

are not eligible to be priced under this method. The Treasury Department and the IRS believe that the simplified method should not be available for such transactions 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, including an analysis under the best method rule. The Treasury Department and the IRS anticipate that, in general, controlled services that are priced at cost under an application of the existing regulations that is consistent with the intent of those regulations should qualify to be analyzed under the simplified method.

Proposed § 1.482-9(f)(4)(i) provides that controlled services that are similar to those provided to uncontrolled parties by either the renderer or the recipient are not eligible for the simplified cost-based method. This rule is similar to the rule of existing § 1.482-2(b)(7)(i), which has not led to compliance or administrative difficulties because taxpayers generally will have access to internal information concerning the comparable uncontrolled price of such services.

Proposed § 1.482-9(f)(4)(ii) provides that controlled services provided to a recipient that receives controlled services in significant amounts are not eligible to be evaluated under the simplified method. This rule is similar to the rule in existing § 1.482-2(b)(7)(iv) but has been simplified and narrowed in scope, and therefore should apply in fewer cases. The Treasury Department and the IRS believe that services routed through conduits or intermediaries should be subject to a full transfer pricing analysis.

Proposed § 1.482-9(f)(4)(iii) provides that controlled services that involve the use of valuable or unique intangibles are ineligible for the simplified method if such intangibles contribute significantly to the value of the services and the costs associated with such intangibles are not reflected in the costs relating to the rendering of the services. The Treasury Department and the IRS believe that such services are likely to have values substantially in excess of their cost and therefore categorically should be subject to a full transfer pricing analysis. The Treasury Department and the IRS anticipate that there will be significant overlap between this rule and the 10 percent rule in proposed § 1.482-9(f)(2)(iii); that is, the arm's length markup on total costs with respect to such services is likely to exceed 10 percent.

Proposed § 1.482-9(f)(4)(iv) provides that controlled services that are combined with other types of controlled transactions, such as a transfer of tangible or intangible property, are not eligible for the simplified method to the extent of those other transactions. The Treasury Department and the IRS intend the application of the simplified method to be limited to low-margin services transactions.

Proposed § 1.482-9(f)(4)(v) identifies several specific types of transactions that are not eligible for the simplified method. The first four types—manufacturing, production, extraction, and construction services—are identical to types of transactions excluded from eligibility for pricing at cost under existing § 1.482-2(b)(7)(ii)(A). Such services generally constitute core profit-making functions of an enterprise. The Treasury Department and the IRS therefore believe that such services should continue to be subject to a full transfer pricing analysis.

Also not eligible for the simplified method are reselling, distribution, or similar activities conducted under a commission or other arrangement, as well as financial transactions, including guarantees, and insurance or reinsurance. The Treasury Department and the IRS believe that it is not appropriate to apply the simplified method to such transactions because total costs generally constitute an inappropriate reference point for determining profitability with respect to such transactions.

Finally, research and development, experimentation, engineering or scientific services are excluded from the simplified method. The Treasury Department and the IRS believe that such services may in a significant number of cases involve valuable intangibles and therefore should be subject to a full transfer pricing analysis.

No inference is intended regarding either the arm's length markup on total services costs with respect to any of the excluded categories or types of transactions or the appropriate transfer pricing method for analyzing any particular transaction. In particular, no inference is intended that the arm's length markup for such transactions in a particular case will exceed 10 percent of total costs. Rather, these transactions are ineligible for the simplified cost-based method because the Treasury Department and the IRS have concluded that a full transfer pricing analysis is appropriate.

*f. Coordination With Documentation and Penalty Rules—§ 1.6662-6(d)(2)(ii)(B) and (iii)(B).* Section 6662 imposes certain accuracy-related

penalties on substantial valuation misstatements as described in section 6662(e)(1)(B) and gross valuation misstatements as described in section 6662(h)(2)(A). These accuracy-related penalties include two categories of transfer pricing penalties, referred to as the transactional and net section 482 transfer price adjustment penalties. These penalties are not applicable if the taxpayer prepares contemporaneous documentation indicating that the taxpayer reasonably selected and applied a transfer pricing method, and provides that documentation to the Commissioner upon request.

Existing § 1.6662-6(d)(2) provides that an amount is excluded from the calculation of a net section 482 transfer price adjustment for purposes of applying the section 6662 penalty if the taxpayer establishes that both the specified method and documentation requirements are met with respect to that amount. Existing § 1.6662-6(d)(2)(ii) provides that the specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. A taxpayer meets this burden only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule. Existing § 1.6662-6(d)(2)(iii) provides rules with respect to the documentation requirement, and in particular contains a descriptive list of categories of documents that must be maintained and provided in order to meet the requirement. A taxpayer is not subject to the section 482 transactional penalty if it meets the requirements of § 1.6662-6(d).

A significant purpose of the simplified cost-based method is to maintain appropriately reduced compliance and administrative burdens with respect to low-margin services. Consistent with that purpose, proposed § 1.6662-6(d)(2)(ii)(B) provides that, for purposes of the specified method documentation requirement, a taxpayer's selection and application of the simplified method will be considered reasonable if the taxpayer reasonably concluded that the relevant transaction meets the conditions and requirements for application of that method, including the rule in proposed § 1.482-9(f)(2)(iii) that provides that the simplified method shall not apply if the arm's length markup exceeds 10 percent of total costs. In addition, the proposed regulations clarify the description of the documents that must be maintained and