

and equipment for the exploration. All three controlled companies provide their own administrative support for their respective functions.

(iii) Analysis of the facts and circumstances indicates that Companies A, B, and C all make nonroutine contributions. In addition, because the transactions between Companies A, B and C are highly integrated, it is difficult to reliably evaluate them on a separate basis. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of the arm's length results of the services performed by all three related taxpayers.

(iv) Under the residual profit split method, profits are first allocated based on the routine contributions of the three controlled taxpayers. Routine contributions include any general, sales, marketing or administrative functions performed by either Companies A, B or C for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions made by each taxpayer. Since Company C provided nonroutine contributions in the form of drilling rights, residual profits are allocated to Company C based on this contribution.

(h) *Unspecified methods.* Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm's length. Any method used under this paragraph (h) must be applied in accordance with the provisions of § 1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction (e.g., outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in

accordance with § 1.482-1(d) (Comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(i) *Contingent-payment contractual terms for services—(1) Economic substance of contingent payment contractual terms recognized.* In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction ordinarily would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period, provided that it is reasonable to conclude that no such payment would be made by uncontrolled taxpayers engaged in similar transactions under similar circumstances. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction ordinarily would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered, provided that it is reasonable to conclude that such payment would be made by uncontrolled taxpayers that engaged in similar transactions under similar circumstances.

(2) *Contingent-payment arrangement.* For purposes of this paragraph (i), an arrangement shall be treated as a contingent-payment arrangement if—

(i) *Written contract.* The arrangement is set forth in a written contract entered into prior to the start of the activity or group of activities constituting the controlled services transaction;

(ii) *Specified contingency.* The contract states that payment is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of paragraph (l)(3) of this section) for the recipient directly related to the controlled services transaction; and

(iii) *Basis for payment.* 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. Whether the specified

contingency bears a direct relationship to the controlled services transaction, and whether the basis for payment reflects the recipient's benefit and the renderer's risk, are evaluated based on all the facts and circumstances. Pursuant to § 1.482-1(d)(3)(ii)(B), one factor that is especially important is whether the contingency and the basis for payment are consistent with the economic substance of the controlled transaction and the conduct of the controlled parties.

(3) *Commissioner's authority to impute contingent-payment terms.* Consistent with the authority in § 1.482-1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) *Evaluation of arm's length charge.* Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this section and other applicable rules under section 482. Payment under a contingent-payment contract must be reasonable and consistent with the economic substance of the controlled services transaction, based on all facts and circumstances, and must reflect the recipient's benefit from the services rendered and the risks borne by the renderer. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm's length, the charge determined under the rules of §§ 1.482-3 and 1.482-4 for the transfer of similar property may be considered. See § 1.482-1(f)(2)(ii).

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

*Example 1.* (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In Year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make