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OECD Issues Discussion Draft on Low-Value- Adding Intragroup Services

Introduction

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

As with other discussion drafts on BEPS Actions, the

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proposals do not represent a consensus view from the G20/OECD countries involved, but are designed to provide substantive proposals for public comment.

Next Steps

The proposed simplified approach to low-value-adding services will be helpful for some groups. In many instances, including experience from tax audits in Greece, it has proved difficult or too costly to provide sufficient evidence to support what may be small individual charges across a wide number of jurisdictions, leading to double taxation. In addition, the simplified approach will benefit tax authorities with limited resources in considering the appropriate mark-up. However, the proposals do not discuss a common key issue -- 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 percent to 5 percent 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 percent to 10 percent, depending on the circumstances, is typically found.

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

For countries with OECD-based double tax treaties, amendment to the transfer pricing guidelines will likely be sufficient to implement the proposals for simplification, but it remains to be seen whether other countries (particularly outside of the OECD) choose to adopt the proposals, and this may affect its practical application on a global basis.

A simplified approach for low-value-adding services

The discussion draft defines low-value-adding intragroup services as those that are supportive in

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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 provides examples of qualifying and nonqualifying services. For some services, a fact-specific functional analysis will be required.

Determination of arm’s length charges

Computing the charge: 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 that are attributable to an in-house activity that benefits solely the company performing the activity (including shareholder activities performed by the shareholding company, based on existing guidance). Those costs related to services performed **solely** on behalf of one other group member should be removed from the pool, as these costs and their mark-up will be charged directly.

The next step is to allocate among members of the group the costs in the pool, 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 percent and 5 percent of the relevant cost.

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Supporting the charge: Usually, an obligation to pay for an intragroup service arises only when 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 it itself. A simplified benefits test is recommended, whereby tax authorities should consider benefits only by **categories of services**. The discussion 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 should also 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 mark-up applied; and
- Calculations showing the determination of the cost pool and the application of the specified allocation keys.

Timetable

The OECD has invited interested parties to submit comments by 14 January 2015. A public consultation meeting on the discussion draft will be held at the OECD in Paris on 19-20 March 2015. Registration details will be published on the OECD website.

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