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**Intra-Group Services - DRAFT**

**Introduction**

1. This chapter considers the transfer prices for intra-group services within an MNE group. Firstly, it considers the tests for determining whether chargeable intra-group services have been provided by one member of an MNE group to an associated enterprise for transfer pricing purposes. Secondly, if chargeable intra-group services have been provided, it considers the methods for determining arm's length consideration for the services. The chapter also considers the circumstances in which tax authorities may provide taxpayers with the option of using a safe harbour for low-margin administrative services or for minor expenses. If a taxpayer chooses to use a safe harbour option for intra-group services that meet the requirements of the safe harbour, the tax authority agrees to not make a transfer pricing adjustment for those services.

2. Under the arm's length principle, if a chargeable intra-group service has been provided to associated enterprises, arm's length transfer prices should be charged to group members receiving an economic benefit from the services. The test for determining whether chargeable intra-group services have been provided between associated enterprises is whether any associated enterprises have received an economic benefit from the services. Economic benefit exists if an independent entity in the same circumstances would be willing to pay for the services or perform the activity itself. This principle is called the benefit test and is considered in below.

3. 3A transfer pricing analysis of intra-group services should be considered from both the perspectives of the service-provider and the associated enterprise receiving the services. Tax authorities may view the provision of intra-group services from either the perspective of a service provider or a recipient of services. The tax authority of the service provider would seek to ensure that if chargeable intra-group services have been provided, the associated

enterprise benefitting from the service is paying an arm's length price for the services. The tax authority of the service-provider would be concerned if there were no payments for intra-group cross-border services or if the charges for such services were below arm's length prices. It would also be concerned if the service provider incurred costs for the benefit of foreign associated enterprises without reimbursement or arm's length consideration if the benefits test has been satisfied. On the other hand, the tax authority of the recipient would be seeking to ensure that the services satisfy the benefit test and that the recipient was being charged arm's length prices for the intra-group services. A tax authority of the service recipient would consider making an adjustment if it considered that the services provided a benefit to the recipient but that the service charges were excessive. It should be recognised that the requirement that the consideration for chargeable services are arm's length prices is different to the issue of whether the charges are deductible under domestic law.

4. Transfer pricing rules require the payment of arm's length transfer prices for chargeable services. Principles of domestic law are then applied to determine if such payments may be deductible by an associated enterprise.

5. NE groups in a globalized economy may have highly integrated business operations. MNE groups seek business advantages from exploiting information, technology and communications systems and other assets. Intra-group services may play an important role in MNE groups as they seek to obtain services at the lowest price to maintain or improve their competitive position.

6. The services that MNE groups require may either be performed within the group or acquired from independent service providers. The performance of service activities required by members of the group may be centralised in one group member or dispersed among many group members. In some cases, MNE groups may outsource services to independent enterprises and then charge out the cost of the services on a pass through basis to those associated enterprises receiving a benefit.

7. Most intra-group services are easily identifiable, such as human resources services. In some situations a service may be connected with the provision of goods. For example, an associated enterprise might be provided with goods and it might also receive services to assist in the use of the goods. In other cases intra-group services may also be provided in conjunction with or embedded in intangibles or other assets.

### **Types of intra-group services**

8. Many types of intra-group services may be provided between the associated enterprises. [UNCTAD has noted in its *World Investment Report 2004: The Shift Towards Services*, that it is 'difficult to formulate a clear-cut definition of services. No commonly accepted definition exists.'<sup>1</sup>] A detailed list in the Appendix to this chapter sets out some of the types of intra-group services. The list in the Appendix is intended to be illustrative and is not comprehensive. Services can generally be allocated into chargeable services and non-chargeable services. Chargeable services can be divided into low-value adding services and

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<sup>1</sup> United Nations Conference on Trade and Development, *World Investment Report 2004: The Shift Towards Services* (Geneva: United Nations, 2004), p. 145.

other services. Simplified transfer pricing approaches may be used for low margin services (see paras. 66–78) while a full transfer pricing analysis may be required for other services.

## The benefit test

9. The benefit test is used to determine whether a member of the MNE group has received a chargeable service from an associated enterprise. The benefit test has two requirements both of which must be satisfied. Firstly, the associated enterprise receiving the service must gain an economic benefit or anticipate gaining an economic benefit from the service. Secondly, the associated enterprise must demonstrate that an independent entity in the same or similar circumstances would have been prepared to pay for the services or perform the services itself.

10. [There are three methods of considering benefits: singular, dual and general. In a singular method, the test only analyses the benefit for one party, whereas the dual method considers the benefit for both parties. The general method considers the benefits for the whole MNE. Many developed countries have adopted a singular approach, focussing on the benefit for the recipient only. However, this approach can cause problems for services rendered by a MNE service centre, since it does not take into consideration the benefit for the whole of the MNE. Centralization of services may be more efficient and save costs for the MNE as a whole, but not necessarily provide a specific benefit for a specific recipient.]

11. An examination of the facts and circumstances will be required to determine whether the benefit test has been satisfied for an enterprise receiving an intra-group service. The level of detail covered by such a factual examination, and the amount and nature of documentation required to demonstrate satisfaction of the benefit test, should be based on the materiality of the service charges. The topic of appropriate documentation for intra-group service charges is discussed in greater detail later in this Chapter.

12. The underlying notion of the benefit test is that, in order to be chargeable, the service must provide the recipient with commercial value to enhance its actual or anticipated commercial position in an identifiable way. For example, a marketing programme may be designed by one member of an MNE group to be used by associated enterprises operating as fully fledged distributors with the expectation that that designated associated enterprises will benefit. Although the marketing strategy is a success in most countries, it may fail to deliver all of the expected benefits in some jurisdictions. Each associated enterprise within the MNE group taking up this marketing strategy has received a benefit for the purpose of the benefit test, despite the fact that some of these enterprises do not fully achieve the expected results. The benefit test is satisfied as to these associated enterprises if an independent distributor would be expected to pay for the marketing services under similar circumstances.

