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Business Judgment Test for Services: Judgment or Process?

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Introduction

The Internal Revenue Service Dec. 20 issued administrative guidance, notably Notice 2007-5, on the 2006 temporary regulations governing the transfer pricing of controlled services transactions.[1] The IRS notified taxpayers that they can continue pricing services at cost under the cost safe harbor in 2007 only if and to the extent such services satisfy the business judgment test.[2] Further, taxpayers will need to document or otherwise evidence their compliance with the business judgment test in 2007 to ensure that transfer pricing penalties will not be imposed.

Although the business judgment test itself was clarified in important ways by Notice 2007-5, it remains a highly subjective test. Because of the effective date rule, the business judgment test will have elevated significance in 2007 before settling into its permanent secondary role as a backstop to the much narrower services cost method of the temporary regulations.

This article provides a preliminary analysis of the business judgment test based in part on the interpretation of similar tests in analogous areas of the law. In particular, the article suggests that taxpayer positions should be afforded a high level of deference by the IRS and should be scrutinized only in rare cases. Further, in the rare cases where the IRS concludes that a taxpayer position merits scrutiny, the focus generally should be on the process by which the taxpayer came to its business judgment, rather than on the merits of the judgment itself.

Overview of Business Judgment Test

The business judgment test was introduced by the temporary regulations issued in August 2006 as one of several tests aimed at distinguishing between services that may be priced at cost under the new services cost method and services that must be priced on the basis of the arm's length standard. Services fail the business judgment test, and therefore are not eligible to be priced at cost under the services cost method of the

[1] Notice 2007-5, 2007-3 I.R.B. 1 and Rev. Proc. 2007-13, 2007-3 I.R.B. 1, released 12/20/06. The Notice generally delays for one year the effective date of the temporary regulations as applied to ''non-integral'' services eligible for at-cost pricing under the pre-2007 regulatory cost safe harbor. However, there is one exception to the one year delay—services are eligible for at-cost pricing under the regulatory safe harbor only if and to the extent the services satisfy the so-called ''business judgment'' test of the temporary regulations (15 *Transfer Pricing Report* 657, 1/3/07).

[2] Note that the effective date of the temporary regulations is delayed only with respect to ''the identification of controlled services eligible to be priced at cost'' under a regulatory safe harbor. Notice 2007-5, §3.01. Thus, taxpayers may need to modify their policies to reflect other aspects of the temporary regulations that may apply to services priced at cost under a regulatory safe harbor, such as the inclusion of stock option costs in the cost base. *See* Temp. Treas. Reg. §1.482-9T(j) (2006).

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temporary regulations, unless the taxpayer "reasonably concludes in its business judgment 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 controlled group.[3]

The preamble states that the IRS will apply a facts and circumstances test to evaluate the reasonableness of the taxpayer's business judgment. This is reiterated by Notice 2007-5, which adds that no source is generally more probative than another to establish the reasonableness of the taxpayer's business judgment.[4] Notice 2007-5 also sensibly provides that an application of the business judgment test should take into account whether a particular activity contributes to the operating profit (as defined in Treas. Regs. §1.482-5(d)(3)) of one or more controlled parties; thus, the activities performed by a corporate tax department should not fail the business judgment test to the extent they affect foreign and domestic income taxes, which are not classified as operating expenses.[5]

The temporary regulations provide a series of examples that illustrate the application of the business judgment test. In general, these examples juxtapose fact patterns in which similar categories of services meet or fail the business judgment test in turn. Approximately half the examples conclude that "under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services" satisfy the business judgment test. Divining any overarching principles from the examples is difficult and the conclusions are presented without analysis. It is noteworthy that several of the examples describe services that likely would be regarded as integral services under the pre-2007 regulatory framework.[6]

Business Judgment Test—Deference to Taxpayers' Judgment

The examples in the regulations focus on the appropriateness of a position considered by a taxpayer without reference to a challenge by the IRS. Thus, none of the examples illustrate the application of the test in a case in which the taxpayer takes the position that the services satisfy the business judgment test and the IRS challenges that position on audit. The examples therefore provide no guidance on the deference owed by the IRS when examining the reasonableness of a taxpayer's business judgment, or the process by which the IRS should go about scrutinizing the position of taxpayers.

[3] Temp. Treas. Reg. §1.482-9T(b)(2), as modified by Notice 2007-5, §3.04(1). Notice 2007-5 clarified that the business judgment test applies at the level of the controlled group, as defined in Treas. Reg. §1.482-1(i)(6). *See* Notice 2007-5, §3.04(1) (15 *Transfer Pricing Report* 214 8/2/06).

[4] Notice 2007-5, §3.04(3).

[5] Notice 2007-5, §3.04(2).

