

provided in order to satisfy the documentation requirement. While these clarifications apply generally, they are particularly relevant where the simplified method is applied.

#### 7. Profit Split Method—§§ 1.482–9(g) and 1.482–6(c)(3)(i)(B)

The proposed regulations provide guidance regarding the application of the comparable profit split and the residual profit split methods to controlled services transactions. Generally, both profit split methods evaluate whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's "contributions" to the combined operating profit or loss.

The proposed regulations provide that the guidance regarding the profit split methods in existing § 1.482–6, as amended by proposed § 1.482–6(c)(3)(i)(B) and other conforming changes, generally is applicable to controlled services transactions. Proposed § 1.482–9(g) also provides specific guidance on the application of § 1.482–6 in the context of controlled services transactions. In particular, proposed § 1.482–9(g)(1) provides that a profit split method may be appropriate when the controlled services transaction involves either high-value services or transactions that are highly integrated and cannot be reliably evaluated on a separate basis.

Proposed § 1.482–6(c)(3)(i)(B) amends the residual profit split method in existing § 1.482–6(c)(3). In general, existing § 1.482–6(c)(3) provides that the residual profit split method allocates the combined operating profit or loss from the relevant business activity between controlled taxpayers according to a two-step process. Operating income first is allocated to each controlled taxpayer to provide a market return for its routine contributions to the relevant business activity. The residual profit then is divided among the controlled taxpayers based upon the relative value of each taxpayer's contributions of intangible property. The proposed regulations amend existing § 1.482–6(c)(3)(i)(B) by providing that residual profits will be divided based on the relative value of each taxpayer's "nonroutine contributions," which may include contributions of intangible property. Proposed § 1.482–6(c)(3)(i)(B) defines nonroutine contributions as contributions by controlled taxpayers that cannot be accounted for by reference to market returns, or that are so interrelated with other transactions that the contributions cannot be reliably

evaluated on a separate basis. The proposed regulations thus make the residual profit split method more suitable in the context of services transactions and highly integrated transactions where data relating to comparable transactions are unavailable, whether or not these transactions involve the technical transfer or use of intangible property.

Proposed § 1.482–9(g)(2) provides examples that illustrate the application of the residual profit split method to controlled services transactions.

#### 8. Unspecified Methods—§ 1.482–9(h)

Proposed § 1.482–9(h) provides that in addition to the specified methods in § 1.482–9(a), an unspecified method may be used to determine an arm's length charge if such a method will provide the most reliable measure of an arm's length result under the best method rule. Proposed § 1.482–9(h) emphasizes that an unspecified method should take into account that under the arm's length standard uncontrolled taxpayers must compare the terms of a transaction to the realistic alternatives to entering into that transaction. Therefore, an unspecified method should provide information on the prices or profits that the controlled taxpayer might have realized by choosing a realistic alternative to the controlled transaction.

#### 9. Contingent-Payment Contractual Terms—§ 1.482–9(i)

Proposed § 1.482–9(i) provides guidance on the treatment of contingent-payment arrangements. The Treasury Department and the IRS recognize that controlled taxpayers may allocate the risks associated with rendering services in a variety of ways, including by specifying that compensation for the services will be paid only in the event that the services yield certain results. For example, taxpayers may enter into a contingent-payment arrangement that provides that the renderer of research and development services will receive compensation only if the research and development results in sales of a commercially viable product. Proposed § 1.482–9(i) provides specific guidance concerning the evaluation of such contractual arrangements in the context of controlled services.

Proposed § 1.482–9(i)(1) provides that the arm's length charge in a controlled services transaction is determined taking into account any contingent-payment terms. Proposed § 1.482–9(i)(2) provides that a contingent-payment arrangement is recognized if the arrangement is set forth in a written contract entered into prior to the start of the activity; the contract explicitly states

that payment is contingent upon the happening of a future benefit for the recipient directly related to the outcome of the controlled services transaction; and the contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. If these three conditions are satisfied, the arm's length result for the controlled services transaction ordinarily would not require a payment to the renderer if the contingency does not occur. If, on the other hand, the contingency occurs, an arm's length result would require payment reflecting the recipient's benefit and the risks borne by the service renderer.

The proposed regulations incorporate the principles of existing § 1.482–1(d)(3) and provide that a contingent-payment arrangement must be reasonable and consistent with the economic substance of the parties' conduct, based on all facts and circumstances. Existing § 1.482–1(d)(3)(ii)(B) provides that in evaluating reasonableness and economic substance, all facts and circumstances are relevant, but the actual conduct and the respective legal rights of the parties will be given greatest weight in the analysis. Proposed § 1.482–9(i)(3) confirms explicitly that the Commissioner's authority under existing § 1.482–1(d)(3)(ii)(B) to impute contractual terms in appropriate cases extends to imputation of contingent-payment terms where such terms are consistent with the economic substance of the controlled services transaction.

Proposed § 1.482–9(i)(4) provides that the arm's length charge in a contingent-payment arrangement is evaluated in accordance with section 1.482–9 and other applicable rules under section 482. In the case of an arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient, the arm's length charge determined under the rules of §§ 1.482–3 and 1.482–4 for the transfer of similar property may be considered.

Examples are provided in proposed § 1.482–9(i)(5) and under existing § 1.482–1(d)(3) to illustrate the application of these rules.

#### 10. Total Services Costs—§ 1.482–9(j)

Proposed § 1.482–9(j) defines the term "total services costs," which is used to determine the arm's length charge under the simplified cost-based method, the comparable profits method in cases where the ratio of operating profits to total services costs is used as the profit level indicator, and in the cost of services plus method in cases where an analysis of the result expressed as ratio