13. Whether or not the benefit test is satisfied does not depend on the level of risk that the anticipated benefit will or will not be achieved. Some intra-group services, such as research and development, may involve a higher level of risk than other services, such as accounting or bookkeeping services. Notwithstanding the risk involved, intra-group research and development services are chargeable if an independent party would have been expected to pay an independent party for the research and development services in the same or similar circumstances or it would have performed this activity itself. Provided the recipient associated enterprise anticipates a potential economic benefit from the research and development, a chargeable service has been provided as the benefit test is satisfied.

14. Some intra-group services may involve a higher level of risk such as research and development services, which may fail to deliver the expected benefits. Intra-group research and development services comply with the arm's length principle if an independent party in the same or similar circumstances would have been expected to pay an independent party for the research and development services in the same or similar circumstances. It is important to note that enterprises engaging in research and development cannot always be expected to provide significant benefits due to uncertainty. Nevertheless, provided the recipient associated enterprise anticipates an economic benefit from the research and development, a service has been provided and the benefit test is satisfied. A separate issue is determining the appropriate remuneration for these services. If the risk of research and development is borne by the service recipient, a transfer price must be paid to the service provider irrespective of whether the anticipated benefits are realized. On the other hand, if the risk is borne by the service provider, then payments would only be warranted if the research and development is successful.

#### **Service activities for the specific requirements of an associated enterprise**

15. Associated enterprises may request the provision of specific intra-group services. Services provided specifically to one member of the MNE group and designed specifically to its operations will generally satisfy the benefit test. For example, an associated enterprise which is part of an MNE group involved in telecommunications may suffer reputational damage and a potential loss of business if information technology (IT) problems prevent customers from using its telecommunications system. If an IT problem arises and direct assistance is provided promptly to the associated enterprise by another member of the MNE group specializing in the provision of IT services, the service would satisfy the benefit test as the associated enterprise has received an economic benefit to maintain its business operations.

16. Similarly, if an associated enterprise seeks assistance in the design of a targeted marketing campaign from a related party which specializes in marketing strategies and practices, the associated enterprise providing the marketing strategy advice is providing a service prepared specifically for the recipient. The benefit test would generally be satisfied in such a circumstance because the associated enterprise anticipates a commercial benefit from the service, and an independent enterprise in the same or similar circumstances would be willing to pay for the provision of such services.

#### **Centralized services**

17. An MNE group often will centralize certain business functions within an associated enterprise operating as a service provider to the rest of the group or to a sub-group of associated enterprises, such as a regional sub-group, for their benefit. A wide variety of services may be centralized in this manner, including both low and high-value adding services. Depending on the facts, each associated enterprise benefitting from the services provided by a centralised service provider should be charged an arm's length price for the services it acquires. The economic benefit is apparent if an associated enterprise would otherwise have to perform the activity itself or engage an external service provider.

18. There are numerous reasons for an MNE group to provide intra-group services on a centralized basis. Services may be provided by an associated enterprise for the rest of the group in order to minimize costs through economies of scale. This may allow the MNE group

to increase its profits or improve its competitive position by being able to reduce the prices charged to customers. Centralizing services may allow for specialization within an MNE group which may also involve the creation of centres of excellence. Some MNE groups may centralize services in a regional management company for associated enterprises in a particular geographic region in order to align functional and management responsibilities. In some cases an associated enterprise may not have the skills or resources locally in-house for the service it requires and may rely on specialists that are responsible for providing the same type of services across a wider geographic or functional grouping of entities. Another potential benefit of having centralized services for an MNE group is the certainty that such services will be available when required and that the quality of the services is consistent within the MNE group.

### **Example 1<sup>2</sup>**

An MNE group carries on an airline business in 5 countries (Countries A, B, C, D and E) with the parent of the group being located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE group decides to create a centralized call centre for the MNE group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows for the centralized call centre to be located in any country in which the MNE group operates. The call centre can operate on a 24 hour basis in providing call services to all time zones in which the MNE group carries on business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and location savings. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre the group members would either have to establish their own call centre or engage an independent party to provide call centre services on their behalf.

### *On-call services*

19. Intra-group on-call services are where an associated enterprise agrees to provide a particular type of service immediately or within a short period of time. In order to do so it must maintain the staff necessary to provide such services promptly as requested, even though some staff members may not be fully utilized by the MNE group at all times. On-call services may also be called ‘call off contracts’ and ‘stand by contracts’. The anticipated economic benefit to the recipient of being able to call on such services without delay when needed may be a sufficient business advantage to satisfy the benefit test, even if the contingency requiring the service never arises and actual services are never or infrequently provided. An associated enterprise that is a recipient of such on-call services would therefore be expected to pay the service provider for maintaining the necessary staff to provide the service, even during times when the potential recipient does not call on the associated enterprise to provide the service. The existence of an economic benefit for on-call services will need to be considered on a case-by-case basis to ensure that an associated enterprise is actually receiving a benefit from having a service provider on call and that an independent enterprise in the same or similar circumstances would have been willing to pay.

<sup>2</sup> The examples contained in this chapter are some illustrations of the principle being considered.

## **Non-chargeable services**

20. Certain intra-group service activities provide a benefit only to the parent company and therefore fail the benefit test for subsidiaries. Charges for these services must be borne exclusively by the parent company and cannot be allocated to associated enterprises. Nevertheless, it is emphasised that a determination of whether an intra-group service has been provided to a particular associated enterprise depends on an analysis of the facts and circumstances of each case. The following section deals with four situations in which the benefit test is failed for one or more associated enterprises.

### *Shareholder activities*

21. Shareholder activities provide an economic benefit only to the parent company of an MNE group [or any shareholder holding shares in the parent company]. Accordingly the cost of shareholder activities must be borne exclusively by the parent company in an MNE group. Other associated enterprises cannot be charged for shareholder activities. Shareholder services performed by an associated enterprise on behalf of its parent company should be charged to the parent company on an arm's length basis.

