

Low value-adding intragroup services

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For efficiency reasons, the headquarters of multinational enterprises (MNE) often provide affiliates with a variety of intercompany support activities. Typically, these services fall into broad categories of support, including human resources, finance, information technology, legal services, and marketing. With the rise in volume of cross-border transactions and intensifying competition among various MNE groups, companies often centralize the entire range of intragroup services in a single location to bring efficiency and avoid duplication of services. This trend has led to the creation of intragroup shared service centers.

Typically, intercompany support services provided by both headquarters and intragroup shared service centers are remunerated based on cost or the cost plus method, as the costs incurred for rendering such intragroup services are allocated among group companies usually based on allocation keys. Tax authorities around the world have expressed skepticism at these allocated costs, citing the potential that MNE groups are eroding the tax base through excessive management fees and head office cost allocations. Under the existing guidelines, tax authorities may request that MNEs justify the benefit to each member group entity in a detailed manner that may not be practical on a large scale, and without a solution, taxpayers may face disallowed deductions, competent authority claims, or double taxation.

The OECD's final report on Actions 8-10 of the BEPS project, *Aligning Transfer Pricing Outcomes with Value Creation*, includes a section on "Low Value-Adding Intra-Group Services -- Revisions to Chapter VII of the Transfer Pricing Guidelines." This guidance introduces an elective, simplified approach to determining whether the service charge is due (the benefit test) and calculating the arm's length charge in the case of low-value-adding services.

Unlike the existing guidelines, the new guidelines state that if taxpayers elect the simplified approach to document low-value-adding intragroup services, they only need to demonstrate that a benefit was received by the group members within the specific categories of services, rather than specifying the specific benefits received by group members. Once implemented by individual tax administrations, the simplified approach may reduce the burden taxpayers face in preparing the documentation of low-value-adding intragroup services.

The final report indicates that the countries participating in the BEPS project have agreed to a two-step approach to implementation. As a first step, a large number of countries

plan to include the simplified elective mechanism in their domestic regulations before 2018. As a second step, the countries that have indicated that intragroup management services and head office charges constitute a major concern will be allowed to combine the introduction of the guidance with the introduction of a threshold that, if exceeded, would permit tax administrators to require a full transfer pricing analysis, including a benefit test. Follow-up work on the design of the threshold and other implementation issues is expected to be completed before the end of 2016.

Simplified approach

Services can qualify for application of the simplified approach if the services:

- Are of a supportive nature
- Are not part of the core business of the MNE group (that is, they do not create profit-earning
- activities or contribute to the MNE group's economically significant activities)
- Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
- Do not involve the assumption or control of substantial or significant risk by the service provider, and do not give rise to the creation of significant risk for the service provider.

The new guidance provides examples of activities that would not qualify for the simplified approach, such as research and development, manufacturing, sales, marketing and distribution, financial transactions, and exploration or extraction. Services provided by corporate senior management are also excluded. This means that companies cannot simply apply the simplified approach to their entire headquarters cost base, but rather must determine the group of costs that qualify for this approach.

The new guidance provides a list of services that may qualify for the simplified approach, which is similar to the services that qualify for the services cost method under the U.S. transfer pricing regulations and includes, for example, accounting and auditing, human resources activities, regulatory issues, communications (internal and external), information technology, legal services, tax support, and administrative and clerical support.

For those services that qualify for application of the simplified approach, the arm's length charge would be calculated following these steps:

- Step 1: Identify, on an annual basis, the pooled costs by category associated with the low value-adding services, excluding any costs that benefit only the service provider; passthrough costs in the cost pool should be identified.
- Step 2: Eliminate costs associated with services provided to only one group entity.
- Step 3: Allocate costs among group members using simplified allocations keys appropriate for the services, such as revenue, assets, headcount, and information technology users (the allocation key selected should reasonably reflect the relative benefits expected to be received by each recipient of the service of particular type).
- Step 4: Apply a markup of 5 percent of the allocated costs; the mark-up does not need to be justified by a benchmarking study.
- Step 5: Calculate the net charge due by a given group member.
- Step 6: Prepare simplified documentation to support the charge.

