revisit the nature and pricing of their intercompany charges for services as soon as practicable. It is now likely that many service charges will require a profit mark-up and the IRS will expect that sufficient analysis and documentation be available for their review at the time of an audit.

The new regulations also attempt to clarify related issues including the determination of the owner of intangible property, the treatment of services connected with the development of intangibles, and contingent payment services arrangements.

Our experienced transfer pricing team is well prepared to assist our clients with transfer pricing planning, practices, and documentation needs. If you have questions or require further information, please contact your Baker Tilly tax advisor or send an e-mail to [tax@bakertilly.com](mailto:tax@bakertilly.com)

[bakertilly.com](http://bakertilly.com)

An independent member of Baker Tilly International

Baker Tilly refers to Baker Tilly Virchow Krause, LLP, an independently owned and managed member of Baker Tilly International. © 2010 Baker Tilly Virchow Krause, LLP.

Disclosure: The information provided here is of a general nature and is not intended to address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought. Pursuant to the rules of professional conduct set forth in Circular 230, as promulgated by the United States Department of the Treasury, nothing contained in this communication was intended or written to be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer by the Internal Revenue Service, and it cannot be used by any taxpayer for such purpose. No one, without our express prior written permission, may use or refer to any tax advice in this communication in promoting, marketing, or recommending a partnership or other entity, investment plan, or arrangement to any other party.