22. Shareholder activities are activities that are carried out by or on behalf of a parent company [or any shareholder] and relate to the parent company's role as the ultimate shareholder of the MNE group. These activities may be carried out by the parent company or on its behalf. Shareholder activities include:

- the preparation and filing of reports required to meet the juridical structure of the parent company;
- the appointment and remuneration of parent company directors;
- the meetings of the parent company's board of directors and shareholder;
- the parent company's preparation and filing of consolidated financial reports, reports for regulatory purposes, and tax returns;
- the activities of the parent company for raising funds used to acquire share capital in subsidiary companies; and
- the activities of the parent company to protect its capital investment in a subsidiary companies.

23. Company law usually requires that a company should be managed by a board of directors. A company's board of directors is required to make the key business, investment and policy decisions of the company. The role of company directors is usually to act in good faith in the best interests of the company. A jurisdiction's company law will usually prescribe the legal duties of a board of directors. The cost of a parent company's board of directors may constitute shareholder expenses and in that case that cannot be attributed to associated enterprises. In this situation, the only enterprise in an MNE group that would satisfy the benefit test is the parent company. The non-chargeable directors' costs would include the directors' fees and the cost of holding meetings. If a parent company in an MNE group is supervising its investments in the group through a supervisory board, the cost of the supervisory board may be a shareholder expense that cannot be attributed to an associated enterprise.

24. Directors of a company may also engage in other activities in connection with the parent's ownership interests and these expenses would also be treated as shareholder expenses. However, directors may also provide services that result in the provision of material and recognizable benefits to members of an MNE group other than the parent company. In this situation, the determining factor is whether a service has been provided to associated enterprises. If it is determined that a service has been provided, the next issue to consider is which group members satisfy the benefits test for the service.

25. Another example of a shareholder expense is the cost of obtaining financing by the parent of an MNE group to acquire a company, as such costs fail to provide an immediate benefit to the entity which has just become a group member. If a parent company raises funds from an independent lender on behalf of an associated enterprise that is a regional headquarter company to acquire a new company, this service would be a chargeable financial service. This would satisfy the benefit test if an independent party would have been willing to pay for the financial services in comparable circumstances. In this situation a service charge from the parent company to the subsidiary would be appropriate as the parent company has provided services in the form of being the associated enterprise's agent to raise finance.

### **Example 2**

Controller Co is a resident of Country A and it is the parent company of an MNE group (group). Controller Co is listed on the stock exchange in Country A, it is required by the stock exchange and securities regulators to report its financial position periodically. The reporting requirements include the group's consolidated profit and loss statements and balance sheet prepared in accordance with International Financial Reporting Standards. Subsidiary Co is a subsidiary company resident in Country B and maintains its own accounting function to support the operation its business. Subsidiary Co is required under the domestic law of Country B to prepare its accounts in accordance with International Financial Reporting Standards and to annually file statutory financial statements. Subsidiary Co's chief financial officer provides certain reports and financial statements to Controller Co for inclusion in the group's consolidated financial statements. Controller Co reviews the information provided by Subsidiary Co. Controller Co files its financial statement as required by law in Country A. The review of Subsidiary Co's financial information and the incorporation of this material into Controller Co's consolidated financial statements are actions that Controller Co carries out as a shareholder of Subsidiary Co, Controller Co cannot impose a service charge on Subsidiary Co for reviewing and incorporating its financial statements into the group's consolidated financial statements that Controller Co is required to file, as these activities do not provide Subsidiary Co with a benefit. These activities are exclusively attributed to the obligations imposed on Controller Co as a listed company. If Subsidiary Co incurs costs in preparing financial statements for the group's consolidated financial statements that exceed the requirements of meeting the financial reporting requirements in Country B, Controller Co should compensate Subsidiary Co on an arm's length basis for the additional activities.

### **Example 3**

Parent Co is incorporated in country A and is the parent company of an MNE group. Assume further that Sibling Co is a subsidiary and is a resident of Country B. Parent Co has a policy of reviewing the performance of senior officers of its subsidiaries and

determining the status of their continued employment and remuneration accordingly. It sends senior staff to Country B to conduct appraisals of the senior officers of Sibling Co who report directly to Parent Co. In addition, Parent Co has the exclusive power to hire and dismiss the senior officers of Sibling Co. Parent Co reviews the performance of the senior officers of Sibling Co on a regular basis. In this situation, Parent Co is providing services to Sibling Co as Parent Co hires the senior staff of Sibling Co, and monitors and reviews their performance. These activities cannot be characterized as shareholder activities. The activities provide a benefit to Sibling Co and an independent enterprise would have had to pay for these services. Under the arm's length principle, the services performed by Parent Co are akin to those of a labour broker and may be charged to Sibling Co on an arm's length basis.

#### *Duplication of activities*

26. Duplication of services occurs when a service is provided to an associated enterprise which has already incurred costs for the same activity performed either by itself or on its behalf by an independent entity. Duplicated activities are usually not chargeable services. The determination of duplication must be made on a case-by-case basis. There are some circumstances in which duplication may provide an associated enterprise with a benefit if an independent party would have been willing to pay for the duplicated services in similar circumstances. For example, this situation may arise if an associated enterprise receives in-house accounting advice on an issue but chooses to get a second opinion to minimize the risk of being penalized for failing to comply with accounting standards.

27. At times an MNE group may engage in service functions which have the same name but the functions are performed at different levels and therefore do not involve duplication. These functions may be carried out at group, regional or subsidiary level. For example, strategic marketing functions are performed at group level as they are for the benefit of the entire group, while at the subsidiary level a subsidiary engages in marketing analysis of the local market conditions. In this situation the marketing services are not duplicated as they are different types of services.

