Release of BEPS discussion draft: Proposed modifications to Transfer Pricing Guidelines relating to low value-adding intra-group services

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In brief

On 3 November 2014, the OECD published its discussion draft on the proposed modifications to Chapter VII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. These proposed modifications have been developed in connection with Action Point 10 of the Action Plan on Base Erosion and Profit Shifting (BEPS). The proposed modifications do not yet represent a consensus view and are intended to provide stakeholders with substantive proposals for analysis and comment. Action Point 10 is focused on developing rules to prevent BEPS though the use of transactions which would not, or would only very rarely, occur between third parties including adopting transfer pricing rules or special measures to provide protection against common types of “base eroding” payments, such as management fees and head office expenses.

The proposed modifications to Chapter VII of the OECD Guidelines seek to achieve a necessary balance between appropriate charges for low value-adding services and the need to protect the tax base of countries in which entities are established that pay the service fees. The Working Party has taken a step in the right direction to achieve that balance, but has not addressed how the additional guidance will be impacted by the other work the OECD is performing as part of the BEPS Action Plan.

There are six (6) areas in which the OECD is proposing additional guidance:

1. Providing a standard definition of low value-adding intra-group services;
2. Clarifying the meaning of shareholder activities and duplicative costs, specifically in the context of low value-adding intra-group services;
3. Guidance on appropriate mark-ups for low value-adding intra-group services;
4. Guidance on appropriate cost allocation methodologies to be applied in the context of low value-adding intra-group services;
5. Guidance on the satisfaction of a simplified benefit test with regard to low value-adding intra-group services; and
6. Guidance on documentation that taxpayers should prepare and submit in order to qualify for the simplified approach.
Multinational enterprises (MNEs) will need to examine how the proposed measures will affect their existing intra-group service arrangements including the option for the elective simplified approach.

**In detail**

Although various changes are being proposed to the existing Chapter VII of the OECD Transfer Pricing Guidelines, the main progress made by the OECD is the proposal to add a new section to Chapter VII that provides explicit guidance on low value-adding intra-group services.

The OECD refers to “low value-adding intra-group services” as a particular category of intra-group services for which it proposes special – simplified – rules on how to allocate the costs related thereto among members of an MNE group.

These rules mainly consist of an elective, simplified approach including a simplified mechanism for determining the amount of low value-adding intra-group services to be charged to and paid by members of an MNE group.

Taxpayers that do not elect to apply the proposed simplified approach would continue addressing the transfer pricing issues related to low value-adding services under the existing guidance of Chapter VII, and should carefully consider the fact that the OECD states that the arm’s length price for what it calls low value-adding intra-group services is closely related to costs.

Cost contribution arrangements have not been addressed by the OECD in its proposed modifications, as those are the subject of the work performed by the OECD in relation to Action Point 8 of the BEPS Action Plan dealing with the transfer pricing aspects of intangibles.

**Definition of “low value-adding intra-group services”**

Low value-adding intra-group services are those services performed by one or more members of an MNE group which (1) are supportive in nature; (2) are not part of the core business of the MNE; (3) do not require the use of unique and valuable intangibles and do not lead to the creation of such intangibles; and (4) do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk.

The “supportive” nature of the low value-adding intra-group services basically means that such services should not constitute the core business of the MNE Group although they can constitute the principal activity of an MNE group member – such as a shared service centre. From the perspective of such a shared service centre, the provision of low-value adding intra-group services might constitute its core business while this should not necessarily be the case for the MNE group as a whole.

Intra-group services that would typically be captured by the definition include:

- Accounting and auditing
- Processing and managing of accounts receivable, payable, etc.
- Human resources matters such as staffing, recruitment, training, remuneration services, etc.
- Activities related to health, safety and environmental activities
- Information technology
- Public relations support activities
- Legal and tax activities
- General services of an administrative or clerical nature.

