MILLER & CHEVALIER
CHARTERED

655 FIFTEENTH STREET, N.W., SUITE 900
WASHINGTON, D.C. 20005-5701
202.626.5800 FAX: 202.628.0858
WWW.MILLERCHEVALIER.COM

October 6, 2006

CC:PA:LPD:PR
(REG-146893-02; REG-115037-00; REG-138603-03)
Internal Revenue Service
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Ladies and Gentlemen:

On August 4, 2006, the Treasury Department and the Internal Revenue Service ("IRS") issued temporary and proposed regulations regarding the treatment of services under section 482 of the Internal Revenue Code of 1986, as amended; the allocation of income and deductions from intangibles; and stewardship expense. In the preamble to the proposed regulations, the Treasury Department and the IRS request comments on the proposed regulations. The purpose of this letter is to provide comments on behalf of Miller & Chevalier Chartered, as more fully set forth below. These comments reflect the feedback we have received from clients and from professionals at the firm.

We also request to speak at the public hearing scheduled for October 27, 2006; please treat these comments as an outline of the topics that we would like to discuss at the hearing. Samuel M. Maruca will be speaking on behalf of the firm at the hearing.

The temporary and proposed regulations make significant changes to proposed regulations that were issued in 2003, and represent a significant departure from regulations now in effect, which were issued in 1968. We commend the Treasury Department and the IRS for making changes in response to comments regarding the 2003 proposed regulations, in particular by providing explicit guidance regarding shared services arrangements, clarifying the role of the profit split method in evaluating controlled services transactions, and clarifying the circumstances in which the IRS may impute a contingent payment services arrangement. Our comments focus on the services cost method, shared services arrangements, and the effective date of the temporary regulations.

Services Cost Method -- Application at Taxpayer Discretion

The temporary and proposed regulations introduce a new services cost method ("SCM"), which replaces the cost safe harbor of the current regulations and the simplified cost-based method of the 2003 proposed regulations. The SCM, like the current cost safe harbor, is intended to allow taxpayers to price controlled services at cost provided that certain requirements are met. As drafted, however, the temporary and proposed regulations could be

read inappropriately to allow the IRS to impose the SCM on a taxpayer even in cases where the taxpayer could support the use of another method as leading to more reliable arm's length results. The regulations literally provide that "[i]f covered services meet the conditions of [Prop. Reg. § 1.482-9(b)], then the services cost method will be considered the best method for purpose of § 1.482-1(c) .... " *See* Prop. Reg. § 1.482-9(b)(1). Although one of the conditions on the use of the SCM is an inclusion by the taxpayer of a statement evidencing its intention to apply the SCM, it is not clear whether or how this condition applies to restrict the ability of the IRS to utilize the SCM.

The arm's length standard is the standard applicable in every case under the transfer pricing regulations and income tax treaties to which the United States is a party. Although the Treasury Department and the IRS by regulation may restrict the IRS's ability to make allocations, it should not so restrict the ability of taxpayers to report their income consistent with the arm's length standard. Thus, taxpayers should be free to choose to apply the SCM or to apply another method provided that such other method leads to a more reliable arm's length result. Consistent with the analogous provisions of the current regulations and the 2003 proposed regulations, consideration should be given to articulating this principle explicitly in the regulations themselves, perhaps by inserting the following bracketed language into the regulatory sentence cited above:

> If covered services meet the conditions of this paragraph (b) [and are priced under or consistent with the services cost method], then the services cost method will be considered the best method for purpose of § 1.482-1(c) ....

Services Cost Method -- Example 12

Two categories of services generally constitute "covered services" that are eligible for the SCM: (i) specified covered services specified by revenue procedure; and (ii) low margin covered services, or services for which the arm's length mark-up is less than or equal to 7%. It is clear from the wording and structure of the temporary and proposed regulations that services transactions excluded from the revenue procedure may nevertheless be covered services under the low margin covered services rule. Example 12 of Prop. Reg. § 1.482-9(b)(6), however, could be read to suggest the opposite result. That example concludes that certain information technology services are not eligible for the SCM because such services are explicitly excluded from the services specified in the applicable revenue procedure. The analysis appears to skip a step required by the regulations by omitting any assumptions or discussion regarding the low margin covered services rule. This example should be modified to conform to the regulation and avoid confusion.

Services Cost Method -- Significant Contribution to Fundamental Business Risks

Notwithstanding the specified covered services list and the low margin services rule, services are not eligible for the SCM 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 renderer, the recipient, or both. Prop. Reg. § 1.482-9(b)(2).

According to the preamble to the temporary regulations, the purpose of this "fundamental business risks" rule is to serve as a backstop to prevent a taxpayer in extreme cases from claiming that a core competency of its business qualifies as a mere back office service. The preamble appropriately suggests that the taxpayer's business judgment in this context will be respected in all but the most unusual cases. The regulations, however, provide a half-dozen examples in which the IRS substitutes its business judgment for that of the taxpayer. Taken together, the examples have the effect of neutralizing the language of the preamble and the intention of the regulation drafters. Consideration should be given to incorporating the language of the preamble into the regulation itself, either by creating a presumption as to the reasonableness of the taxpayer's business judgment in all but the most unusual circumstances, or otherwise.

In addition, the focus of the regulations on the trades or business of the renderer, the recipient, or both appears inappropriate given the narrow purpose of this rule. The focus on the renderer, for example, could lead to inappropriate results in cases in which a controlled group effectively incorporates its back office as a separate entity. Similarly, the focus on the recipient could lead to inappropriate results in cases in which the recipient serves as an intermediary provider and coordinator of back office services for the controlled group. It is not clear whether these anomalous results were intended. Consideration should be given to refocusing the rule on whether the service contributes significantly to key competitive advantages, etc., of one or more trades or businesses of the overall controlled group of taxpayers that include the renderer and the recipient.