28. An exception to the duplication rules may arise when an activity is in the process of being centralized for an MNE group, acceptable duplication may occur during the transition phase. For example, an MNE group may decide to centralize its human resources function for the group and this alteration would require the closure of each associated enterprise's human resources department after the necessary data has been provided to the centralized human resources database. This process is likely to involve a period of overlap and acceptable duplication during the transition phase. In this situation an independent entity would have a period of duplication if it were in the process of outsourcing its human resources function to an independent service provider. Nevertheless, care should be taken in determining whether a situation involves acceptable duplication.

#### **Example 4**

Subsidiary Co, a company resident in Country A, is part of an MNE group (group). The group's business is growing primary produce and distributing it in local markets. The parent company is Parent Co in Country B. Parent Co oversees treasury functions for the group. Parent Co's treasury function ensures that there is adequate finance for the group and monitors the debt and equity levels on its books and those of its subsidiaries.



Subsidiary Co maintain its own treasury function and manages its finances on an independent basis. It manages its treasury operations and ensures that it has finance available either in-house or externally. A functional analysis indicates that Subsidiary Co carries on its own treasury functions in order to ensure that it has adequate debt capital to finance its operations. In this situation, duplication arises as Subsidiary Co is performing treasury functions necessary for its operations and Parent Co is performing the same treasury functions for Subsidiary Co. Accordingly, Parent Co's treasury activities are duplicated activities that fail the benefit test. Under the arm's length principle, Parent Co cannot charge a service fee to Subsidiary Co for Parent Co's treasury functions.

**Example 5**

An MNE group has its Parent Company in Country A. Parent Company performs treasury functions for itself and its subsidiaries. The treasury functions include raising capital, obtaining financing and cash management. Subsidiary Company is an associated enterprise in Country B and does not perform any treasury functions itself. In this situation there is no duplication as Subsidiary Company does not perform treasury functions. In this case, Subsidiary Company is considered to obtain a benefit from the functions performed by Parent Company.

**Example 6**

An MNE group has a parent company called Controller Company in Country A. Controller Company has in-house legal advisers with expertise in intellectual property. The expertise includes registering patents and protecting intellectual property rights. Property Company is an associated enterprise in Country B and it is the legal and economic owner of patents that it has developed itself for its own benefit. Property Company has a dispute with one of its customers over the improper use of its intellectual property. Property Company attempts to discuss the dispute with the customer but the customer denies that there is a breach of the licence agreement and refuses to negotiate. Property Company does not have in-house legal counsel and engages an independent legal firm in Country B to provide it with advice on whether it is entitled to damages from the customer for the purported breach of the agreement. The legal advice is that the customer is in breach of agreement and that Property Company should take legal action to recover substantial damages from the customer. As litigation is expensive Property Company seeks a second opinion from Parent Company on whether it should take legal action against the customer. Both Country A and Country B have similar legal systems. Parent Company uses its in-house legal counsel to provide advice on whether Property Company is entitled to damages for the breach of agreement as well as assessing the extent of the damages. In this situation the legal advice provided by Parent Company has provided Property Company with an economic benefit as it has the comfort of the second opinion. In this situation there is no duplication and the use of a second legal opinion is a justified measure for dealing with a dispute with a customer. Independent entities involved in legal disputes may seek a second opinion to confirm their legal rights.

*Passive association*

29. Benefits to members of an MNE group may arise that are incidental to an associated entity's membership of the MNE group; the incidental benefits are attributable to entity's passive association with the MNE group. The incidental benefits of association with an MNE group are not a chargeable service for members of the MNE group. For example, independent enterprises transacting with an enterprise that is a member of an MNE group may be willing to provide goods or services to it at prices that are below the prices charged to independent buyers. These discounts may be provided because the independent supplier hopes that it will be able to generate future sales to other group members if it provides favourable pricing and good service. Moreover, the associated enterprise may be viewed by the independent supplier as a low risk customer that is unlikely to default on any trade credit. It is emphasised that in this situation the independent enterprise has made an assumption on credit risk as it cannot take legal action against the parent company if the subsidiary defaults as the parent has not provided the enterprise with a formal guarantee. Under these circumstances, the associated enterprise's membership of the MNE group does not result in a chargeable service being provided to the associated enterprise by the MNE group. The key feature of this type of incidental benefit is that it is passive and cannot be attributed to an overt action taken by another member of the MNE group. In contrast, if a member of an MNE group provided a formal guarantee of an associated enterprise's trade credit, the formal guarantee may be a service a chargeable service provided that an independent entity would have been willing to pay for a formal guarantee in similar circumstances. Another example of a situation in which a chargeable service may occur is where an associated enterprise is able to get additional discounts from an independent supplier on condition that other MNE group members commit to additional purchases from that supplier.

30. The passive association of an associated enterprise with its MNE group may improve the associated enterprise's credit rating. An associated enterprise that is part of an MNE group may be able to receive a higher credit rating from lenders on the basis of its membership in the MNE group. If the associated enterprise were assessed on a stand-alone basis it would be expected to receive a lower credit rating from the lender. In this case, the associated enterprise has received an incidental benefit from being its passive membership in the MNE group. In this situation there is no chargeable service. This incidental benefit cannot be subject to a service charge from other group members. On the other hand, if the parent company provided a lender with a formal guarantee for a loan made to an associated enterprise, the parent would be actively seeking the advantage of a lower finance charge for the associated enterprise and the guarantee would accordingly qualify as a chargeable service for transfer pricing purposes requiring the payment of an arm's length guarantee fee.

31. There are other situations in which one associated enterprise may provide an intra-group service to another associated enterprise under circumstances where that service also gives rise to benefits being received by other members of the MNE group other than the primary beneficiary of the service. Whether follow-on benefits to other group members may support the payment of service fees by the incidental beneficiaries depends on the facts. The determination of whether a service fee should be paid by the incidental beneficiaries of the service depends on whether an independent party in the same circumstances would have been willing to pay for the intra-group service. In some cases, the incidental follow-on benefits that an associated enterprise receives may be remote and would fail the benefit test as an independent party would not be willing to pay for the service.

