Second First??
Transfer Pricing Issues In Secondment of Personnel

By Patricia Gimbel Lewis

International short-term transfers of personnel among related entities are common and involve predictable, albeit complex, issues relating to *individual* income taxes, employee benefits, etc. Tax consequences from the broader *corporate* perspective often get little attention. Recent administrative guidance in Germany shines the spotlight on transfer pricing considerations, which are gaining particular interest as the IRS revises its transfer pricing regulations for services.

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Corporate-level transfer pricing issues present intriguing theoretical issues that exhibit tension with the individual tax issues. Absent development of more uniform standards, it may be necessary to accept the fact-or-fiction of secondment before being able to effectively analyze the transfer pricing issues.

Definition and Example

Strictly speaking, secondment refers to the deployment of an individual from one related employer to another on a temporary basis, with eventual return to the first employer anticipated,[1] often referred to as the *loan* of an employee. A seconded individual does not change payrolls; instead, the receiving company reimburses the sending company for the individual's employment costs or pays some other type of fee or cost-plus arrangement.[2] (For simplicity, the discussion below refers to "corporate" consequences as meaning those of a business entity, regardless of its legal form.)

Here is a simple example: USCO, a U.S.-based multinational, uses an integrated computer network for ordering, tracking sales, etc.. One of USCO's foreign subsidiaries (FORCO) needs an extra computer specialist to ensure it is using the system properly and to train some employees. USCO agrees to second Joe to FORCO for a year from USCO's large New York IT department. Joe stays on USCO's payroll and in USCO's various employee benefit programs, and FORCO agrees to reimburse USCO for the latter's $150,000 employment costs with respect to Joe.

The transfer pricing status of secondment depends in the first instance on whether secondment is considered the provision of a service. After characterization comes quantification, as required by the pertinent transfer pricing regime.

A. Characterization

1. Is the arrangement a service contract or something else?

The first conundrum is whether USCO's secondment of Joe constitutes a provision of services from USCO to FORCO.[3] If USCO had explicitly contracted with FORCO to provide computer consulting services for a year for $150,000, common sense would view USCO as providing services to FORCO. That the consulting services were carried out by sending Joe to FORCO's premises for a year would not change that result.

What, if anything, differentiates such a service contract from a secondment arrangement? Possible tests are:

a. ***Is USCO is providing a benefit to FORCO?*** If this were the test, most secondments would effectively be service contracts.

b. ***Who is responsible for the services?*** This approach would pivot on the bearing of financial and entrepreneurial risk — for example, the obligation to send others at no additional cost to correct or complete Joe's work.

c. ***What does the contract say?*** For certain purposes, the transfer pricing regulations generally respect pre-existing contractual terms.[4] Under this approach, secondments would seldom be service contracts.

d. ***Is there such a thing as a personnel "loan"?*** If so, the transfer and repayment of the "principal" (whether considered the personnel or funds to pay them) would have no income tax consequences, though arguably a charge for use of the principal might be appropriate.

e. ***Does the result depend on the "common-law employee" test used for employment tax purposes under U.S. law?***[5] This standard would suggest that if Joe remains under high-level review and control by USCO, the continuation of the nominal employer-employee relationship between Joe and USCO would be appropriate, but if Joe is sent to FORCO with no continuing oversight or legal control by USCO, the employment relationship would have terminated. If sufficient control is retained by USCO, however, to keep Joe its common-law employee within employment tax concepts (a key goal of secondment arrangements), a consistent view for income tax purposes would treat the transaction as the provision of a service.

2. Moving to "Whose Expense Is It?"

With little articulation, analysis of this issue seems to have morphed into "Whose expense is it?" rather than "Whose employee is he?" Although incorporating some notions of control, the expense inquiry also includes consideration of which entity's business purposes are served by the services and which entity is benefited by the services. For example, if Joe's services focus mostly on investigating and reporting back to USCO whether FORCO is properly using the computer system and needs to expand its computer department to work efficiently with other group members, this might be viewed as an oversight, or "stewardship," service that is considered an expense of USCO only, regardless of who bears the financial expense or whose payroll Joe is on.

The evolution of this standard can be elicited from two early cases under section 162 of the Code: *Columbian Rope Co. v. Commissioner*, 42 T.C. 800 (1964), *acq.*, 1965-1 C.B. 4, and *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233 (Ct. Cl. 1969). Neither case involves secondments *per se*, although the situations embody the same "whose-employee-is-he" conundrum (*e.g.*, day-to-day services for a subsidiary carried out by the employees of the parent or persons paid by the parent). The clear thrust of these cases is that one company cannot deduct another's expense, relying on a benefit test to determine whose expense it is.

3. Application of Section 482

Deciding whose expense it is may effectively preempt — or overlap with — section 482, which authorizes the IRS to allocate gross income, deductions, etc., among related entities to clearly reflect income or prevent evasion of taxes. It would seem consistent with the statute to view the section 162 disallowance as congruent with a reallocation of *deductions* under section 482. The section 482 approach to services, however, has focused more on the reallocation of *income* under an arm's-length standard, which injects an additional consideration of valuing the services as if provided by an unrelated party.

