



41st Annual Conference of the USA Branch of the International Fiscal Association

Can't There Be an App for That?



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Agenda

- Charging Services at Cost
- Benefit test and Shareholder Activities
- Allocating Expenses
- Additional Considerations
 - Charging for Secondments
 - Contingent Payment Services



Pricing Services at Cost

- U.S. regulations permit at-cost pricing
 - Services cost method (SCM) at taxpayer's election
 - Limited to “covered services”
 - RP 2007-13 list
 - Low-margin services (mark-up <7%)
 - Exception for certain excluded activities
 - Exception for “core capabilities” under business judgment standard
 - Taxpayer must maintain adequate books and records
- OECD Guidelines also envision at-cost pricing of certain services



Covered Services

- RP 2007-13 list
 - Lists basic elements of back office
 - 81 activities grouped into 20 functions
 - Activities within functions that are similar to the specified activities also are included
 - Departmental approach rejected
- Low-margin services
 - Mark-up on total costs <7%



Excluded Activities

- Listed excluded activities
 - Manufacturing, production, exploration/exploitation/production
 - Construction
 - Reselling, distribution, or acting as a purchase/sales agent
 - R&D, engineering, or scientific
 - Financial transactions (incl. guarantees), insurance/reinsurance
- May excluded activities be priced at cost under arm's length analysis?
 - Arm's length standard and OECD guidelines
 - U.S. intangible development cost sharing arrangements and OECD cost contribution arrangements



Business Judgment Test

- Excluded activities under business judgment test
 - Activities excluded 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”
- Examples
 - Executive suite
 - Activities of key importance to particular industries (risk analysis, health and safety)
- Process for identifying and testing activities
 - Materiality/aggregation
 - Documentation



“Shareholder activities” and the benefit rule

- ❖ Under 1968 regulations, the benefit rule did not require taxpayers to charge for benefit that was “indirect and remote,” and “stewardship” type costs were routinely borne by the headquarters
- ❖ Beginning with temporary regulations in 2007, the benefit test was retained, but additional guidance and examples made it much more likely that headquarters-type costs would be considered to confer benefit and be required to be charged out to related entities



§1.482-9(l)(3)– The benefit rule

- (i)- If activity results in identifiable increment of economic or commercial value... recipient would be willing to pay.
- (ii)-(v) provide guidance whether there is benefit
- (ii) Indirect and remote- no benefit
 - Ex.3- Parent co decides to change management structure and compensation of subsidiaries to increase profitability- benefit
- iii) Duplicative activity- generally no benefit, unless duplicative activity itself provides additional benefit
 - Ex.6- Duplicative IP legal services - benefit