**Example 7**

Motorcycle manufacturing MNE X has an associated enterprise that serves as a distribution company in Country A, which is incurring losses. The Parent company's marketing department is asked for assistance and advice as to how to make the associated enterprise in Country A profitable. After studying the Country A consumer market and comparing that market with other markets where MNE X motorcycles are sold, the parent company marketing department develops a marketing campaign for Country A where specifically adorned and highly decorated motorcycle helmets are given away for free together with motorcycles sold in Country A. There is no law requiring the use of motorcycle helmets in country A. The marketing campaign is a success and sales in Country A increase the next year. The helmets are actually quite popular due to their specific designs and adornments. The year after, an independent study shows that motorcycles of MNE X are less likely to be involved in deadly accidents. This study boosts the sales of MNE X's motorcycles in Country A. The associated enterprise in Country A is allocated the cost of the marketing campaign developed for it by Parent company. As a result of the independent study on motorcycle safety, however, the sales of MNE X motorcycles go up in countries B, C and D as well. These countries also have no laws that require the use of motorcycle helmets when riding a motorcycle. In issue is whether the marketing campaign cost incurred by the Parent company's marketing department perhaps ought to be allocated to associated enterprises in Countries B, C and D as well. The increased sales in Countries B, C, and D appear to be incidental benefits of the marketing campaign developed for Country A specifically, and most likely should not be charged out to the associated enterprises in countries B, C and D as a result.

**Example 8**

Assume that an MNE group has an Asia Pacific regional headquarters company that request the management of its parent company to review the structure and operations of associated enterprises in that region to ensure the regional group maintains its profitability. The managerial review of the associated enterprises may result in the decision to terminate certain business activities which are failing to meet profit expectations and are unlikely to improve. The reduction in profitability may be the result of structural market changes caused by technological developments. In this situation, the review would satisfy the benefit test at the level of the regional holding company. An independent enterprise in the same circumstances would be willing to receive advice from an independent management enterprise. The resulting decision on which business lines to retain and discard may provide incidental benefits for associated enterprises which are regional headquarters in other regions, such as South America. If the business lines of the associated enterprises in other regions are similar to the Asia-Pacific region, then the benefit test has been satisfied and a service charge may be imposed on these associated enterprises. On the other hand, if the business lines in the other regions are dissimilar, these associated enterprises cannot be subject to a service charge for the follow-on benefits resulting from the managerial review. In this circumstance, the benefit test would fail to be satisfied if an independent party would be unwilling to pay for an evaluation of business lines not relevant to its business. [On the other hand, there are some cases where an intra-group service performed by a group member, such as a shareholder or service centre relates only to some group

members but incidentally provide benefits to other group members. Examples could be analysing the question of whether to reorganize the group, to acquire new members, or to terminate a division. These activities could constitute intra group services to the particular group members involved, for example, those members who will make the acquisition or terminate one of their divisions, but they also may produce economic benefit for other group members not involved in the decision by increasing efficiencies, economies of scale or other synergies. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be one for which an independent enterprise ordinarily would be willing to pay.]

## **Determining an arm's length charge for**

### **Functional analysis**

32. If chargeable intra-group services have been rendered, the next step is to determine the arm's length service charges for transfer pricing purposes. Under the arm's length principle, charges for the services should reflect the charges that would be paid by independent entities in the same or similar circumstances.

33. As can be seen from a review of the types of services listed in Appendix A, services that may be provided between associated enterprises vary widely both in nature and value. Some services may be routine or administrative in nature and can appropriately be compensated at prices approximating the cost of the service plus a small mark-up. Other services may be unique, require significant skill to perform, involve the use of valuable intangibles of the service provider, and may be key contributors to the profitability of the MNE group. At arm's length, such services may command prices that result in significant profits for the provider of the service. Accordingly, no single approach to determining arm's length prices will be appropriate in all situations. Specifically, cost plus methods will not always yield the best estimate of the arm's length value of the services provided.

34. To determine an arm's length charge for intra-group services, a functional analysis should be undertaken. The functional analysis would consider the functions performed by the service provider, the assets used by it and the risks borne by it. The functional analysis would also consider any involvement of the service recipient and the use the service recipient makes of the service in conducting its own business. The functional analysis would provide evidence of the economic benefit expected or received from the services by the recipient and it would also provide assistance in determining the reliability of the available comparables. If a service activity is a separate activity engaged in for the benefit of the group, the functional analysis of the service provider may be relatively simple. If the services are connected with the provision of know-how or other intangibles, the analysis may be more complex. Intangibles are considered in a separate chapter.

35. An example of a chargeable service activity would be the provision of marketing services for an MNE group by an associated enterprise. The functional analysis of that activity may involve an analysis of the activities of the associated enterprise's staff in designing and implementing the marketing services. This consideration would also involve the skill and expertise of the staff of the service provider and the time involved in developing

the marketing strategy. The assets used may include the business premises as well as an office and computer equipment. The intangibles involved may include knowledge of independent enterprises providing advertising services, customer lists and know-how developed through other marketing campaigns. A marketing strategy may involve an element of risk as a prediction can only be made on the expected outcomes of the campaign.

### **Charging approaches**

36. There are two general approaches that may be used in charging for services, the direct charge and the indirect charge.

#### *Direct charging*

37. The direct charging method requires that the specific services is where a direct charge is imposed for the services provided. This method requires the specific services provided and the price for those services be identified in order to allow a determination of whether the charges satisfy the arm's length principle or not. In general, any of the transfer pricing methods identified in the following section may be applied to identify an arm's length price under a direct charging method. [Under the direct charge method associated enterprises are charged for specific services. For example an overseas subsidiary may be directly charged for a 2-day visit of a software engineer who is employed by the parent company and who may have visited the overseas subsidiary's site at the latter's request to render certain consultancy services or advisory services. In such a case the parent company can charge the specific costs for these consulting services with or without a mark-up (as the case may be) directly to the foreign subsidiary, even if a third party would proceed in this way under similar conditions and circumstances.]

