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Comments on the Proposed Regulations Under Section 1.482-2(b)(3) and (7)

American Institute of Certified Public Accountants. Committee on Federal Taxation

TAX COMMITTEE COMMENTS AND RECOMMENDATIONS

Comments on the Proposed Regulations
Under Section 1.482-2(b)(3) and (7)

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GENERAL COMMENTS

The original proposed Section 482 regulations dealing with the performance of services seemed on balance to be fairly reasonable. Because of this fact, the Institute's tax committee offered no substantial comments. In particular, it was felt that the distinction recognized between services which were a part of a trade or business and those which were not, was realistic and that no profit element would be required except in those trade or business situations set forth in subparagraph (7). The services considered in that subparagraph where those: (1) rendered by or to a related company which was in the business of rendering similar services to unrelated parties, (2) rendered in connection with a unique product which was to be constructed for an unrelated party, or (3) which entered into the cost of sales of a product to be sold to an unrelated party. To recognize a profit in these situations is in line with the third party concepts of the entire Section 482 regulations.

The newly proposed regulations depart substantially from this concept and as such seem to go beyond the spirit and the principles of Section 482.

Of particular importance is the effect of the proposed regulations on related companies organized to provide for

maximum efficiency in the rendition of certain supporting services of related entities. For example, many related companies operate a separate corporation whose exclusive function is to provide the supporting services on a pool basis for those companies. If these services were performed separately by each entity, the unwarranted duplication would result in a substantial increase in costs to the group. By organizing one entity to provide those services, the maximum of efficiency of operations is accomplished. To penalize this type of company is to penalize efficient management. It should be noted that few, if any, of these service-type companies render services to third parties.

What is said for the service-type organization can also be said for separately incorporated research companies where such research is accomplished for related companies and not for third parties. Certainly the pooling of research activities of a number of related companies is by far the most efficient method of handling those activities. To require each separate unit to conduct its own research would substantially increase the cost thereof. So long as the research activity is not conducted for unrelated parties, there seems no reason to charge any of the related companies anything other than an allocation of cost. This is the philosophy of the cost sharing arrangement provided for in the intangible areas of Section 482. This section of the regulations should be consistent with the intangibles section.

It is felt that the revised proposed regulation sections

1.482-2(b)(3) and (7) should be withdrawn completely and the originally proposed regulations reinstated. As indicated, the extension of the services area to cover basically supporting services among related parties is beyond the spirit and principles of Section 482. There is no tax avoidance motive or problem of a clear reflection of income which are the two facets for which Section 482 is intended. An allocation of costs among the related companies accomplishes the same thing as if the costs were incurred separately by each member, the only difference being that the total costs are reduced, resulting also in a lesser deduction for tax purposes.

If this suggestion is not followed, the following specific comments should be considered.

Specific Comments

Section	
1.482-2 (b)(7)(iii)	1. Subparagraph (iii) and Example (4) provide for a profit element rather than an allocation of costs where a corporation is particularly capable of rendering certain services. The example given covers research and development areas presumably among members of a related group. We believe that the proposed regulations in this area, if retained, should be made consistent with the cost sharing provisions of the intangibles regulations, or that they be revised to recognize a profit element only where the services will ultimately have a direct relationship to

either products or services ultimately destined for third parties.

Section

1.482-2(b)(7)(iv)

2.

Of particularly questionable merit is Subparagraph (iv) which deals with the rendition of a substantial amount of services from related entities and Example (6) which sets forth an example of Subparagraph (iv). The services described in Example (6) are substantially those supporting services which a service-type company renders. These include accounting, billing, shipping and routine management functions. None of these functions are normally rendered for profit to third parties, but are merely supporting functions for a related major business activity. This concept is recognized in Example (5) in dealing with a supporting function of an accounting department. We believe these areas should be either deleted or revised to recognize a profit element only when the services will ultimately have a direct relationship to either products or service ultimately destined for third parties.