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Pricing Method and SCM-Eligibility under the BEAT

April 15, 2019

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If related party services meet certain eligibility requirements for the use of the services cost method ("SCM"), U.S. taxpayers could qualify for an exception to the base erosion and anti-abuse tax ("BEAT"). But determining the scope of the new BEAT SCM exception can be a complex undertaking. The good news is that mark-ups, commissions, and combined service prices alone do not preclude eligibility for the exception.

Section 59A,[1] the BEAT, provides an exemption for certain amounts paid or accrued for services that meet (with one exception) the requirements for eligibility for SCM use[2] (the "BEAT SCM Exception"). Much has been written about the availability of the BEAT SCM Exception for services that meet the relevant SCM-eligibility requirements but for which the transfer price equals the sum of the total costs of providing the services and a mark-up. The section 59A proposed regulations would allow the BEAT SCM Exception even if a mark-up is paid, assuming the other applicable requirements for the BEAT SCM Exception were satisfied. This article evaluates the availability of the BEAT SCM Exception for services for which the price is not explicitly set as total services costs plus a mark-up but takes a different form, such as a commission on sales, and concludes that the service payments can qualify for

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 The SCM, described in section 1.482-9(b), is an elective method for pricing controlled services transactions.

the BEAT SCM Exception. The payment amount that can be excluded from the BEAT will equal the lesser of the actual charge for the qualifying services and the total services cost associated with the services. The article also discusses certain other considerations related to the pricing method and the BEAT SCM Exception, such as whether an aggregate price for SCM eligible and non-SCM eligible services can be disaggregated for purposes of the BEAT exception. Generally, a combined service price can be disaggregated for BEAT exception purposes.

The BEAT SCM Exception

Section 59A imposes a minimum tax on certain taxpayers making base erosion payments.[3] One feature of the BEAT provision is that it provides an exception—tied to the SCM—from the definition of a base erosion payment for certain amounts paid or accrued by a taxpayer for services.

Section 59A(d)(5) states that a base erosion payment does not include "any amount paid or accrued by a taxpayer for services if—

(A) such services are services which meet the requirements for eligibility for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure), and

(B) such amount constitutes the total services cost with no mark-up component."

To be eligible for the BEAT SCM Exception, proposed regulations issued on December 13, 2018 (the "Proposed Regulations"), if finalized, would provide that all the section 1.482-9(b) requirements must be satisfied, except that the section 1.482-9(b)(5) business judgment rule would not apply, and adequate books and records must be maintained as described in proposed section 1.59A-3(b)(3)(i)(C), instead of as described in section 1.482-9(b)(6).[4]

Therefore, to be eligible for the BEAT SCM Exception, the following requirements must be satisfied:

- The service is a covered service as described in section 1.482-9(b)(3);
- The service is not an excluded activity as described in section 1.482-9(b)(4); and
- Adequate books and records are maintained within the meaning of proposed section 1.59A-3(b)(3)(i)(C).

Availability of the BEAT SCM Exception If Mark-Up Is Paid Over Total Services Cost

Prior to the release of the Proposed Regulations, there was significant debate around the meaning of the statutory language in section 59A(d)(5). In particular, there was debate as to whether the BEAT

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[3] The BEAT provision is complex and is not fully described in this article.

[4] Proposed section 1.59A-3(b)(3)(i)(B).

SCM Exception applies when an amount paid or accrued for services exceeds the total services cost, but the payment otherwise meets the other requirements for the BEAT SCM Exception set forth in section 59A(d)(5).

The Proposed Regulations clarify the application of the statutory language, and would allow the BEAT SCM Exception even if a mark-up is paid (assuming the other applicable requirements for the BEAT SCM Exception are satisfied). In other words, the BEAT SCM Exception is not limited to services that are priced exactly at cost. However, the BEAT SCM Exception is available only to the extent of the total services costs and the portion of any payment that exceeds the total services cost is ineligible for the BEAT SCM Exception.[5]

Availability of BEAT SCM Exception for Different Pricing Methods

A common approach for pricing a controlled service transaction is to set the price for the service equal to the total costs of providing the service plus a mark-up based on arm's length benchmarks. Much of the discussion to date around the availability of the BEAT SCM Exception has been framed in terms of service payments determined as the total services costs plus a mark-up.