The final report indicates that, due to the nature of low-value-adding intragroup services, the task of documenting the charges based on the general guidance for services may be difficult or require an effort disproportionate to the value of the charges. The new guidance indicates that, for those reasons, tax administrations generally should

- The rationale for the provision of services within the context of the MNE's business;
 - A description of the expected benefits of each category of services;
 - A description and support for the selected allocation keys; and
 - Confirmation of the mark-up applied.
- Written contracts or agreements for the provision of services;
 - Calculations showing the determination of the cost pool, including a detailed listing of all categories of services and amounts of relevant costs; and
 - Calculations showing the application of the specified allocation keys.

The new guidance indicates that provided the information listed above is made available to the tax administrators, a single annual invoice describing a category of services should suffice to support the charge, and no further evidence (such as correspondence, reports, etc.) should be required.

Shared services centers

The new guidance does not distinguish between low-value-adding services provided by shared service centers or by headquarters companies. For that reason, the recommendations presented in the report should be applicable equally to intragroup services provided by shared services centers.

Cost contribution arrangements

Example 2 of the guidance on cost contribution arrangements (CCAs) contains another approach to sharing low-value-adding services. If the requirements of a CCA are met, the parties may be able to share management fees and headquarters charges, but not separate shared services center costs, at cost with no mark-up. The example indicates that services with an arm's length mark-up of 3 percent or 5 percent would qualify in this case as low-value-adding services. One potential drawback of a CCA is that participants would not qualify for the reduced benefit test and would still be required to show that the services benefited each of the participants.

Implications

The simplified approach may reduce the time and effort MNEs spend supporting the benefit provided by low-value-adding services, justifying allocation keys, and supporting the mark-ups applied. Whether the simplified approach is an option for MNEs depends on how and the extent to which tax authorities around the world implement the guidance.

For developed countries that are often locations for service providers, broad adoption of the simplified method is more likely. The simplified method generally would ease the burden on headquarters to retain records documenting in detail beneficial services to each recipient entity and potentially reduce controversy. For U.S. MNEs, the general approach is in keeping with the overall outline of the services cost method under the U.S. transfer pricing regulations, and the U.S. regulations do not require a

Once implemented by individual tax administrations, the simplified approach is likely to reduce the burden taxpayers face in preparing the documentation of low-value-adding intragroup services.

refrain from reviewing or challenging the benefits (in cases when the simplified approach has been applied) provided the documentation requirements specified in the guidance are met. Taxpayers are expected to maintain the following documentation:

- A description of the categories of qualifying services provided:
 - The description would include the reasons justifying that each category of services qualifies for application of the simplified approach;

mark-up. It is unclear whether the United States will now change its rules to require a mark-up.

The impact on developing nations, which are often service recipients and service providers in shared services arrangements, is less clear. Many developing countries have indicated that the services represented by management fees and headquarters charges are less relevant in their markets, and that the cost of the services exceeds the cost of local service providers. These countries have requested that the guidance be limited to situations in which the costs do not exceed certain thresholds. Whether the guidance will provide simplification in these cases will depend on the threshold and its implementation, which will be decided in 2016. In addition, many developing countries are the location for shared services centers that take advantage of lower labor and other costs. In some situations, developing countries have taken the position that these location-

specific advantages should be considered in the mark-up on costs. It is unclear whether those countries will be willing to accept the 5 percent mark-up envisioned by the guidance as compensation.

Conclusion

The guidance on low-value-added services has the potential to simplify the policy and documentation requirements for intercompany charges for management fees and headquarters allocations and reduce controversy. However, in order for MNEs to apply the simplified guidance, the rules will have to be adopted and applied by the countries in which they provide intra-group services. Questions remain as to how easy it will be for countries to opt out of the rules because threshold levels of charges have been met, or whether countries will fail to adopt the rules because they believe the cost plus margin provided in the rules is inadequate.

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