Shared Services Arrangements

The temporary and proposed regulations introduce the concept of shared services arrangements ("SSAs") in response to comments to the 2003 proposed regulations. These rules generally allow taxpayers to identify shared services activities that benefit two or more members of a controlled group and allocate the cost of these activities to group members on a basis that reflects the anticipated benefits from the services to each member. We commend the Treasury Department and the IRS for the simple and relatively flexible guidance they have provided in this area.

A substantial limitation of the guidance on SSAs, however, is that it applies only with respect to services eligible for the SCM. This limitation will greatly reduce the practical utility of SSAs because of the uncertainty regarding whether certain services are eligible for the SCM or not, and because certain services may be eligible for the SCM in one period but not another (e.g., by operation of the low margin covered services rule).

Further, there is no conceptual reason why services that are not eligible for the SCM could nevertheless be included in an arrangement such as an SSA. Indeed, the OECD Transfer Pricing Guidelines contemplate cost contribution arrangements that are consistent with SSAs but that are not limited to back office services or services provided at cost. On this basis, consideration should be given to expanding the scope of SSAs to include all services. Services included in an SSA would be charged out to group members on the basis of reasonably anticipated benefits.

Effective Date

The temporary regulations are generally applicable for taxable years beginning after December 31, 2006. We understand that several industry and other taxpayer groups, including the Tax Executives Institute, have submitted or are submitting comments requesting that the effective date be moved to tax years beginning after December 31, 2007. The reasons underlying these requests include the practical impossibility of designing and implementing accounting systems consistent with the regulations in the time currently required. Taxpayer groups such as TEI are in a better position than we are to articulate the practical difficulties with the upcoming effective date.

We understand from public presentations by government officials that there is a predisposition towards maintaining the current effective date for two reasons: (1) under the current effective date taxpayers will have almost two years to comply with the regulations given that corporate tax returns for the calendar year 2007 will not be due until September 2008; and (2) there is precedent for imposing similarly accelerated effective date rules in the transfer pricing context, notably with respect to the 1993 temporary regulations and 1994 final regulations. We believe that these reasons do not support maintaining the current effective date, and that serious consideration should be given to calls for moving the effective date of the temporary regulations to tax years beginning after December 31, 2007.

Taxpayers cannot wait until preparing a 2007 tax return to take actions necessary to implement the temporary regulations. Under the terms of the regulations themselves, several provisions are operative only if contracts or arrangements are in place prior to the occurrence of certain transactions. For example, a taxpayer may utilize contingent payment services arrangements only if there is a contract in place prior to the performance of services under the arrangement. Even where contracts are not technically required, Treasury Department and IRS officials have been steadfast in maintaining that one goal of this regulatory project is to encourage taxpayers to document their arrangements in written contracts and therefore avoid or mitigate disputes with the IRS. The current effective date simply does not allow taxpayers to appropriately document their arrangements consistent with the regulations.

Further, the comparison of these temporary regulations to regulations issued in the early 1990s is inapposite. There have been many significant changes since the 1990s which have tended to make it more difficult for taxpayers to quickly implement fundamentally new transfer pricing and other regulations. These changes include the increasing size and complexity of the

foreign operations of U.S.-based taxpayers; the increasing scrutiny of transfer pricing issues by foreign governments; and the increasing implementation and assertion by the United States and other countries of penalties in the transfer pricing area. A more apt comparison might be to the recently issued proposed section 987 regulations, which were issued within a month of the temporary regulations. The proposed section 987 regulations generally are proposed to be effective for taxable years beginning one year after the first day of the first taxable year following the date of finalization; in other words, if such regulations were finalized in August 2007, they would be effective for calendar year taxpayers beginning in January 2009. This type of effective date rule seems appropriate in light of the complexity of the proposed section 987 regulations, and would be even more appropriate in the context of the temporary regulations at issue.

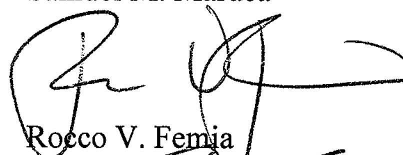
In our experience, large multinational taxpayers make every effort to comply with regulations given the opportunity to do so. We understand that the Treasury Department and the IRS have an interest in having modern rules in place in this area as soon as practicable. We believe that the government's goals in this context would be better served by allowing taxpayers an additional year to ensure full compliance with the new regulations and to minimize future disputes.

* * * * *

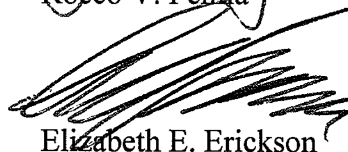
We recognize that the Treasury Department and the IRS have expended significant energy in an attempt to address this important area of the transfer pricing rules. We appreciate the opportunity to provide these comments. Please direct any questions to Sam Maruca at (202) 626-5928.

Respectfully submitted,

Samuel M. Maruca



Rocco V. Femia



Elizabeth E. Erickson

cc: Mr. Harry J. Hicks, III
International Tax Counsel
Department of the Treasury

Mr. David Ernick
Attorney Advisor
Department of the Treasury

Mr. Michael McDonald
International Economist
Department of the Treasury

Mr. Steven A. Musher
Associate Chief Counsel (International)
Internal Revenue Service

Mr. John Breen
Branch Chief
Associate Chief Counsel (International), Branch 6
Internal Revenue Service

Mr. Thomas A. Vidano
Associate Chief Counsel (International), Branch 6
Internal Revenue Service

Ms. Carol B. Tan
Associate Chief Counsel (International), Branch 6
Internal Revenue Service