However, while service payments equal to total services costs plus a mark-up are common, there is no requirement for services to be priced based on measures related to total services costs. The regulations issued under section 482 (the "Section 482 Regulations") require that a controlled transaction, including a controlled service transaction, must meet the arm's length standard, that is, the result of the transaction must be "consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."[6] The Section 482 Regulations do not prescribe the pricing method for a service transaction. Pricing methods other than total services costs plus a mark-up are permissible so long as the pricing is consistent with the arm's length standard and, in practice, controlled parties do price service transactions using other approaches, such as commissions, fixed fees, hourly rates, etc.

A question is whether the pricing method for the controlled services transaction has any relation to the availability of the BEAT SCM Exception for that payment for services, that is, is the BEAT SCM Exception available to service payments that are not determined as the sum of total services cost and a mark-up or, more generally, by reference to the total services cost? For instance, is the BEAT SCM Exception available for a service payment equal to a commission on sales?

As noted above, to qualify for the BEAT SCM Exception, the Proposed Regulations would require all the requirements of section 1.482-9(b) to be satisfied, except that the business judgment rule would not apply and the adequate books and records requirement would be modified. Besides the business judgment rule and the adequate books and records requirements, a controlled service transaction must be a covered service and must not be an excluded activity to be eligible for the SCM. Both the covered

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5 Proposed section 1.59A-3(b)(3)(i).

6 Section 1.482-1(b)(1).

service and excluded activity requirements are framed in terms of the nature of the underlying activity in the controlled service transaction, as described below.

Covered Services

Covered services are ones that meet the definition of specified covered services or low margin covered services.[7]

- Specified covered services are controlled transactions that the Commissioner specifies by revenue procedure. Services are included in the revenue procedure based upon the Commissioner's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable mark-up on total services costs. [8]
- Low margin covered services are controlled services transactions for which the median comparable mark-up on total services costs is less than or equal to seven percent. The median comparable mark-up on total services costs for the SCM purposes is determined under the general Section 482 Regulations without regard to the SCM.[9]

Excluded Activities

Excluded activities that are ineligible for use of the SCM are listed in section 1.482-9(b)(4). These are:

- Manufacturing
- Production
- Extraction, exploration, or processing of natural resources
- Construction
- Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement
- Research, development, or experimentation
- Engineering or scientific
- Financial transactions, including guarantees
- Insurance or reinsurance

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7 Section 1.482-1(b)(2).

8 Section 3 of Rev. Proc. 2007-13 provides a list of specified covered services for the application of the SCM.

9 Section 1.482-9(b)(3).

The only reference to pricing method in the description of covered services or excluded activities is in the excluded activity "reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement." The phrase "acting under a commission or other similar arrangement" refers to the pricing method in an excluded activity. However, this phrase needs to be read in the context of the entire excluded activity. Every item in the excluded activity list (and similarly, every item in the specified covered services list) refers to a type of activity. The excluded activity list (and, similarly, the specified covered services list) identifies the qualified or disqualified services by their nature. The phrase "acting under a commission or other similar arrangement" follows the terms "reselling, distribution, acting as a sales or purchasing agent" which refer to types of activities. The phrase "acting under a commission or other similar arrangement," read in context, therefore, refers to activities related to reselling, distribution, acting as a purchasing or sales agent that are conducted under a commission or other similar arrangement, and should not be read in isolation to exclude all services that are compensated through a commission or other similar arrangement.

Consistent with our discussion above, whether a service is a covered service or an excluded activity depends on the nature of the activity performed in the controlled services transaction. The pricing method for the controlled services transaction *per se* does not determine whether the service is a covered service or an excluded activity.

Nor does the adequate books and records requirement of the Proposed Regulations preclude service payments based on certain pricing methods from qualifying for the BEAT SCM Exception. The adequate books and records provision requires that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with section 1.482–9(k). The Proposed Regulations require that taxpayers include a calculation of the amount of profit mark-up (if any) paid for the services. However, there is no requirement that there be a profit mark-up or that, if there is one, the profit mark-up be part of any specific pricing method for the services. The profit mark-up simply refers to the portion of any payment that exceeds the total services cost.

Therefore, a service charge not explicitly determined as total services costs plus a mark-up, such as a commission, is not precluded from being eligible for the BEAT SCM Exception. In other words, total services costs (subject to the qualification below) associated with the SCM-eligible services that are compensated using a commission or any other payment form can qualify for exclusion from the BEAT.

