

lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of $(100 \text{ hrs.} \times \$100/\text{hr.}) + (400 \text{ hrs.} \times \$75/\text{hr.}) = \$10,000 + \$30,000 = \$40,000$. Applying the markup of 300%, the total fee charged would thus be $(4 \times \$40,000)$, or \$160,000, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm's length result for the controlled services transaction is equal to \$144,000. This is calculated as follows: $[4 \times (75 \text{ hrs.} \times \$100/\text{hr.})] + [4 \times (380 \text{ hrs.} \times \$75/\text{hr.})] = \$30,000 + \$114,000 = \$144,000$, reflecting a 4x markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A's pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(e) *Comparable profits method*—(1) *In general.* The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in § 1.482–5 for application of the comparable profits method apply to controlled services transactions, except as modified in this paragraph (e).

(2) *Determination of arm's length result*—(i) *Tested party.* This paragraph (e) applies where the relevant business activity of the tested party as determined under § 1.482–5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under § 1.482–5(b)(2) is instead the recipient of the controlled services, the rules under this paragraph (e) are not applicable to determine the arm's length result.

(ii) *Profit level indicators.* In addition to the profit level indicators provided in § 1.482–5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting.* Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method.

Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as “cost of goods sold” and “selling, general, and administrative expenses.” Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in § 1.482–5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) *Examples.* The principles of this paragraph (e) are illustrated by the following examples:

Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator. (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under § 1.482–5(c). Neither Company A nor the comparable companies use valuable intangibles in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable

companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

Example 2. Application of the operating profit to total services costs profit level indicator. (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its 2005 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company A incurs in performing the consulting services, and do not make use of valuable intangibles or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables only report an aggregate figure for costs of goods sold and operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 2003 through 2005, Company B shows the following results for the services performed for Company A: