

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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subject: Services cost method exception for purposes of section 59A(d)(5)

This Chief Counsel Advice responds to your request for assistance in determining the proper interpretation of legal authorities regarding taxpayers' selection of a transfer pricing method for services other than the services cost method while also excluding certain amounts paid for services from base erosion payments under the section 59A(d)(5) services cost method exception.<sup>1</sup> This advice may not be used or cited as precedent.

**ISSUES**

1. If a taxpayer does not apply the Treas. Reg. § 1.482-9(b) services cost method to determine the appropriate arm's length price for services rendered to the taxpayer by a foreign related party, is the taxpayer able to exclude the cost portion of those amounts paid or accrued for services under the section 59A(d)(5) services cost method exception to base erosion payments (assuming the taxpayer is otherwise eligible for the section 59A(d)(5) services cost method exception)?

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<sup>1</sup> Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986 (26 U.S.C. § 1 et seq.), as amended, (the "Code") and all regulation references are to the Treasury Regulations issued thereunder.

2. If a taxpayer claims the section 59A(d)(5) services cost method exception but does not apply the Treas. Reg. § 1.482-9(b) services cost method to determine the appropriate arm's length price, does documentation supporting the section 482 pricing method applied satisfy the taxpayer's burden of substantiation under the books and records requirements of Treas. Reg. § 1.59A-3(b)(3)(i)(C)?

## CONCLUSIONS

1. Yes, neither section 59A(d)(5) nor Treas. Reg. § 1.59A-3(b)(3)(i) requires taxpayers to apply the Treas. Reg. § 1.482-9(b) services cost method to be eligible for the section 59A(d)(5) services cost method exception.
2. Books and records prepared to document a taxpayer's section 482 method may not satisfy the requirements of Treas. Reg. § 1.59A-3(b)(3)(i)(C), which are independent of recordkeeping requirements imposed by other provisions of the Code. Records maintained for purposes of avoiding penalties under section 6662(e)(3) will also satisfy the taxpayer's recordkeeping obligations under Treas. Reg. § 1.59A-3(b)(3)(i)(C) only if they include the mandatory elements enumerated in that regulation.

## FACTS

Taxpayers have excluded amounts paid or accrued for services rendered by foreign related parties from their base erosion payments under the section 59A(d)(5) services cost method exception ("section 59A SCM exception") but have not applied the Treas. Reg. § 1.482-9(b) services cost method ("Treas. Reg. § 1.482-9 SCM") to price these transactions. The Treas. Reg. § 1.482-9 SCM prices services rendered at cost with no mark-up. These taxpayers use another method acceptable under section 482, such that they pay an amount that exceeds the total services costs and take a corresponding deduction,<sup>2</sup> which is greater than they could claim if they had applied the Treas. Reg. § 1.482-9 SCM for purposes of section 482.

## LAW

### *Section 482 Services Cost Method*

The "arm's length standard" for determining the appropriate amount charged between commonly controlled taxpayers is met "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. § 1.482-1(b)(1). Treas. Reg. §§ 1.482-2 through 1.482-7 and 1.482-9 provide methods for determining arm's length results. Treas. Reg. § 1.482-1(b)(2)(i).

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<sup>2</sup> This memorandum does not address whether taxpayers' payments or accruals constitute arm's length amounts. Moreover, the analysis assumes that taxpayers that do not elect to apply the Treas. Reg. § 1.482-9 SCM will pay or accrue arm's length amounts for services rendered in a controlled transaction and otherwise comply with section 482 requirements.

Treas. Reg. § 1.482-9(a) enumerates several methods that can be applied to controlled services transactions to determine an arm's length result. One method, the Treas. Reg. § 1.482-9 SCM, "evaluates whether the amount charged for certain services is arm's length by reference to the total services costs . . . with no markup." Treas. Reg. § 1.482-9(b)(1). A transaction must meet threshold requirements to be eligible for the Treas. Reg. § 1.482-9 SCM. Treas. Reg. § 1.482-9(b)(2). Specifically, "[t]o apply the services cost method to a service . . . , all of the following requirements must be satisfied with respect to the service": (i) it must be a covered service; (ii) it may not be a specifically excluded activity; (iii) "[t]he service is not precluded from constituting a covered service by the business judgment rule" as defined in the regulation; and (iv) adequate books and records are maintained as described in the regulation. The "business judgment rule" limits the services cost method to services that do not "contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group." Treas. Reg. § 1.482-9(b)(5).