#### *Indirect charging*

38. A direct charging method may be difficult to apply and the cost of direct charging may be an administrative burden which is disproportionate to the services provided. Many MNEs have developed indirect charging methods using an apportionment method to reflect the relative benefit that each associated enterprise is expected to receive from the provision of intra-group services. Allocation keys used by MNE groups are based on objective factors which are proxy measures for the relative economic benefit an associated enterprise receives from centralized services. The allocation keys are considered below at paras. 63–4. Allocation keys are acceptable provided they reasonably comply with the arm's length principle. The main feature of indirect methods is that the allocations are estimates of the relative benefits that associated enterprises expect to receive from services. The allocation method may be based on a single factor or several factors used in combination to apportion the expenses. For example, if human resources services are centralized for an MNE group, the allocation may be based on the number of employees in each associated enterprise. For services related to marketing, an objective basis for allocating expenses may be turnover.

39. At times it may be difficult to measure the anticipated economic benefit of some centralized services within an MNE group. For example, it would be difficult to estimate the benefit of a promotional campaign at a major national sporting event which has a worldwide television audience. Once the promotion rights are obtained and a payment made, the MNE

group is required to allocate the cost of the centralized promotion prospectively on the basis of the anticipated economic benefit for group members. [Tax administrations of developing countries find it difficult to verify the authenticity of these types of fees. Furthermore, determining whether the applied allocation method is in accordance with the arm's length principle is another practical difficulty since intra-group services are mostly charged applying an indirect charge method, utilizing various allocation keys. Due to the fact that most of the parent companies of MNEs are located overseas, the local subsidiary companies can often only provide information regarding their own operations instead of an overall understanding of the entire intra-group services structure. Potential relevant information could be whether subsidiaries in other countries who similarly benefit from the services follow the same methodology to pay the service fees and the actual amount of the service fees charged to the various subsidiaries.

40. Generally, the direct charge method is preferred over the indirect charge method in cases where the services rendered by an associated enterprise to other group members (i) are the same or similar as those rendered to independent companies, or (ii) can be reasonably identified and quantified. In many circumstances, MNEs will not have an option but to use indirect cost allocation methods. In such cases, intra group services charged on an allocation basis will be acceptable if the outcome can be justified from an objective perspective..]

#### *Provision of assets and ancillary services*

41. It may be necessary to distinguish between the transfer of tangible or intangible assets and services as the transfer agreement may include the provision of ancillary services. The services may include the provision of training or advice on the use and operation of machinery and equipment. In the case of intangible assets, the services may be training and assistance on the use of patents, copyright or know-how. If the provision of intra-group services is separate to the provision of tangible or intangible assets then it may be appropriate for an arm's length service charge to be allocated to the recipient. Determining whether a service is connected to the transfer of tangible or intangible assets depends on the facts and circumstance of the transaction.

42. If a payment for tangible or intangible assets covers accompanying ancillary services, a separate service fee may be inappropriate as this would involve a second charge for the same services. The transfer price for such transactions may be supported by comparables in which similar ancillary services are provided, such as internal comparables. Nevertheless, it may be difficult to obtain external comparables. On the other hand, if the transfer price for the transfer of a tangible or intangible asset did not cover the provision of services, it would be appropriate for a service charge to be made.

#### **Example 9**

Crimson Co is a resident of Country A and is the parent of an MNE group that carries on a business of mining and processing minerals. Violet Co is an associated enterprise resident in Country B and also carries on a business of mining and processing minerals. Crimson has developed a processing system for minerals which reduces the cost of processing minerals and the processing time. The processing system is know-how and Crimson has not sought a patent for the processing system. Crimson Co agrees to provide a licence to Violet Co for the right to use know how for the processing of minerals. The royalty fee for the licence to use the know-how is 3 per cent of Violet's

sales income from sales of minerals to independent customers. Under this arrangement Crimson agrees to provide ancillary services to the staff of Violet Co on the use of the know-how. Assume that a functional analysis has been carried out by Crimson Co and appropriate comparables have been identified in setting the 3 per cent royalty fee. In addition, the comparables provide the same or similar ancillary services, the fees for which are embedded in the royalty fee. In this situation, Crimson has been fully remunerated for the provision of know-how and any ancillary services in the 3 per cent royalty fee. It would be inappropriate for the tax authority in Country A to claim that the royalty payment only applies to the licence arrangement and that Crimson Co is required to receive a further payment for the provision of ancillary services. The fees for the ancillary services are embedded in the transfer price of the know-how. Consequently, it would be inappropriate for any additional service charges for training to be imposed on the associated enterprise.

### **Calculating arm's length consideration**

43. For both direct and indirect charging methods, the transfer pricing methods in this Manual (Chapter 6) may be used to determine arm's length prices for intra-group services provided that they are reliable. If there is a disagreement between the tax authorities of the service provider and the service recipient on intra-group service charges, double taxation will occur. The next section focuses on the most commonly used transfer pricing methods for intra-group services, the Comparable Uncontrolled Price (CUP) method, the Cost Plus Method and the Transactional Net Margin Method (TNMM).

#### **CUP**

44. The CUP method (see paras. 6.2.1-6.2.5.4.) requires a high degree of comparability between controlled and uncontrolled transactions. If an MNE group's service provider renders the same services in comparable circumstances to independent entities as it provides to associated enterprises, these may qualify as internal comparables allowing it to apply the CUP method. In addition, the service-provider would have a charging system in place. Similarly, if an associated entity receives the same or similar services from both an associated enterprise and from independent service providers, that entity may be able to use these as internal comparables for the CUP method. If the service provider only provides centralized services to intra-group members, external CUPs may in some cases be available. An external CUP may be used provided it is comparable to the intra-group services. However, for the CUP method to be applicable, an analysis of the types of services provided in controlled and uncontrolled transactions is required.