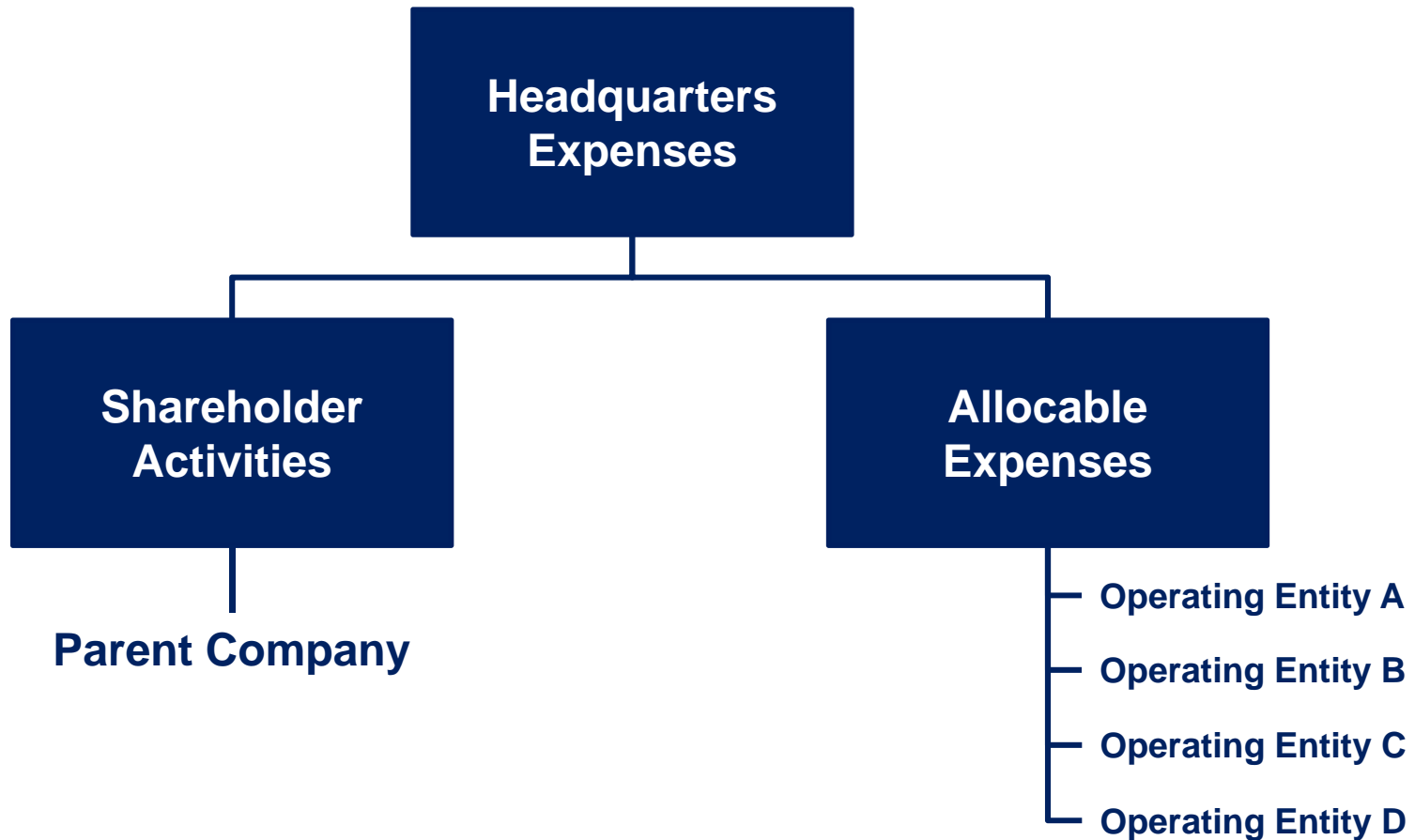


§1.482-9(l)(3)– The benefit rule (continued)

- (iv) Shareholder activities- no benefit if the **sole** effect of activity is to protect renderer's investment or facilitate renderer's regulatory compliance
 - Ex. 8- Subsidiary able to use Parent co's compilation of financial statements to file its own- benefit
 - Ex. 13- Parent co's cost of preparing personnel policies and evaluating employee performance- benefit
 - Ex. 14- Parent co's cost of executive retreat and preparation of strategy statement- benefit
- (v) Passive association – not a benefit
 - Ex. 15- Volume discount available to Subsidiary entirely due to its status as member of consolidated group- no benefit



Allocating Expenses - Typical Approach



The typical approach does not often fit a complex multinational corporation today.



Considerations – Headquarters Expenses



- Treatment of expenses provided to Headquarters.
 - Related service providers in other countries
 - How transfer priced?
 - 3rd party service providers
 - E.g. outsourced IT services
 - Directly chargeable?
- Are there HQ activities directly related to parent country operations?
- Are there HQ activities directly related to specific entities?

Some miss the opportunity to directly charge many expenses to specific entities.



Considerations – Shareholder Activities

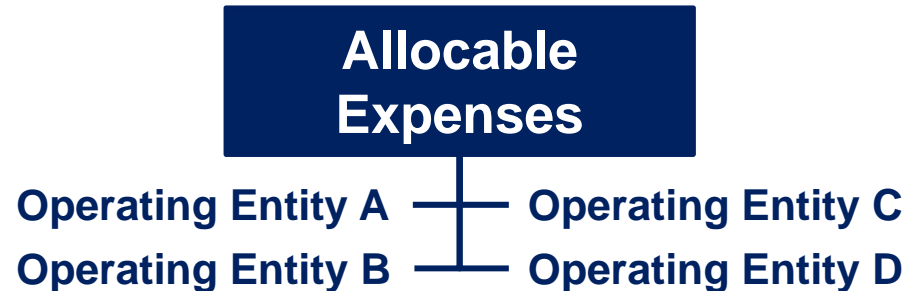
- The table below provides examples of typical Corporate Executive activities which would be determined to be shareholder related or related to business operations.

Shareholder Activities	Business Activities
<ul style="list-style-type: none">• Review/participate in SEC Filings/Hearings• Develop communications to Shareholders• Develop press releases/interviews relating to quarterly earnings, filings, etc.• Involvement in any compiling of shareholder results or financial reports that are required under regulations applicable to publicly held U.S. corporations• Reporting business activities to Board of Directors	<ul style="list-style-type: none">• Management and operational strategy relating to overall business• Meet with department heads regarding finance, marketing, human resources, etc.• Develop global marketing strategy• Visiting with clients• Manufacturing site visits• Personnel related activities (including setting policies, hiring, overseeing compensation, etc.)

New service regulations clarify and narrow the definition of shareholder activities.



Considerations – Allocable Expenses



- Which entities should absorb expenses?
 - Limited risk Entities?
 - Customs considerations.
 - Deductibility concerns.
 - Potential impact on taxable income (cost plus entities).
- What is an appropriate allocation basis?
 - Measurable?
 - Fair?

Carefully consider which entities should be charged Headquarters expenses and how best to defend the allocation basis.



Other Considerations

- The definitional narrowing of what constitutes shareholder expenses increases the challenge of obtaining local deductions for certain corporate management activities.
- Minimizing the “Allocable” portion of service charges reduces risks of audit challenges.
 - Direct charge whenever possible.
- Transaction form and support can be critical.
 - Service Agreements signed.
 - Regular Invoicing process.
 - Master HQ Study/Activity Analyses in place; regularly updated.
 - Charges must confer benefits to recipient
 - Action Verbs!



Practical problems for US-based companies

- ❖ Focus on willingness of recipient to pay may encourage other governments to contest increased charges under the new “shareholder activities” standard
- ❖ Easy for either government to discover whether companies have changed treatment of HQ-type expenses
- ❖ One US adjustment will affect taxable income in multiple other countries
- ❖ Difficult to address with APAs



Charging for Secondments

- Secondees often remain formally on the HQ company payroll
 - Whose employee?
 - 10 Factor Independent Contractor Test
 - If employee of subsidiary:
 - Service is provide by subsidiary's own employee
 - Secondment is not a controlled transaction; no transfer price
 - Some HQ services to run secondment program



Contingent Payment Services

- Reg. § 1.482-9(i) authorizes contingent payment service arrangements
 - Written contract, in advance, with specified contingency
 - Allows deferral of payment until service actually provides a benefit
 - Payment must take into account risk
- Consider arrangement to allow current deduction in high tax jurisdiction for service related to a future possible benefit



Thank you

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