The current section 482 services regulations are predicated on one company *performing services* for another.[6] If the employment-law standard is used for this purpose, section 482 could apply because the seconded individual remains employed by the sending company. Viewed from a substantive perspective, however, section 482 would not apply if seconded employees are rendering their services directly to the receiving company.

The 1996 OECD Transfer Pricing Guidelines with respect to Intra-Group Services,[7] while phrasing the standard differently, are similarly insensitive to this issue. Generally speaking, the Guidelines determine whether a service has been provided by evaluating —

> whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.[8]

Either this suggests that *any* secondment involving services of benefit to the subsidiary is covered and thus subject to the arm's-length standard *or* the Guidelines have simply skipped over the preliminary question of whether a service has been provided by someone other than the receiving company.

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Thus, if the services of the seconded employee are "non-integral" — which would typically be the case, assuming that no significant intangible property of the sending company is utilized — the sending company could simply charge its total costs to the receiving company and comply with section 482. The problems with complacency under this analysis are the risk of revision to the cost-only provision in the pending IRS review of the section 482 services regulations and inconsistency with the arm's-length rules in other countries.[10]

Perhaps the key to handling secondment costs can be found in an oft-cited IRS technical advice memorandum under section 482. P.L.R. 8806002 (Sept. 24, 1987) provides an extensive discussion of the allocation of intra-group services under Treas. Reg. § 1.482-2(b)(2). The ruling summarizes its favored "benefit test" as "presum[ing] that expenditures deducted by one affiliated corporation

are properly considered expenses of that corporation unless an allocation is appropriate due to the fact that the expenditures benefitted another affiliate." This comment suggests that one takes the taxpayer's treatment of the expenses as a given and then superimposes the section 482 tests. Thus if, for instance, the subsidiary has deducted the secondment costs, the expenses stay with the subsidiary unless some portion of those expenses are for the direct benefit of the parent (per the categories delineated in P.L.R. 8806002).

Stated another way, perhaps it makes no difference whether the services in question are conducted by "common-law employees" of the parent (or the affiliate) or by seconded employees. Instead, the gist of P.L.R. 8806002 is the IRS power to *reallocate deductions,* however otherwise incurred, notwithstanding any inconsistent secondment arrangements.

4. Best View?

Under such a pragmatic approach, secondment would allow the parties to select the employment method that is most convenient and least complex within local employment law constraints, albeit knowing that the tax authorities retain the ability to reallocate the deductions under applicable transfer pricing rules. One could step back from seeking perfect alignment of the employment tax standards with deduction and transfer pricing principles – ***second first*** – and then revisit the employer-level income tax issues through the transfer pricing lens.

Second best (no pun intended) would be to treat the arrangement as a loan of money to pay another's expenses, with expectation of reimbursement. This approach would lead to the same ultimate result (deduction at FORCO, with little or no markup to USCO), but is more facially inconsistent with employment tax treatment of Joe as an employee of USCO.

B. Amount

After characterization is established, one must determine whether the amount of intercompany payments is correct — either because transfer pricing rules apply or because an under- or over-payment of the "correct" amount has secondary tax consequences.

Under current U.S. transfer pricing rules, a cost-only approach applies to non-integral services, with an arm's-length test applied to integral services. The OECD Guidelines (Chapter VII, ¶¶ 7.19-7.37) rely primarily on arm's-length tests, *i.e.*, incorporating a profit. The soon-to-be-revised section 482 services regulations are expected to provide more specific guidance on any arm's-length determinations required, presumably along the lines of those for tangible property.

The integrated nature of a secondment transaction strongly suggests the netting of all payments from USCO's perspective. Treating USCO's payments to Joe and FORCO's reimbursement to USCO as separate transactions (*e.g.*, as a capital contribution to FORCO plus a distribution back) would be at odds with the essence of the transactions as a loan, due to the expectation of reimbursement.[11]

C. Germany Kicks Off the Public Debate

Germany is the first country to promulgate specific administrative guidelines for the transfer pricing aspects of cross-border personnel secondments. The German guidance, in the form of a circular published by the Federal Ministry of Finance on November 9, 2001 ("Secondment Circular" or the "Circular"), is premised on applying arm's-length principles to determine how the applicable costs should be borne for tax purposes.[12]

1. Characterization

The Secondment Circular implies that secondment is *not* the "provision of services" by the sending company. This conclusion is reached by defining secondment *not* to occur if an employee works for another entity to fulfill the first company's obligation to render services or accomplish defined work and the employee costs are included in the charge for the services or work. While arguably somewhat circular, this approach suggests that the contractual arrangement chosen by the parties — service contract or secondment contract — controls.

The consequence is that no profit markup is appropriate for the seconding company. The properly allocated costs are considered original costs of the economic employer (see below).