45. The CUP method may not be applicable if services are only provided within an MNE group and there are no comparable uncontrolled transactions between independent parties. In performing the comparability analysis, the controlled and uncontrolled transactions should be compared based on the comparability factors discussed in Chapter 5. As the CUP method requires a high degree of comparability, details on the services rendered, functions performed, assets used and the risks borne in controlled and uncontrolled transactions is required. In addition, comparability may be affected if provision of the services involves the use of intangible assets. Other comparability factors may have an effect on the prices charged

in uncontrolled transactions such as quantity discounts and contractual terms which may provide extended periods for payment of services rendered and associated guarantees.

46. If there are material differences between controlled and uncontrolled service transactions, reasonably accurate adjustments are required. If such adjustments cannot be made, the CUP method will be inapplicable as the comparables will be unreliable. While comparable service transactions between independent parties may take place, it is unlikely that the critical information on these transactions (such as the prices charged, functions performed, assets used and risk borne by the parties) will be available for comparison. This type of information on uncontrolled transactions is often confidential and unlikely to be publicly available.

#### **Example 10**

Grain Co and Shipper Co are associated enterprises. Grain Co is resident in Country A and produces wheat for export. Shipper Co is resident in Country B and carries on a business of providing grain shipping services. Shipper Co provides grain shipping services to four independent enterprises and approximately 60 per cent of its business is made up of performing shipping services to these independent customers and 40 per cent of its business is performing shipping services for Grain Co. In this situation it is likely that Shipper Co would be able to use the CUP method as it has internal comparables to use in setting its transfer prices for Grain Co. The reliability of the comparables depends on a comparability analysis. Assume that there is a high comparability in terms of the type of service provided, the volume of transactions, the contractual terms and the economic conditions. In this case, Shipper would be able to use the internal comparables in setting its transfer prices for shipping services provided to Grain Co.

#### **Example 11**

Assume the same facts as Example 7, except that 90 per cent of Shipper Co's business is providing shipping services for Grain Co. The remaining 10 per cent of its business is providing shipping services on an ad hoc basis to independent customers. Assume further that the independent customers only use Shipper Co in times of acute shortage of shipping capacity by other independent shipping enterprises. In these situations, shipping services may be more costly than when there is no shortage. In this situation, the comparability analysis is likely to lead to the conclusion that the comparables need to be adjusted for the significant differences between the controlled and uncontrolled transactions which would affect the shipping charges. The main differences on the facts are the volume of business (90 per cent of volume originates by Grain Co and 10 per cent by independent entities) and the regularity of providing grain transporting services that must be taken into account as they would be expected to have a material effect on the transportation charges. Moreover, Grain would be expected to benefit from a significant quantity discount. If reasonably accurate adjustments cannot be made to the uncontrolled transactions as material differences exist between the controlled and uncontrolled transactions, the CUP method will be unreliable and should not be used.

#### **Cost Plus Method**

47. In practice, it is often the case that the CUP method is inapplicable. In this situation, an MNE group may consider using the Cost Plus Method which is less dependent on similarity between the controlled and uncontrolled service transactions than the CUP. As stated at para.



6.2.15.1., the financial ratio considered under the Cost Plus Method is the gross profit mark-up. The aim of the Cost Plus Method is to set the appropriate cost plus mark-up on cost base so that the gross profit in a controlled services transaction is appropriate in light of the functions performed, risks assumed, assets used and market conditions. The Cost Plus Method focuses on the service provider as the tested party. The Cost Plus Method is used to determine arm's length service charges based on the gross profit mark-up on costs earned by comparable independent service providers. The Cost Plus Method is often used for determining transfer prices for services.

48. Although the Cost Plus Method is less dependent on similarity between the controlled and uncontrolled services under the CUP method, the services in controlled transactions and comparable uncontrolled transactions should be similar. If material differences arise between the controlled transactions and the comparables, adjustments are required provided they are reasonably accurate.

49. The cost base of service for controlled and uncontrolled transactions should be comparable. The application of the Cost Plus Method depends on ensuring that the cost base of the associated enterprise and the comparables is the same as there is the possibility of differences between the cost bases arising from the use of different indirect expenses in the cost base. A list of the types of direct and indirect costs are set out below at para. 54. The profit mark-up is the gross margin that an independent enterprise providing services in the same or similar circumstances to independent customers could expect to record. Differences between the cost bases can arise from the use of different indirect expenses in the cost and may make the Cost Plus Method unreliable.

50. It is likely that it will be difficult to find comparables for low-value administrative services as independent enterprises would be less likely to provide these types of services for large enterprises. While the appropriate mark-up for the Cost Plus Method should be based on available comparables from independent service providers, as a matter of simplicity it may be appropriate to use the safe-harbour option for administrative services considered below. The cost of finding appropriate comparables for the purposes of the cost plus method may be disproportionate to the tax liability at stake and thus the safe harbour provides a compromise that limits compliance costs and imposes an appropriate fixed mark-up. In addition, the task of finding comparable gross profit margins may prove challenging in many jurisdictions, as gross profit margins are not reported.

*Total service costs: Direct and indirect costs*

51. Total costs means all costs in calculating the operating income. The items that would be expected to be included in the direct cost base are: salaries of the staff providing services; bonuses; travel expenses; materials used in providing services; communication expenses attributable to the provision of services. Indirect expenses may include the following items: depreciation of equipment and buildings; rent for leased items or immovable property; property taxes; occupancy and other overhead costs; maintenance costs; insurance; personnel costs, accounting, and payroll expenses; and other general, administrative and managerial expenses.