#### *Base Erosion Anti-Abuse Tax Overview*

The Base Erosion and Anti-Abuse Tax ("BEAT") is intended to combat tax practices whereby multinational enterprises erode their U.S. taxable income by shifting profits to overseas entities.<sup>3</sup> To address this, section 59A imposes tax on an alternative tax base not reduced by certain payments to foreign related parties that would normally be deductible; there are limited exceptions for certain payments that are not treated as base erosion payments or creating base erosion tax benefits. "Base erosion payments" include "any amount paid or accrued by the taxpayer to a [foreign related party] and with respect to which a deduction is allowable under this chapter." Section 59A(d)(1).<sup>4</sup> "Base erosion tax benefit" generally includes any deduction allowed for the taxable year arising from base erosion payments as defined by section 59A(d)(1). Section 59A(c)(2)(A).

Section 59A(b)(1) limits the imposition of the BEAT to "applicable taxpayers," which are defined in section 59A(e) and Treas. Reg. § 1.59A-2(b) as a corporation (subject to certain exceptions) with (i) average gross receipts above a threshold for the prior three-year period (on an entity or group basis) and (ii) a "base erosion percentage" (discussed below) in excess of a certain threshold depending on the type of taxpayer. The "base erosion minimum tax amount" is the excess of the product of a tax rate (generally 10 percent) and the taxpayer's modified taxable income over the taxpayer's regular tax

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<sup>3</sup> See Pub. L. No. 115-97, sec. 14401(a), 131 Stat. 2054, 2226 (2017).

<sup>4</sup> The definition also includes certain other ordinarily deductible payments (or payments that reduce gross receipts), such as purchases of depreciable property, reinsurance payments, and certain payments to expatriated entities. Secs. 59A(d)(2)-(4).

liability adjusted for certain credits. Section 59A(b).<sup>5</sup> “Modified taxable income” is the taxpayer’s regular taxable income plus “any base erosion tax benefit with respect to any base erosion payment” and “the base erosion percentage [defined in section 59A(c)(4) and Treas. Reg. § 1.59A-4(b)(2)(ii)] of any net operating loss deduction allowed under section 172 for the taxable year.” Section 59A(c).

#### *Services Cost Method Exception*

Section 59A(d)(5) specifically excludes from the term “base erosion payment”:

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 business judgment rule]), and

(B) such amount constitutes the total services cost with no markup component.

A taxpayer excludes amounts under the section 59A SCM exception only to the extent of the total services cost of those services. Treas. Reg. § 1.59A-3(b)(3)(i)(A). Thus, any amount paid or accrued to a foreign related party for eligible services in excess of the total services cost—referred to as the “markup component” in section 59A(d)(5)(B)—remains a base erosion payment. Treas. Reg. § 1.59A-3(b)(3)(i)(A).

Finally, a taxpayer asserting that a payment satisfies the section 59A SCM exception must maintain adequate records to allow the Commissioner to verify eligibility for this exception. Treas. Reg. § 1.59A-3(b)(3)(i)(B)(2). The books and records must include “the amount charged for the services and the total services costs incurred by the renderer [of the services], . . . a description of the services in question, identification of the renderer and the recipient of the services, calculation of the amount of profit mark-up (if any) paid for the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services in question in accordance with § 1.482-9(k).” Treas. Reg. § 1.59A-3(b)(3)(i)(C).

#### ANALYSIS

1. Taxpayers may benefit from the section 59A SCM exception without applying the Treas. Reg. § 1.482-9 SCM.

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<sup>5</sup> The tax rate is generally 10 percent for tax years beginning before January 1, 2026, but certain banks and securities dealers are subject to an eleven percent rate. Compare sec. 59A(b)(1)(A), (2)(A), with sec. 59A(b)(3).

Although the section 59A SCM exception requirements generally cross-reference the Treas. Reg. § 1.482-9 SCM requirements, section 59A(d)(5) and Treas. Reg. § 1.59A-3(b)(3)(i) do not require taxpayers to apply the Treas. Reg. § 1.482-9 SCM to a controlled transaction to benefit from the section 59A SCM exception. Compared to the Treas. Reg. § 1.482-9 SCM, the section 59A SCM exception broadens the scope of services eligible for the exception by including services that fail the business judgment rule. Moreover, taxpayers are eligible for the section 59A SCM exception even if they pay a mark-up component on those services.<sup>6</sup>

*Plain Language of Section 59A(d)(5)(A)*

Under the plain meaning of “eligible” as used in section 59A(d)(5)(A), the Treas. Reg. § 1.482-9 SCM need not be selected and applied by a taxpayer for that taxpayer to benefit from the section 59A SCM exception. Eligible is defined as “[f]it and proper to be selected or to receive a benefit” and does not strictly require actual selection.<sup>7</sup> Under a literal interpretation of the text, the amount paid or accrued for services need only meet the requirements enumerated under the Treas. Reg. § 1.482-9 SCM (as modified by section 59A(d)(5)) without necessarily applying them for transfer pricing purposes.<sup>8</sup>

