

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

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to:

(Large Business & International)

from: Robert Z. Kelley
Branch Chief, Branch 6
(International)

subject: Cost Allocation Methods under Treas. Reg. § 1.482-9

This Chief Counsel Advice memorializes our response to your request for assistance. This advice may not be used or cited as precedent.

FACTS

For Tax Year 1 and Tax Year 2, Taxpayer priced certain controlled services transactions it performed for various affiliates using the comparable profits method (“CPM”) with a markup on costs as the profit level indicator.¹ During the examination of those tax years, via an affirmative disclosure described in Rev. Proc. 94-69, Taxpayer sought to retroactively change the cost allocation method (or key) used to estimate each affiliate’s proportionate share of the services costs for purposes of applying the CPM. Specifically, Taxpayer seeks to change the allocation key from (i) one in which costs are apportioned to regional operating companies (“Regional OpCos”) based on their respective shares of total worldwide gross revenue to (ii) one that first allocates costs among Taxpayer’s various business divisions then apportions those costs among the

¹ Taxpayer describes its method as a CPM with a markup-on-costs profit level indicator. Depending on the details of the methodology, a method using a markup on costs could be a cost of services plus method described in Treas. Reg. § 1.482-9(e) rather than a CPM as described in Treas. Reg. § 1.482-9(f). The distinction is immaterial to our analysis.

Regional OpCos based on each OpCo's respective share of each revenue.²

In the first step, Taxpayer identifies and allocates costs through the following process:

- Identify relevant cost centers and the names of the cost centers booked to each general ledger account;
- Assign each cost center to a corresponding (a business unit that is a subset of a) and function representing the or business function to which the cost center relates;³
- Identify, specifically, the cost centers assigned to the particular part of the ("Sub-area") to which the cost center specifically relates; and
- Use the description (and the "Sub-area" description, if necessary) to group each cost center within the appropriate , using the following steps:
 - Identify cost centers that can be clearly assigned to a specific based on the or Sub-area descriptions; and
 - If no clear assignment is possible, then assign such cost centers to the "other" category.

This identification process is also used for management purposes to budget, manage expenses, approve workflows, control access to applications, and track employee owners of cost centers, among other functions.

In the second step, Taxpayer apportions the costs allocated to each to each Regional OpCo based on that OpCo's respective share of that

revenue. For cost centers in the "other" category, Taxpayer apportions costs based on the OpCo's respective shares of total worldwide revenue.

In response to an information document request, Taxpayer described the adjustment resulting from the allocation key change as a "setoff" under Treas. Reg. § 1.482-1(g)(4)(i). Taxpayer thus claims the adjustments as a setoff and acknowledges the

² Notwithstanding that, in its section 6662(e) documentation for Tax Year 1, Taxpayer stated that its original one-step method was the "most reliable method" to allocate the costs in issue, Taxpayer applied this two-step method for Tax Year 3. We understand that Exam has reviewed Taxpayer's supporting documents for the new method and accepted Taxpayer's position for Tax Year 3.

³ For this purpose, Taxpayer relied on a schedule, the Schedule," that ties cost centers to and as noted is used for multiple purposes within its business operations. Because it is a "live" document not subject to consistent preservation, Taxpayer initially relied on a later-year version of the schedule for its Tax Years 1 and 2 allocation and apportionment. After receiving the NOPA, Taxpayer was able to recover contemporaneous versions of the Schedule. The recovered versions corroborated Taxpayer's position that use of the later-year version for its Tax Years 1 and 2 allocation and apportionment was reasonable because no cost centers were deleted during that time and the assignment of cost centers to remained materially the same.

adjustments are allowable only to the extent of and only to reduce other section 482 adjustments between the same controlled taxpayers in the same taxable years.

In its section 6662(e) documentation for Tax Year 1, Taxpayer stated that its original method was the “most reliable method” to allocate the costs in issue. Exam reviewed Taxpayer’s submission and supporting documents for the new method.

LAW AND ANALYSIS

1. Application of Setoff Rules to Cost Allocation

A setoff under § 1.482-1(g)(4) will be taken into account only if the taxpayer, *inter alia*, “[e]stablishes that the transaction that is the basis of the setoff was not at arm’s length and the amount of the appropriate arm’s length charge.” Treas. Reg. § 1.482-1(g)(4)(ii)(A).

“The arm’s length amount charged in a controlled services transaction must be determined under one of the methods provided for in” Treas. Reg. § 1.482-9. Treas. Reg. § 1.482-9(a). The CPM is an acceptable method under Treas. Reg. § 1.482-9. *Id.* § 1.482-9(a)(5), (f). Under the CPM for services, “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.” *Id.* § 1.482-9(f)(2)(ii).

“In any case where the [service] renderer’s activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient ... also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, costs *must be allocated* among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group under [Treas. Reg. § 1.482-9(k)].” *Id.* § 1.482-9(k)(1) (emphasis added).

An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so. *Id.* § 1.482-9(l)(3). “An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity.” *Id.* “In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.” *Id.* § 1.482-9(k)(1).

“Any reasonable method may be ... an appropriate method” for allocating and apportioning costs under Treas. Reg. § 1.482-9. *Id.* § 1.482-9(k)(2)(i). Accordingly, in the context of a controlled services transaction in which “the amount charged ... is

determined under a method that makes reference to costs,” *Id.* § 1.482-9(k)(1), like Taxpayer’s CPM, a change in allocation key resulting in a more reliable method of cost allocation and apportionment under Treas. Reg. § 1.482-9(k)(2) would suffice to establish that a “transaction that is the basis of the setoff was not at arm’s length and the amount of the appropriate arm’s length charge,” *Id.* § 1.482-1(g)(4)(ii), even if the original method was a “reasonable” method. For this purpose, a “more reliable” method is one that would be expected under the facts and circumstances to more closely or directly trace costs to the specific benefits conferred by the activities for which the costs are incurred.

2. Application of Cost Allocation Rules to Taxpayer’s Cost Allocation Keys

“In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent.” Treas. Reg. § 1.482-9(k)(2)(i). “The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments’ costs by applying reasonable departmental overhead rates.” *Id.* “The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner.” *Id.* § 1.482-9(k)(2)(ii).

Here, one should expect assigning costs more specifically to _____, *i.e.*, business divisions, before apportioning them between Regional OpCos, *i.e.*, entities, based on each entity’s respective divisional revenue, to be more reliable than solely apportioning costs based on each entity’s respective share of worldwide revenue.⁴ The former factually connects costs to benefits more specifically than the latter. Moreover, that Taxpayer also uses this methodology tying cost centers to business divisions for business management purposes indicates reliability under the considerations laid out in Treas. Reg. § 1.482-9(k)(2)(ii).

Taxpayer’s cost allocation and apportionment method used in its setoff claim is therefore more reliable than that used for its return position and its setoff claim should be accepted.

Please call (202) 317-6161 if you have any further questions.

⁴ This remains the case notwithstanding Taxpayer’s suggestion to the contrary in its transfer pricing documentation for Tax Year 1.