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BEPS Action 10: Proposed modifications to transfer pricing guidelines relating to low value-adding intragroup services

On 3 November 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), released a discussion draft in relation to Action 10 that proposes a simplified transfer pricing approach for low value-adding intragroup services, which ultimately would lead to revisions in Chapter VII of the OECD's transfer pricing guidelines. The aim is to reduce base erosion through excessive management fees and head office expenses, particularly in developing countries. The simplified approach, which a group may elect to adopt, recognizes that the arm's length price is closely related to costs and allocates the costs of providing each category of such services to the group companies that benefit from using the services using consistent group-wide allocation keys with an associated consistent small mark-up.

As with other discussion drafts on BEPS actions, the proposals do not represent a consensus view from the G20/OECD countries involved, but are designed to provide substantive proposals for public comment (comments are invited by 14 January 2015).

The discussion draft addresses the following

Definition: Low value-adding intragroup services are services that are supportive in nature, are not part of the core business of the group, do not use or create intangibles and do not involve significant risk. The draft includes examples of qualifying and nonqualifying services. For some services, a fact-specific functional analysis would be required.

Determination of arm's length charges: A group that elects to apply the simplified method should identify, on an annual basis, a pool of costs associated with categories of low value-adding services that are provided to multiple members of its group. The cost pool should exclude costs attributable to an in-house activity that benefits only the company performing the activity (including shareholder activities performed by the shareholding company, based on existing guidance). Costs related to services performed solely on behalf of one other group member also should be removed from the pool, since these costs and their mark-up would be charged directly.

The next step would be to allocate the costs in the pool among members of the group, by selecting an allocation key dependent on the nature of the services. A consistent approach is expected; the same allocation key or keys should be applied in determining the allocation to all group companies of the same category of low value-adding services, and the same key(s) should be used each year unless there is a valid reason to change.

The discussion draft specifies that the same mark-up should be used for all low value-adding services, irrespective of the categories of services. It proposes that the applied mark-up should be between 2%-5% of the relevant cost.

Supporting the charge: Usually, an obligation to pay for an intragroup service arises only where the activity provides the group member with economic or commercial value to enhance or maintain its commercial position. The discussion draft recognizes that, while low value-adding services may provide benefits to all recipients of those services, it may be difficult to demonstrate whether the recipient would have been willing to pay for the individual service from an independent party or perform the service itself. A simplified benefits test is recommended, under which tax authorities should consider benefits only by categories of services. The draft suggests that a single annual invoice describing a category of services should suffice to support the charge, and correspondence or other evidence of individual services should not be necessary. Documentation also should include:

- Reasons justifying why the services meet the definition and expected benefits of each category of service;
- Description and justification of choice of allocation keys and confirmation of the mark-up applied; and
- Calculations showing the determination of the cost pool and the application of the specified allocation keys.

Comments and next steps for business

The proposed simplified approach to low value-adding services would be helpful for some groups. In many instances, it has proved difficult or too costly to provide sufficient evidence to support what may be small amounts of individual charges across a wide number of jurisdictions, leading to double taxation. In addition, the simplified approach would benefit tax authorities with limited resources in considering the appropriate mark-up. However, the proposals do not discuss a common key issue, which is the disparity in the costs incurred in high-cost developed countries where services are provided to low-cost developing countries where comparable services cannot be obtained locally, and this may remain a source of disputes.

The proposed mark-up range of 2%-5% is narrower and lower than the EU Joint Transfer Pricing Forum’s guidance for similar low value-added services (endorsed by the European Commission), which suggests that a mark-up range of 3%-10%, depending on the circumstances, typically is found.

The simplified approach, for a group that chooses to apply it, would need to be applied on a globally consistent basis, and this would entail (1) a greater coordination of cost pooling and allocation of service fees, particularly where this currently is done on a regional basis; and (2) additional compliance in the year of adoption to establish the appropriate cost pools, allocation keys and documentation.

For countries with tax treaties based on the OECD model, amendment to the transfer pricing guidelines likely would be sufficient to implement the proposals for simplification, but it will remain to be seen whether other countries (particularly outside of the OECD) choose to adopt the proposals, and this may affect their practical application.

Views from the China State Administration of Taxation on intragroup service charges

Intragroup service charges have been an increasing focus of the China's State Administration of Taxation's (SAT's) in recent times. The SAT's latest views on intragroup service charges can be found in its Letter to the UN Tax Committee, the "Six Tests" (the benefits test, necessity test, duplication test, value creation test, remuneration test and authenticity test)[1], and the recent Notice of Anti-Avoidance Examination of Significant Outbound Payment (Shuizongbanfa [2014] No. 146, hereafter referred to as "Circular 146").

Whilst the SAT generally agrees with the OECD framework on intragroup services, and some of the "Six Tests" such as benefits test, duplication test are generally consistent with the OECD approach, other tests imply a more stringent approach in China. For example, taxpayers are required to tie subject services back to the core functions and characterization of the local Chinese entity (Needs Test) and that the charging party has not already been compensated through transfer pricing policies of other related party transactions (Remuneration Test). Also, the SAT's interpretation on the "benefits test" emphasizes the analysis be done "from both the perspectives of the service provider and the service recipient" which as noted earlier may be a source of disputes regarding high-low cost disparities situations. It will also be interesting to see if the supporting documentation as proposed under the OECD framework will satisfy the authenticity and validation requirement by the SAT.

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[1] As highlighted by Mr. Liao Tizhong, Director General of the SAT's International Taxation Department at an international conference in 2014

The SAT currently does not provide any "safe harbor" mark-up range for entities to apply in intragroup services, hence it remains to be seen whether the proposed "safe harbor" mark-up range of 2%-5% would be adopted by the SAT.

Other Mainland China practice and observation

Many Chinese subsidiaries of MNCs have been dealing with the remittance of cross-border intercompany service charges, which are often in the form of indirect charge method (e.g., allocated to the Chinese entity based on allocation keys such as sales revenue or headcounts, etc.). While in theory the service fee allocation using reasonable allocation key(s) is acceptable in China, in practice some local tax authorities have strong preference on the direct charge method against the indirect charge method. Sometimes the taxpayer may be asked to provide extensive supporting documents/explanation for the multi-layer charges and allocation when using indirect charge method, while complete information is often unavailable to the local subsidiary of MNC. As a result, it is not uncommon that some local subsidiaries have difficulties in settling the cross-border intercompany service charges driven by a global allocation model.

Through Circular 146, the SAT has requested State and Local Bureaus to identify large outbound services payments made by local Chinese affiliates of MNE groups and to formally launch transfer pricing audits where they deem high risk. In practice, we have also noted that some local tax bureaus have established internal screening systems based on taxpayers' information and data, including setting up certain quantitative threshold, to target the potential audit cases for further scrutiny.

In light of the above, corporate taxpayers in China with outbound payments to affiliated companies for services received should review the charges taking into account both the OECD approach as well as the various local requirements and practices in China.

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