The qualification referred to in the previous sentence arises in instances when the price for a controlled services transaction is not set at total services cost plus a mark-up and the resulting payment is not sufficient to cover total services cost. In such a case, not only is there no mark-up on the total services cost, but also the payment for the controlled services transaction is below the total cost of providing the services. The payment amount in this case that can be excluded from the BEAT will equal the lesser of the actual charge for the qualifying SCM-eligible services and the total services cost associated with the services. The preamble to the Proposed Regulations notes that "the SCM exception is available if there

is a mark-up, but only to the extent of the total services costs." The preamble further notes that "[t]he most logical interpretation is that a payment for a service that satisfies subparagraph (A) is excepted *up to the qualifying amount* under subparagraph (B), but amounts that do not qualify (i.e., the mark-up component) are not excepted." (Emphasis added.) Further, given that the BEAT SCM Exception applies only to an "amount paid or accrued by a taxpayer" for the SCM eligible services as described in section 59A(d)(5), we conclude that when the service payment is not sufficient to cover the total services cost, the BEAT exception is only available to the extent of the service payment and not the total services cost.

Other Considerations

There may be situations in which multiple services or other transactions are covered in an intercompany agreement for one aggregate price. This aggregate price could take any form—total services cost plus a mark-up, commission, or some other form. As discussed above, a pricing method for services other than a mark-up over total services cost does not preclude the services from qualifying for the BEAT SCM Exception. Therefore, if some of the services covered in the intercompany agreement are SCM-eligible for BEAT purposes while others are not, the SCM-eligible services can qualify for the BEAT exception irrespective of how the aggregate price in the intercompany agreement is structured. The total services costs for the services within the unified agreement that are SCM-eligible services as described in section 59A(d)(5) can be excluded from the BEAT calculation.

A corollary to the discussion above is that the intercompany agreement covering multiple services does not need to split the aggregate price into prices associated with the qualifying and other services since the pricing method is not determinative of whether a service qualifies for the BEAT SCM Exception. For BEAT purposes the taxpayer books and records are required to permit verification of the amount charged for the qualifying services, the total services costs associated with the services (including description of the services), the renderer and recipient of the services, calculation of the profit mark-up (if any), and verification of the methods used to allocate and apportion the costs to the services.

We note that while it is not required that an intercompany agreement covering multiple services separately identify the prices associated with the qualifying services, the taxpayer books and records are required to permit verification of the amount charged for the qualifying services. In other words, the books and records must provide verification of the price paid for the qualifying services. Since a taxpayer will likely not have separate prices in its regular transfer pricing documentation for the qualifying and non-qualifying services covered under one aggregate intercompany service charge, the taxpayer should consider the best approach to documenting the actual charge (in addition to the total services costs) for the qualifying services. An option the taxpayer may consider is pricing the qualifying services at cost, effectively electing the SCM for the services, if the qualifying services are eligible for the SCM election. The optimal approach to documenting the price for a qualifying service should be evaluated on a case by case basis. For instance, pricing services at cost may not be the best approach if it implies a mark-up on the non-qualifying services in the aggregate service transaction outside the arm's length range.

Further, it is important to evaluate the best approach to the intercompany agreement on a case by case basis. For instance, there may be situations in which it is optimal to separately identify the arm's length charges for the SCM-eligible and non-SCM-eligible services in the agreement. One example is when the intercompany agreement covers sales and marketing services and also some additional SCM-eligible services for an aggregate commission payment. Upon further analysis, the taxpayer might determine that the sales and marketing services fall into the excluded activity category "reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement" and are thus ineligible for the BEAT SCM Exception. To reduce the risk of the SCM-eligible services being evaluated together with the sales and marketing services and considered within the "reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement" excluded activity, the taxpayer could clearly identify the different services in the intercompany agreement and the payments for those services. Further, it may be optimal to set the payment for the SCM-eligible services by reference to their total services costs to distinguish it from the commission payment for the sales and marketing services.

Another instance in which it may help to separately specify the pricing for the SCM-eligible and other services is when the aggregate payment has a likelihood of not covering total services cost of the combined services. In such a case there could be a question around whether the entire amount of the total services cost of the SCM-eligible services can be excluded from the BEAT. As noted above, if the service payment does not cover total services costs, the exclusion from BEAT is only to the extent of the service payment. An intercompany agreement that identified the portion of the aggregate payment for the SCM-eligible services could provide support for the BEAT exclusion amount.

On the other hand, there may be instances in which disaggregating the intercompany prices between the different services covered in the intercompany agreement provides no additional benefit, or alternatively, leads to additional risks. The latter may occur, for instance, when any amendment to intercompany agreements invites greater tax authority scrutiny or if the tax authority in the jurisdiction of the U.S. entity's counterparty finds reason to dispute the price of one or more of the component services.

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