In addition, the Circular indicates that the transfer of knowledge or experience via the mere employment of the seconded individual does not require additional remuneration for intangibles, because this is an integral part of and reason for the secondment.

2. Covered Transactions

The Circular is limited to secondment defined as follows: The transfer of personnel between related parties for a limited period, where the receiving party either enters into an employment contract with the transferred employee *or* is to be regarded as the individual's "economic employer." A company is considered the economic employer if it integrates the seconded employee into its business, has a right of direction and control over the employee, and bears the costs incurred for the seconded employee, either by paying the employee directly or by having the other enterprise advance the remuneration on its behalf. Integration is assumed if the assignment exceeds three months. The Circular thus covers *both* shifted employees and loaned employees.

3. Cost Allocation Rules

The Circular sets forth somewhat different standards for determining the amount of costs to be absorbed or transferred, depending on whether the secondment is outbound or inbound. The premise is that the cost split must correspond to the respective business interests of the companies.

- Outbound Secondment — Presumptively, all costs must be absorbed by the foreign receiving company. To have *any* deductible expenses in Germany, the

German sending company must show its own separate business interest.

- Inbound Secondment — A German receiving company is only allowed cost deductions based on a prudent business manager standard. Such a manager is presumed to bear costs only to the extent they do not exceed expenses for a comparable local employee. To accept more expenses it must be shown that the excess is paid in the German receiving company's own interest, *e.g.*, because the benefit of the employee's special knowledge outweighs the incremental cost.

Pricing methods for determining appropriate allocations are:

- Internal comparables (*i.e.*, costs borne by the company for comparable non-seconded personnel)
- External comparables (*i.e.*, costs borne by unrelated companies operating under similar circumstances, in the same country, for comparable employees)
- "Hypothetical arm's length comparison" (as a last resort): Would a prudent business manager of an uncontrolled enterprise under similar circumstances have incurred all such costs or have insisted that the sending company bear a portion? This test is based on facts and circumstances, including, *inter alia*, the correlation between additional costs incurred for the employee and his/her contribution to the economic success of the company.

Special allocation rules are provided for certain situations. At one extreme, secondment of an expert typically justifies the receiving (*e.g.*, German) company bearing the total costs, if comparable personnel are not reasonably available locally. At the other extreme, the incremental costs of secondment for educational or training purposes must be borne by the sending company. In between, for "rotation" systems (defined along the lines typical of Japanese multinationals), the receiving company is only entitled to bear costs at the local salary level.

4. Administrative Matters

The Circular permits taxpayers to work out a uniform allocation key for all secondments during years under audit (or for subsequent periods if the situation has not changed materially) where there are mixed business interests. Consultation with pertinent foreign tax authorities is suggested.

A considerable amount of documentation and supporting evidence must be maintained, including contracts, job descriptions, comparative data, etc.

5. Observations

Although some commentators have expressed concern that Germany proceeded on its own without first developing an OECD consensus, the Circular spotlights the fundamental conceptual issues and provides a setting to ponder and critique them.

a. ***Basic Characterization:*** The Circular's effective presumption that secondment is not the provision of services is a reasonable and pragmatic view. The further presumption that no transfer of intangibles has occurred provides beneficial — but potentially more controversial — simplicity.

Looking to the person *who economically bears* the employment costs and controls the individual to determine whether there has been a secondment is likewise a sensible approach. The potential of conflict, however, with employment tax, treaty, and other countries' rules remains.

b. ***Transfer Pricing Rubric:*** The Circular circumscribes the issue as an allocation of deductions rather than an allocation of income through its characterization approach. This is arguably congruent with the statutory provisions of Code section 482, though it is outside the current section 482 services regulations because of the premise that no services are being "provided."

c. ***Internal consistency:*** It is troubling to see different standards for outbound and inbound situations.

d. ***Administrability:*** The spectre of a detailed arm's-length cost determination and the required documentation is daunting. The benefit test may be particularly hard to quantify. One commentator indicates, however, that advance pricing agreements may be entertained by German tax authorities.[13]

Regrettably, the final version of the Circular omits the safe harbor in an earlier draft, which would automatically have accepted a secondment cost allocation if the sending company assumed 20 percent of the total expenses.

D. Conclusions

Secondment practices in our pervasively global business world cry out for clear, objective, and easily administered rules. Because of the frequency, the relatively small dollars involved, and the incredible potential for complexity and conflict, safe harbors or bright lines are highly desirable. Moving (perhaps through the OECD) toward a global standard for identifying the deduction-entitled entity —and ideally for achieving consistency for various tax and legal purposes — is a critical step. This standard could be the German "economic employer" concept, a U.S.-style "proximate-and-direct-benefit" test, or an employment tax "control" approach — whichever is most likely to achieve general acceptance. Obviating any need to consider arm's-length returns on secondment costs would be the icing.

But we are not there yet. The U.S. perspective on secondment is obscure. Explicitly carving secondment situations out of service-provider transfer pricing rules, or at