The OECD also identified a number of activities that would not be considered as low value-adding intra-group services. These activities include (1) all services that constitute the core business of the MNE group; (2) research and development services; (3) manufacturing and production services; (4) sales, marketing and distribution activities; (5) financial transactions; (6) extraction, exploration or processing of natural resources; (7) insurance and reinsurance activities; and (8) services of corporate senior management.

**Proposed simplified approach**

For qualifying low value-adding intra-group services, the OECD proposes a simplified methodology to determine an arm’s length charge. This method would be elective, and, in a case where it was elected by an MNE, would need to be applied on a consistent, group-wide basis in all countries in which the MNE operates. The proposed simplified approach contains five steps:

1. **Determination of the costs incurred** by all MNE group members performing low value-adding intra-group services. Those costs would be pooled on an annual basis and reduced by (1) costs attributable to in-house activities that only benefit the company performing the activity (including shareholder costs); and (2) costs related to services that are performed solely on behalf of one other group member.
2. **Allocation of the cost pool to the MNE group members**

should be by means of allocation keys whereby the appropriate keys depend on the nature of the services. The discussion draft provides examples of allocation keys such as headcount for services related to people, total users for IT services, share of vehicles for fleet services and share of assets or transactions for account support services. Alternatively, share of total turnover may be the most relevant allocation key in other cases, where it best reflects the underlying need for the particular services. However, the examples of allocation keys provided are not meant to be an exhaustive list. The decision to use more-, or less-, sophisticated allocation keys and whether to use a single or multiple allocation keys will depend on the facts and circumstances unique to each particular case. Absolute precision should not be required, however, and a proper balance between theoretical sophistication and practical administration should be struck.

3. **With respect to the profit mark-up**, a single mark-up should be utilised for all services irrespective of the category of service. The profit mark-up – which would function as a safe-harbour and thus would not have to be supported by a benchmarking study – should not be lower than 2% and should not exceed 5% of the relevant cost base. These levels of mark-up can only be applied to the category of services that fall within the “low value-adding” service definition and thus cannot be used as a benchmark for other categories of services. In addition, the proposed modifications call for the application of the profit mark-up on all costs and thus exclude the possibility of qualifying certain costs as disbursements or so-called “pass-through costs”. That is contradictory to the general rule under ¶7.36 of the Discussion Draft, which allows treating costs as pass-through costs on which no profit mark-up needs to be applied.

4. **The total charge for low value-adding services** shall include (1) the costs incurred by an MNE group member for services rendered specifically to that group member by another group member; and (2) that group member’s share in the overall pool of low value-adding services costs.

5. The OECD proposes a simplified benefit test for the category of services that qualify as low value-adding services. The benefit test should be fulfilled by means of a documentation and reporting package prepared by the MNE group and be made available to the tax administration of any entity within the MNE group making or receiving a payment for low value-adding intra-group services.

This documentation and reporting package will consist of:

a. A description of the categories of low value-adding services provided including (1) the reasons justifying the low value-adding nature of the services; (2) the rationale for the provision of services within the MNE group; (3) the description of the (expected) benefits for each category of services; (4) the selected allocation key(s) and the reasons for justifying that the selected allocation key(s) best reflects the benefit received; and (5) confirmation of the level of mark-up applied;

b. Written contracts or agreements. Although Chapter VII recognizes that the absence of contractual agreements should not automatically lead to the conclusion that no intra-group services have been rendered (¶7.19) such written contracts or agreements shall nevertheless need to be prepared and made available for low value-adding intra-group services under the elective approach;

c. Calculations showing the determination of the cost pool; and

d. Calculations showing the application of the specified allocation keys and a single annual invoice describing the category of services charged.

**Other proposed changes**

Other modifications are proposed by the OECD to the other sections of Chapter VII. The main proposed modifications relate to:

- The expansion of the list of examples of shareholder activities (e.g., costs related to compliance of the parent company with relevant tax laws and costs which are ancillary to the corporate governance of the MNE group as a whole);
- Additional guidance on “duplicative services,” including that an examination of the possible duplication of services needs to include the nature of the service in detail. In other words, it is not because a company performs marketing services in-house for itself and is also charged for marketing services by another MNE group member that those services are not “additional”,

“different” or “complementary” to those performed in-house; and

- The examples of intra-group services – and mainly the one on research activities – have also been updated to align them with the other work performed by the OECD under the BEPS Action Plan.