[6] *Compare, e.g.,* Temp. Treas. Reg. §1.482-9T(b)(6), Example 9 (data verification services performed for controlled taxpayers fail the business judgment test where similar activities are performed for third parties in the context of the renderer's trade or business) *with* Treas. Reg. §1.482-2(b)(7)(v) (2006), Example 1 (printing services for controlled taxpayer treated as integral services where similar activities are performed for third parties in the context of the renderer's trade or business).

The preamble to the temporary regulations, as well as Notice 2007-5, does provide guidance regarding the appropriate level of deference that should be exercised by the IRS when examining this issue. The preamble to the temporary regulations indicates that the IRS anticipates the business judgment test to be applicable only in rare circumstances. According to the preamble, "[t]here will be little need in all but the most unusual cases to challenge the taxpayer's reasonable business judgment."[7] Notice 2007-5 reiterates that the IRS generally will defer to the judgment of the taxpayer in applying this test. Indeed, Notice 2007-5 rejects calls by commentators to include explicit language to that effect in the text of the temporary regulations itself on the basis that such language would be superfluous, reiterating that "the temporary regulations already incorporate a high threshold for the application of the business judgment rule."[8] In particular, Notice 2007-5 provides as follows:

> The [business judgment] test is satisfied by a reasonable exercise of the taxpayer's business judgment, not a reasonable exercise of the IRS's judgment in examining the taxpayer. In the view of the Treasury Department and the IRS, the gloss in the preamble to the temporary regulations, such as that this is a business judgment preeminently within the business person's own expertise, flows directly from the regulations' specification that the matter lies in the taxpayer's reasonable business judgment.[9]

Thus, the preamble to the regulations, as well as Notice 2007-5, states that the IRS will afford a high level of deference to the positions taken by taxpayers with respect to the business judgment test. This position is consistent with the interpretation of similar tests in other areas of the law. For example, in the context of the accumulated earnings tax under Internal Revenue Code Sections 531-537, which is applicable only if a company has accumulated earnings beyond its "reasonable business needs," courts frequently state that the existence of reasonable business needs is a matter for the officers and directors of the corporation to decide. Therefore, courts hesitate to substitute their judgments unless the facts and circumstances clearly warrant the conclusion that the accumulation was unreasonable in amount and was retained for the prohibited purpose.[10]

Similarly, in the context of corporate law, the business judgment rule provides a high level of deference to the decisions of corporate directors provided that the directors exercise the care "that a person in a like position would reasonably believe appropriate in similar circumstances."[11] The business judgment rule often arises in shareholder derivative suits that accuse officers or directors of violating their fiduciary duty of care to shareholders. Under the context of the business judgment rule, a court typically "will not substitute its own notions of what is or is not sound business judgment" if

[7] *See* 71 Fed. Reg. 44,466-67 (Aug. 4, 2006).

[8] Notice 2007-5, §3.04(3).

[9] *Id.*

[10] *See, e.g., Thompson Eng'g Co. v. Comr.*, 751 F.2d 191, 197 (6th Cir. 1985) ("The determination of reasonable needs of its business is, in the first place, a task for the officers and directors of a corporation. . . . IRC Section 531 does not empower the tax court to substitute its judgment for the corporation's officers concerning whether corporate dividends should be declared.").

[11] Model Bus. Corp. Act §8.30(b) (1984).

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"the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[12]

The parallels between these contexts and the transfer pricing context, of course, are not exact. For example, in the context of both the accumulated earnings tax and the corporate business judgment rule, courts are evaluating business decisions by business actors that have import outside of the legal framework being considered. The decision to accumulate and reinvest earnings is first and foremost a business decision. In the transfer pricing context, on the other hand, the decision to characterize a service as one that does not contribute to a core capability of a corporate group has no non-tax consequences.

On the other hand, the language used by the IRS in the preamble to the temporary regulations, as well as in Notice 2007-5, to describe the deference it intends to afford taxpayers in the transfer pricing context is virtually identical to the language employed by courts in the context of the accumulated earnings tax and the business judgment rule. Thus, it seems helpful to analyze such authorities to determine steps taxpayers could take to ensure that their application of the business judgment test is not challenged by the IRS. Further, an analysis of these authorities reveals concrete steps the IRS could consider to ensure that the business judgment test is interpreted and administered in a manner consistent with its expressed intent.

Business Judgment Test—Focus on Process

Notice 2007-5 and the preamble to the temporary regulations state the IRS will afford a high level of deference to the positions taken by taxpayers with respect to the business judgment test. Although such statements have not been included in the regulations themselves, Notice 2007-5 says that such deference is consistent with the essence of any test that hinges on the reasonable business judgment of business actors. As discussed briefly above, this is consistent with the interpretation of similar tests by courts in the tax and non-tax contexts.

