

approaches 10 percent, the applicable number of percentage points declines ratably to zero. This ensures that only relatively low-margin services benefit from the simplified method. Proposed § 1.482-9(f)(2)(iii) also provides an upper bound for the application of the simplified method of 10 percent. Thus, in no event would the Commissioner be limited under this method in making an allocation if the arm's length markup on total costs exceeds 10 percent. Proposed § 1.482-9(f)(2)(iv) provides equations and a table with respect to these rules, and proposed § 1.482-9(f)(5) provides several examples that describe and illustrate the application of these rules.

The Treasury Department and the IRS intend these quantitative rules, applied in conjunction with the other requirements for and conditions on the application of the simplified method, to provide objective, administrable guidance for determining whether controlled services may be priced under the simplified method rather than subject to a full transfer pricing analysis, including an analysis under the best method rule. Further, because the benefits of the simplified method decline as the margin attributable to the service increases, the pricing of a relatively high-margin controlled service under the simplified method converges with that under a full transfer pricing analysis. The objective of these quantitative rules is to provide a sufficient range with respect to the pricing of low-margin services to maintain appropriately reduced compliance and administrative burdens with respect to such services, while safeguarding against the inappropriate application of the simplified method to services that should be subject to a more robust arm's length analysis.

The simplified method does not grant authority to the Commissioner to make allocations that could not be made under the general transfer pricing rules. Thus, the qualitative rules of the simplified method apply in conjunction with, and not in lieu of, the interquartile range that may be available under certain other transfer pricing methods. For example, if the markup charged by the taxpayer on a controlled services transaction exceeds the arm's length markup by more than the applicable number of percentage points but is within the interquartile range of results under a best method analysis, the Commissioner may not make an allocation with respect to the underlying service. This interaction between the upper bound and the interquartile range further ensures that the benefits of the simplified method are focused on relatively low-margin

services because the arm's length range can be expected to provide a wider tolerance band than the applicable number of percentage points as the markup on total services costs approaches 10 percent.

These limitations on the Commissioner's authority to make an allocation apply only if the markup charged in the controlled transaction is less than the arm's length markup. If instead the markup charged in the controlled transaction exceeds the arm's length markup, proposed § 1.482-9(f)(2)(v) provides that the limitation on the Commissioner under the simplified method does not apply to prevent the Commissioner from making an allocation.

Further, proposed § 1.482-9(f)(2)(v)(A) provides that the limitation on the Commissioner does not apply to prevent an allocation if the amount charged by the taxpayer is less than the "total services costs" in the controlled services transaction. The Treasury Department and the IRS believe that it is appropriate to subject controlled services that are priced at less than cost to a full transfer pricing analysis.

Finally, proposed § 1.482-9(f)(2)(v)(B) provides that the Commissioner's authority to determine the cost base is not limited if the taxpayer's method of determining, allocating and apportioning costs is not consistent with the methods used by similar uncontrolled taxpayers in similar circumstances. This authority, which is similar to the Commissioner's authority under existing § 1.482-2(b)(4) to make appropriate allocations of costs, constitutes an important safeguard on the reliability of the results determined under the simplified cost-based method. Consistent with the purpose of the simplified method—to provide certainty concerning the pricing of low-margin controlled services, and to reduce the number of disputes where taxpayers make a good faith effort to price qualifying services under this method—the Treasury Department and the IRS anticipate that the Commissioner will exercise this authority to correct an erroneous allocation only where that allocation has a significant impact on the amount of consideration in the controlled transaction.

In all cases in which the Commissioner's authority to make an allocation is not limited by the simplified method, allocations nevertheless must be consistent with the arm's length standard and otherwise appropriate under the generally applicable transfer pricing rules.

Proposed § 1.482-9(f)(5) provides examples that illustrate the application of the rules in proposed § 1.482-9(f)(2).

d. Conditions on Use of Simplified Method—§ 1.482-9(f)(3). There are two conditions on the application of the simplified method. Proposed § 1.482-9(f)(3) provides that taxpayers must maintain adequate books and records with respect to the determination and allocation of total costs, and subject to a *de minimis* exception must have a written contract in place that provides for current compensation for the services. The written-contract requirement ensures that the controlled taxpayers allocate risks attributable to the services transaction before the relevant services are rendered, and ensure in particular that the service renderer does not bear risks in a manner that would be inconsistent with the charging of a relatively low margin on total costs. The Treasury Department and the IRS believe that many large and mid-size taxpayers already have in place such basic agreements for controlled services transactions, or can execute such contracts without incurring undue expense. Thus, the written-contract requirement is not intended to impose significant compliance burdens on such taxpayers, or to limit their ability to use this method in appropriate cases.

The Treasury Department and the IRS recognize that the written-contract requirement could impose an undue burden on smaller taxpayers or on taxpayers that choose to apply the simplified method to a limited amount of services. Accordingly, the proposed regulations provide that the written-contract requirement does not apply to taxpayers that are members of a U.S. controlled group with an annual gross income of less than \$200 million, or to taxpayers that apply the simplified method to services whose aggregate costs are less than \$10 million. In order to apply the simplified method in the absence of a written contract, however, the conduct of the parties to the services transaction must be consistent with an agreement that provides for current compensation of the services.

e. Transactions Not Eligible for Simplified Method—§ 1.482-9(f)(4). The Treasury Department and the IRS intend the simplified method to apply only to low-margin controlled services for which total costs constitute an appropriate reference point for determining profitability. The arm's length charge for other controlled transactions is more appropriately determined under another transfer pricing method, subject to the best method rule. The proposed regulations identify categories of transactions that