**The takeaway**

The discussion draft states that the OECD’s guidance on low value-adding intra-group services seeks to achieve the necessary balance between appropriate charges for low value-added services and the need to protect the tax base of payer countries.

By including a specific section on low value-adding services that lowers the burden on MNE groups to demonstrate the beneficial nature of those low value-adding activities for other MNE group members and also imposes a limit on the profit mark-up that can be applied on those low value-adding services, the OECD has taken a step in the right direction to achieve that balance.

The current discussion draft, however, fails to substantially address how the additional guidance on low value-adding services will be impacted by the other work the OECD is performing in view of the BEPS Action Plan.

One aspect that has currently not been addressed is how the proposed documentation package ties in to the work performed as part of Action 13 on Transfer Pricing Documentation and Country-by-Country reporting, in the sense that the discussion draft seems to indicate that no separate local files would be needed in case the elective approach is opted for by an MNE.

With respect to the determination of the appropriate profit mark-up, a literal reading of the discussion draft supports the position that a taxpayer may select any point within the safe harbour range. It may serve to eliminate any doubt, and thus the potential for controversy, if the OECD could make that point explicitly in the next version of the document. Further consideration should also be given to the appropriate bounds of the range, including whether the lower bound should be zero; i.e., allowing for pricing at cost. If pricing at cost is not allowed as a general matter, the OECD should also consider how the apparent conflict with ¶7.36 (which allows for the treatment of certain costs as pass-through costs on which no profit mark-up needs to be applied) can be resolved.

Finally, although the discussion draft sets forth useful proposals to bring clarity and needed uniformity to an area that often creates controversy as to the deductibility of low value-adding intra-group services, its usefulness in practice will obviously depend upon how many countries agree with and adopt the proposed measures. Although the OECD is only a standard-setting organization and is not involved in implementation and enforcement of its recommendations, it is hoped that OECD and G20 countries participating in the process of drafting the proposed measures recognize the mutual benefits that would inure to both taxpayers and tax administrations from widespread adoption of a uniform approach to this issue. To the extent that such uniform adoption and implementation is not achieved in this area (and other areas of the BEPS Action Plan), more pressure is placed on Action Point 14 of the BEPS Action Plan, dealing with making dispute resolution mechanisms more effective.

MNEs will need to carefully assess and consider the impact the proposed measures would have on their existing intra-group service arrangements (e.g., the fact that services of corporate senior management are specifically categorized as not low value-adding) including the option for the elective approach.

The OECD has asked for comments to be submitted by interested parties no later than 14 January 2015 and intends to hold a public consultation on this discussion draft and other topics on 19 and 20 March 2015.
Let’s talk

If you would like to discuss these issues further, please call your usual PwC contact or one of the following:

Isabel Verlinden, Brussels
+32 2 710 4422
isabel.verlinden@be.pwc.com

Horacio Peña, New York
+1 646 471 1957
horacio.pena@us.pwc.com

Patrick Boone, Brussels
+32 2 710 43 66
patrick.boone@be.pwc.com

Adam Katz, New York
+1 646 471 3215
adam.katz@us.pwc.com

Ian Dykes, Birmingham
+44 (0) 12 1265 5968
ian.dykes@uk.pwc.com

David Ernick, Washington
+1 202 414 1491
david.ernick@us.pwc.com

Jonas Van de Gucht, Brussels
+32 9 268 8336
jonas.van.de.gucht@be.pwc.com

Richard Collier, London
+44 207 212 3395
richard.collier@uk.pwc.com

Phil Greenfield, London
+44 207 212 6047
philip.greenfield@uk.pwc.com