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International Tax

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Proposed modifications to transfer pricing guidelines relating to low value-adding intragroup services

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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 services, 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.