Beyond the basic proposition that the IRS will afford a high level of deference to taxpayers, however, the regulations leave many practical questions unanswered:

- How will such deference be manifest in practice?
- How will the IRS determine whether the business judgment exercised by taxpayers in reaching a position is reasonable or is undertaken in good faith?
- What can taxpayers do to ensure that their business judgments will not be challenged by the IRS?

An analysis of the case law interpreting similar tests reveals some preliminary answers to these questions. As noted above, courts in the context of the accumulated earnings tax and the corporate business judgment rule have afforded business actors a high level of deference, using terms that are virtually identical to those used by the IRS in the transfer pricing context.

A striking feature of the case law in these analogous areas is that courts tend to focus more on the process by which the position at issue was reached than on the merits of the position itself. In the accumulated earnings tax context, for example, taxpayers that had not developed contemporaneous business plans to address business needs tend to be vulnerable to the tax, while taxpayers that had prepared such plans generally are able to avoid the tax.[13] In surveying the case law, courts have concluded that "the relevant inquiry is whether the company's plans appear to have been a real consideration during the tax year in question rather than simply an afterthought to justify the challenged accumulations."[14] Thus, the focus is on the existence of business plans that justify the accumulation of earnings rather than on a court's assessment of the reasonableness of such plans.

The focus on the process by which a decision was reached, rather than the merits of the decision itself, is even more pronounced in the context of the corporate business judgment rule. In *Caremark*, for example, the Delaware Court of Chancery noted that "compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed."[15] The Court went on to argue that "whether a judge or jury considering the matter after the fact, believes a decision substantively wrong . . . or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests."[16] Employing the business judgment rule and relying on a good faith, process-oriented test, the Court failed to find "sustained or systematic failure of a director to exercise reasonable oversight."[17]

In *Caremark*, the Delaware Court considered what process would satisfy its business judgment test for informed decision-making. According to the court, information and reporting systems should exist "in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."[18]

In the context of both the business judgment rule and the accumulated earnings tax, by focusing on the process by which a decision was made rather than the

[12] *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[13] *Compare, e.g.*, *Northwestern Ind. Tel. Co. v. Comr.*, 127 F.3d 643 (7th Cir. 1997) (holding the taxpayer liable for the accumulated earnings tax where it lacked actual plans to meet alleged future business needs) *with Otto Candies, LLC v. United States*, 91 A.F.T.R.2d (RIA) 2003-2520 (E.D. La. 2003) (holding the taxpayer not liable for the accumulated earnings tax based on credible testimonies and documents that reflected feasible, cost-specific plans for business needs).

[14] *Otto Candies*, 91 A.F.T.R.2d at 2003-2550 (citing *J.H. Rutter Rex Mfg. Co., Inc. v. Comr*, 853 F.2d 1275 (5th Cir. 1988)).

[15] *In re Caremark Int'l*, 698 A.2d 959, 967 (Del. Ch. 1996) (emphasis in original).

[16] *Id.* (emphasis in original).

[17] *Id.* at 971.

[18] *Id.* at 970. *See also Treco, Inc. v. Land of Lincoln Sav. & Loan*, 749 F.2d 374 (7th Cir. 1984) (focusing on whether the board's decision-making process was adequate rather than on whether the business decision was sound in holding that the plaintiffs failed to make the case that a company's directors had violated their fiduciary duty of care).

correctness of the position in the abstract, courts avoid substituting their own judgment for that of the relevant business actors and ensure an appropriate level of deference. In light of these authorities, taxpayers should consider developing and documenting consistent and robust policies by which the business judgment test is applied.

Further, the IRS could indicate that in evaluating all of the facts and circumstances, it will give due regard to the process by which a taxpayer's position was developed, rather than the merits of the position itself. Of course the IRS could continue to challenge the position of taxpayers in this context in the exceedingly rare case where a taxpayer has an adequate decision-making process but there is a suspicion that the decision-makers are not acting in good faith.

In addition to focusing on process rather than results, many of the cases under the accumulated earnings tax note that Section 534 shifts the burden of proof to the IRS where the taxpayer files a statement with ''substantial, material, definite, and clear'' facts showing that the accumulation was for reasonable business needs. The statutory shifting of the burden of proof further reinforces the high level of deference provided under the substantive law. There is nothing to prevent the IRS as an administrative matter from viewing itself as having the burden of proof in the context of challenging or overturning a position of the taxpayer. Although this would be a substantial departure from the typical practice in the transfer pricing area,[19] it would be consistent with the intent underlying the business judgment test.

