

country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for each category of employee. The company also charges, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. The Company has established the following schedule of hourly rates:

Category/Rate

Project managers—\$400 per hour
Technical staff—\$300 per hour

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses): $(100 \text{ hrs.} \times \$400/\text{hr.}) + [400 \text{ hrs.} \times \$300/\text{hr.}] = \$40,000 + \$120,000 = \$160,000$.

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of \$144,000, (or $[75 \text{ hrs.} \times \$400/\text{hr.}] + [380 \text{ hrs.} \times \$300/\text{hr.}] = \$30,000 + \$114,000$) may be used as a measure of the arm's length price for the work performed by Company A project managers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. See paragraph (b)(2)(ii)(A) of this section.

Example 6. Adjustments for differences. (i) The facts are the same as in *Example 5*, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources required to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A's portion of the engagement results in fees of \$144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A \$144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In

addition, Company A's records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm's length, it is determined that no adjustments to the intercompany service charge are warranted. See § 1.482-1(d)(3)(ii) and paragraph (b)(2)(ii)(A) of this section.

Example 7. Adjustments for differences. The facts are the same as in *Example 6*, except that Company A does not typically enter into fixed fee engagements with clients, and in addition Company A typically receives payments equal to its full fee (*i.e.*, the appropriate hourly fee rate multiplied by the number of hours to complete the engagement) for all consulting work that it performs, regardless of whether actual hours exceed pre-engagement estimates. When Company A's realistic alternatives to entering into the engagement with Company B are taken into account, it is determined that the intercompany charge paid by Company B to Company A should be adjusted to the amount of its full fee. See § 1.482-1(d)(3)(ii) and paragraph (b)(2)(ii)(B)(8) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction*—(i) *In general.* The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if the following requirements are met—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(ii) *Example.* The following example illustrates this paragraph (b)(5):

Example. Indirect evidence of comparable uncontrolled services price. (i) Company A is a United States insurance company. Company A's wholly owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the

price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which relies on the gross value of the policies in the customer's portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors' programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).

(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer's portfolio together with other factors, the prices charged in Company B's uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm's length price for the studies performed by Company B for Company A, Company B's proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm's length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(c) *Gross services margin method*—(1) *In general.* The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with a related uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to