As further evidence that transactions covered by the section 59A SCM exception need not be priced under the Treas. Reg. § 1.482-9 SCM, some services ineligible for the Treas. Reg. § 1.482-9 SCM are covered by the scope of the section 59A SCM exception. Specifically, services eligible for the section 59A SCM exception may fail the business judgement rule. Section 59A(d)(5) explicitly excludes amounts paid or accrued for services from base erosion payments if (i) the services “meet the requirements for eligibility for use of the services cost method under section 482,” determined without regard to the business judgment rule; and (ii) “such amount constitutes the total services cost with no markup component.” The business judgment rule, one element of the four-part Treas. Reg. § 1.482-9 SCM eligibility test, requires that services priced under the Treas. Reg. § 1.482-9 SCM not “contribute significantly to fundamental risks of business success or failure.” Treas. Reg. § 1.482-9(b)(2)(iii). These amounts paid or accrued for services would necessarily be priced other than under the Treas. Reg. § 1.482-9 SCM.

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<sup>6</sup> Treas. Reg. § 1.482-9(b)(1).

<sup>7</sup> *Eligible*, *Black’s Law Dictionary* (11th ed. 2019).

<sup>8</sup> Congress rejected an earlier version of the BEAT that would have required taxpayers to “*elect*[] to use a services cost method for purposes of section 482” to exclude the payment from the tax computation under the earlier bill draft. Tax Cut and Jobs Act, H.R. 1, 115th Cong. sec. 4303 (Nov. 13, 2017) (emphasis added) (“The term ‘specified amount’ shall not include . . . in the case of a payor which has elected to use a services cost method for purposes of section 482, any amount paid or incurred for services if such amount is the total services cost with no markup.”); H.R. Rep. No. 115-409, at 105, 401 (2017).

*Regulatory Interpretation of Section 59A(d)(5)*

Regulatory guidance similarly provides that a taxpayer need not apply the Treas. Reg. § 1.482-9 SCM to claim the section 59A SCM exception. Treas. Reg. § 1.59A-3(b)(3)(i)(A) states that only “amount[s] paid or accrued to . . . foreign related part[ies] in excess of the total services cost of services eligible for the services cost method exception (the mark-up component) remain[] a base erosion payment.” The cost portion of such amounts are excluded from the definition of base erosion payments.

By defining the section 59A SCM exception to cover transactions even if the amounts paid or received for services exceed costs, Treas. Reg. § 1.59A-3(b)(3)(i) clearly contemplates the section 59A SCM exception applies to transactions not priced under the Treas. Reg. § 1.482-9 SCM. Further reinforcing this, Treas. Reg. § 1.59A-3(b)(3)(i)(A) coordinates with Treas. Reg. § 1.59A-3(b)(3)(i)(B)(1), which, like the statute, allows taxpayers to enjoy the benefit of the exception without satisfying the business judgment rule. Finally, the regulations require that proper documentation related to the section 59A SCM exception be maintained “regardless of whether the taxpayer determined its payments for those services based on the services cost method.” Treas. Reg. § 1.59-3(b)(3)(i)(C).

*Conclusion*

The overwhelming weight of authority permits taxpayers to use the section 59A SCM exception without applying the Treas. Reg. § 1.482-9 SCM for transfer pricing purposes.

2. Taxpayer documentation related to a section 482 method may not satisfy the requirements of Treas. Reg. § 1.59A-3(b)(3)(i)(C).

Although taxpayers may maintain records for transfer pricing purposes under section 6662(e) and Treas. Reg. § 1.6662-6(d)(2)(iii) to avoid the potential imposition of penalties related to transfer pricing, these records alone may not be sufficient to satisfy the section 59A SCM exception recordkeeping requirements. In such cases, Treas. Reg. § 1.59A-3(b)(3)(i)(C) requires records that demonstrate “the total amount of costs that are attributable to each of those services, the method chosen under § 1.482-9(k) to apportion the costs between the service eligible for the services cost method under this section and the other service, and the application of that method in calculating the amount eligible for the [section 59A] services cost method exception.” This may require additional documentation beyond that which taxpayers must maintain to avoid penalties under section 6662(e). For example, if the taxpayer selects and applies a comparable profits method using a profit level indicator other than the ratio of operating profit to total services costs,<sup>9</sup> then a taxpayer’s section 6662(e) documentation may not contain an

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<sup>9</sup> See Treas. Reg. § 1.482-9(f)(2)(ii) (allowing a comparable profits method using the ratio of operating profit to total services costs or a profit level indicator provided in § 1.482-5(b)(4)).

apportionment of total services costs as necessary to comply with its obligations under Treas. Reg. § 1.59A-3(b)(3)(i)(C).

Please call Sarah Ellen Floyd at 202-317-6938 if you have any further questions.