Applying Business Judgment Test In 2007 and Beyond

In the context of the temporary regulations once fully implemented in 2008, the business judgment test is best considered a test of last resort for determining whether services may be priced at cost under the services cost method. Under the temporary regulations as applicable post-2007, there is no need to reach the business judgment test unless several other hurdles have been overcome. In particular, services cannot be described in the extensive list of excluded activities, which includes the following: manufacturing; production; extraction, exploration, or processing of natural resources; construction; reselling, distribution, or acting as a sales, purchasing, or commission agent; research, development, or experimentation; engineering or scientific; financial transactions including guarantees; and insurance or reinsurance.[20] Further, services cannot have an arm's-length markup of greater than 7 percent, unless they are identified as specified covered services under an applicable revenue procedure.[21] Under this framework, only a relatively narrow subset of services transactions should give rise to issues under the business judgment test.

For 2007, however, the business judgment test has been engrafted upon the pre-2007 regulatory framework to determine whether services may be priced at cost under the regulatory cost safe harbor. In general, the regulatory cost safe harbor under the pre-2007 regulations is much broader than that of the 2006 temporary regulations.

Further, in the pre-2007 regulatory environment, the determination of whether services are non-integral and therefore eligible for at-cost pricing under the safe harbor has been relatively certain for the vast majority of services. Although the application of several of the tests for whether a service is eligible for at-cost pricing can be uncertain at times and therefore has given rise to disputes, several factors have worked to limit the scope of the areas of dispute.[22]

Several observations could be made regarding the IRS application of the business judgment test in 2007 in the context of the pre-2007 regulatory framework. First, the IRS should resist the urge to use the business judgment test to incorporate the other substantive rules of the services cost method of the 2006 temporary regulations. The regulatory history to the temporary regulations makes clear that the expansive list of excluded services, for example, includes services that may not be central or core to a taxpayer's business.[23] Thus, in assessing whether a service fails the business judgment test, it should not be relevant whether that service is included in the list of excluded services or whether the service would have an arm's-length markup of greater than 7 percent.

Second, although the insertion of the business judgment test in the pre-2007 regulatory framework likely expands the categories of services to which it might apply, there is no reason why the IRS should afford any lower level of deference to taxpayer positions in the context of the business judgment test in 2007 than

[19] In general, the taxpayer has the burden in a transfer pricing case of showing that the IRS's determination is arbitrary, capricious, or unreasonable. *See, e.g., Sundstrand Corp. v. Comr*, 96 T.C. 226, 353 (1991).

[20] *See* Temp. Treas. Reg. §1.482-9T(b)(3)(ii).

[21] *See* Temp. Treas. Reg. §1.482-9T(b)(4) (defining covered services eligible to be priced at cost under the services cost method).

[22] The so-called peculiarly capable test has given rise to disputes because it includes subjective elements not well defined by the regulation. *See* F.S.A. 20023001 (July 26, 2002) (discussing the possible application of the peculiarly capable test in the context of a joint development project). Under this test, services are not eligible for the cost safe harbor if the renderer is ''peculiarly capable'' of rendering the services, the value of the services is ''substantially in excess of cost,'' and the services are a ''principal element'' in the operations of the recipient. Treas. Regs. §1.482-2(b)(7)(iii) (2006). (11 *Transfer Pricing Report* 351, 8/7/02).

One factor limiting the scope of disputes under this test is that the regulatory history to the pre-2007 regulations indicates that the peculiarly capable test does not apply unless the markup on costs of a service exceeds 20 percent at a minimum, and perhaps 50 percent or even 200 percent. *See* 1969 TM LEXIS 16, at *50-*51 (Jan. 14, 1969). Needless to say, very few categories of services or activities exist in which a comparability analysis would yield markups of that magnitude, particularly where the service provider does not undertake entrepreneurial risk. *See, e.g., Westreco Inc. v. Comr.*, T.C. Memo 1992-561 (concluding in the context of contract research services that a tiered profit above costs ranging from 3.5 percent to 7.5 percent of expenses was consistent with the arm's-length standard based on a comparability analysis).

[23] *See, e.g.*, 68 Fed. Reg. 53,448, 53454 (Sept. 10, 2003) (noting that the regulatory safe harbor should not be available for certain excluded services because ''they tend to be high-margin transactions, transactions for which total costs constitute an inappropriate reference point for determining profitability, or other types of transactions that should be subject to the more robust arm's-length analysis'').

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would be afforded once the temporary regulations are fully phased in. The statements in Notice 2007-5 providing that the IRS will allow substantial deference to the business judgment of taxpayers apply with equal force to the application of the business judgment rule in 2007 as in cases after the temporary regulations are fully phased in.

Conclusion

A significant effect of Notice 2007-5 is to elevate the importance of the business judgment rule for the first tax year beginning after Dec. 31, 2006. Notwithstanding the useful clarifications in Notice 2007-5, the business judgment rule remains amorphous and subjective. Taxpayers need to consider both whether their non-integral services historically priced at cost satisfy the business judgment test and how to document consideration and compliance with this test. This is particularly important given that authorities in similar contexts suggest that the IRS may focus as much or more on the process by which the taxpayer came to its business judgment than on the reasonableness of the judgment itself.