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Intragroup services caught the attention of the tax authority

Due to the international environment, increasing competition and for efficiency reasons, it is quite common that multinational enterprises provide different services within the group. In addition, the creation of intragroup service centers to centralize the service offering in the group has been the trend of the recent years. Thus, there is no need for group members to separately outsource different services from third parties. Usually, these services are of supportive nature, which are not directly related to the group´s core business, for example HR, accounting and legal services. Also, it is quite common that the main function of the parent company is a holding activity and offering a management service to group members.

Intercompany services are transactions between related parties, thus transfer pricing regulations apply. The definition of related parties is stipulated in the Estonian Income Tax Act §8 - parties are deemed to be related if they have common economic interests or if one person has dominant influence over the other. The price of related party transactions - transfer price - must be comparable with the transaction price, which is used in case of transactions between non-related parties. Thus, the transaction between related parties needs to be in accordance with the arm´s length principle. Otherwise, the difference between market price and transfer price could be taxed with income tax.

On the international level, intragroup services are quite challenging for tax authorities, as companies use these transactions (of course, also other transaction types as loans etc.) to optimize with taxes. Services are commonly used for shifting untaxed profit to a country, where lower income tax rate applies. Therefore, the intragroup transactions have caught the interest of the tax authorities and are being constantly monitored. The importance of the issue reflects also BEPS *(base erosion and profit shifting)* action plans developed by OECD and G20 to address tax avoidance, ensuring that profits are taxed, where economic activities generating the profits are performed and where value is created, not in the jurisdiction, where the company is legally registered.

According to the OECD assessment, due to heavy tax planning estimated global annual revenue loss is 4 – 10% of the global corporate income tax revenue, which in monetary value is 100 – 240 billion USD. The BEPS final report Action 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation)* includes a section about guidelines for low value-adding intragroup services, which is revision to OECD guidelines published in 2010 (*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 22 July 2010).*

In case of rendering or receiving intragroup services, number of factors must be considered in order to prevent possible tax risks. Quite often the risks that may arise are not caused intentionally, but occur due lack of knowledge, thus it is important that providing or receiving services within the group is carefully considered. In addition, in case of cross-border transactions the practice of the tax authority in the relevant country needs to be taken into account.

Hence, we provide some practical guidelines to mitigate the potential transfer pricing risks, which may arise from intragroup services.

Providing proof that the service is actually received

First, companies must be able to prove that the service has been actually received and is beneficiary for the company’s business activity (*benefit test*). The tax authority would analyze whether a third party in similar circumstances would consume these services on similar terms – whether outsource or consume internally (would employ persons with necessary qualification – for example, would employ a lawyer). For example, costs related to shareholders activity should not be charged as service to other group companies by parent or holding company as interdependent enterprise would not be willing to pay for it. These costs should be borne and allocated at the level of the shareholder.

The following are examples of costs related to the shareholder’s activities:

a) Costs related to the juridical structure of the parent company itself, such as meetings of shareholders of the parent etc.;
b) Costs related to reporting requirements (including financial reporting and audit) of the parent company, including the consolidation of reports;

c) Costs of raising funds for the acquisition of its participations and costs related to the parent company's investor relations, such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company;
d) Costs related to compliance of the parent company with the relevant tax laws;
e) Costs which are ancillary to the corporate governance of the MNE as a whole.

In addition, services, which could be performed with internal resources or which are already outsourced from a third party, should not be purchased within the group – duplication should be avoided.

For example, a related party issues invoices on a monthly or quarterly basis for different services (IT, HR, accounting etc.), which are stipulated in the agreement between the parties, but in case tax authority request information about which exact service was received at a particular time point, the service recipient is not able to explain. In other cases, the company purchases services from related parties, but the company has employees to provide the function in-house, thus duplication issue arises. Therefore, there is a risk that the tax authority could classify costs related to these services as non-business expense and tax with income tax. In conclusion, the service recipient must be able to provide proof that the service has been actually received and is beneficial for the company's business activity.

Pricing policy of services

The next step for the tax authority would be to analyze the pricing policy of the services. In case of services between related parties, it is important that the pricing policy of the services is in accordance with the arm's length principle. Therefore, the pricing policy should correspond to the pricing, which is used between non-related parties in similar conditions. In case the pricing is not in market terms, then risk exists that the difference between market price and transfer price could be taxed with income tax. Typically, services provided within the group are remunerated based on cost plus method (costs + mark-up). In case of determining the pricing policy of service transaction, it is important to analyze the formulation of cost base and whether the service is low or high value added service.

Generally, the cost base should be calculated as follows: total costs (direct + indirect) – directly charged costs (costs, which can directly be allocated to particular service recipient) – shareholders costs = costs, which should be charged to service recipients. In case of cost allocation, different allocation keys as number of employees, revenue etc. are used when it is not possible to charge the costs directly to service recipients and based on how much services have been consumed by the recipients.

High value-added services are services constituting the core business of the MNE group, for example research and development services; manufacturing and production services; purchasing activities relating to raw materials; sales, marketing and distribution activities etc. Low value-added services are not part of the core business of MNE group, are of a supportive nature and do not involve the assumption or control of substantial or significant risk. Also, do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles.

For example, company's core business is IT-related activity and the company purchases accounting and HR services from the related party. In such case, the transaction could be classified as a low value-added service. However, when an IT company purchases research and development service for IT software, which would be sold to its clients from the related party, then these services are related to the company's core business and shall be classified as high value-added.

In case of low value-added services, simplified approach can be used to determine the arm's length mark-up and to document the transactions. In this article, we will not focus on the documentation requirements. According to BEPS action report 8-10, in case of low value-added services, moderate 5% mark-up can be added to cost base without performing separate benchmarking analyses. The Estonian Tax and Customs Board accepts the BEPS approach, but for example, Latvian tax authority does not. Previously, EU Joint Transfer Pricing Forum guidance for low value-added services recommended that the arm's length mark-up be in the range of 3-10%. In case of high value-added services, separate benchmarking analysis should be performed to determine the arm's length pricing for the services. The methods for determining the arm's length price are stipulated in regulation No. 53 issued by the Estonian Ministry of Finance on 10th November 2006 "Methods for determining the value of transactions conducted between associated persons”. All circumstances that could affect the price for services shall be taken into account when performing a benchmarking analysis - the type, extent and duration of the service, and the expenses and risks related to the provision of service.

In conclusion, it is important to carefully analyze the service transactions from the provider, as well as the recipient perspective, as transfer pricing risk could be at both side dependent on which party carries loss from the transactions.