**Example 12**

A company that is a member of an MNE group provides an on-call service to its associated enterprises and the service satisfies the economic benefit test. Once it is established that an on-call service provides a benefit to group members the next issue for consideration is the service fee that may be charged. The fee for an on-call service may include part of the capital costs of providing the service, such as business premises and equipment as well as a profit margin. If the premises and equipment are leased, the charge would be a proportion of the annual lease fees. If the premises and equipment are purchased, it would be appropriate to allocate depreciation expenses to the recipients. An independent enterprise providing such services would be expected to include these expenses in the prices it charges its customers.

**Transactional Net Margin Method (TNMM)**

52. The TNMM may be used for services. (See 6.3.1.2-12.7. for more details on the TNMM). The TNMM examines an associated enterprise's (the tested party) net profit margin relative to an appropriate base that the enterprise makes from controlled transactions. The TNMM focuses on net profit rather than gross profit margins and the TNMM provides comparable net profit margins for uncontrolled transactions. The TNMM may be based on internal comparables, such as from uncontrolled transactions that the associated enterprise enters into. Alternatively, the profit margins may be obtained from transactions by independent parties.

53. The TNMM may be used for intra-group services if the Cost Plus Method cannot be used because gross profit margins are unavailable for comparable service providers or because the cost base used for controlled and uncontrolled transactions is different. As the method is based on net profit levels, the TNMM has a greater tolerance for accounting inconsistencies arising from cost base differences between controlled and independent service providers.

54. The profit level indicator that may be appropriate for intra-group services provided by an associated enterprise would be the ratio of the operating profit to the cost base of providing services called the "Return on Total Costs". The profit for independent service providers carrying on similar businesses may be available. These independent services may provide reliable comparables to be used in applying the TNMM. Another profit level indicator is a mark-up on the total costs of services.

**Example 13**

Service Provider Co in Country A is a member of an MNE group and it provides marketing services for the group. Service Provider is requested by an associated enterprise Seller Co in Country B to design a marketing program for a new product. Following research, Service Provider has concluded that the CUP and Cost Plus Methods are inapplicable. In applying the TNMM to Service Provider, the costs of providing services and operating expenses are known. The unknown variable is the arm's length charge for the intra-group service. A comparability analysis is then made to determine the appropriate arm's length net profit margin for Service Provider. If we assume that the cost of providing the service is \$80,000 and the operating expenses are \$20,000, the total direct and indirect costs of providing the services are \$100,000. Assume that Service Provider makes a net profit to costs of 5 per cent. A search of

comparable independent marketing enterprises has revealed they are making a net profit to costs of providing services of 3-8 per cent. Country A accepts the range of indicative comparables. The comparables are marketing enterprises which are listed on the stock exchange in Country A and provide similar marketing services to those provided by Service Provider. In this situation, Service Provider's net profit of 5 per cent is within the arm's length range of net profit to the cost of providing the services. The service provider is treated as making a net profit of \$5,000 from providing intra-group services to an associated enterprise.

### **Profit Split Method**

55. The Profit Split Method may be used for services (see 6.3.13.1-18. for more details on the Profit Split Method). The Profit Split Method is a two-sided analysis which applies to the profits of two or more associated enterprises engaging in controlled transactions. Moreover, the Profit Split Method is usually used when both sides to controlled transactions contribute significant intangible property. The aim of this method is to allocate profits on the basis that independent enterprises would have used in comparable independent transactions. Under the Profit Split Method the profit derived from controlled transactions is allocated between the associated enterprises. These profits are allocated between the associated enterprises on the basis of each associated enterprise's relative contributions. The relative contributions would be determined on the basis of functions performed, risks assumed and assets used by each associated enterprise. The Profit Split Method may be applied on the basis of a contribution analysis or a residual analysis (see para. 6.3.14.1 – 7 for more details).

### Pass-through costs

56. In some circumstances an MNE group may decide to outsource services for the whole group to an independent entity and to use an associated enterprise to act as an agent for the group to pay the accounts and to then allocate the charges to its associated enterprises on an objective basis. These may be called pass through costs. As an agent, its only role may be to pay the independent service provider and to then allocate the total cost of services among group members on an objective basis. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the outsourced services rather on the costs of the agency function itself and allocate without mark-up the outsourced costs. Alternatively, depending on the type of comparable data without being used, the mark-up on the total cost of services should be lower than would be appropriate for the performance of the outsourced services themselves, and the entire amount allocated.

### **Example 14**

An MNE group has a parent company, Controller Company, in Country A and has an associated enterprise; Subsidiary Company in Country B. Controller Co has 10 subsidiaries in total around the world. The MNE group has reviewed its operations and has decided to keep in-house the activities in which it has a comparative advantage and to outsource activities that independent enterprises can provide at a lower cost. The MNE group has decided to outsource its human resources activities to an independent enterprise, Independent Company, in Country B for the whole group. It has decided to outsource the work through Subsidiary Company as it is located in the same jurisdiction as the service provider. The role of Subsidiary Company is to pay the independent

enterprise and to recharge the costs it incurs in doing so to group member. In this situation Subsidiary Company is operating as an agent. Subsidiary Company charges the service costs charged by Independent Company to group members on the basis of full time employee equivalents in the group. The charge is on a flow through basis of full time employee equivalents in the group. The charge is on a flow through basis as Subsidiary Company is not adding value and merely used for convenience to distribute the human resource costs of outsourcing to Independent Company without a profit mark-up. In addition, Subsidiary Company may provide a service in paying Independent Company and allocating the cost to group members.

## Allocation keys

57. The use of allocation keys provide an effective proxy for allocating the cost or value of services within an MNE group, once the benefit test has been satisfied. The main feature of an allocation key is that it is determined consistently for all associated enterprises and reasonably reflects an associated enterprise's anticipated benefits from intra-group services. Allocation keys are a proxy for allocating intra-group service charges. For example, the allocation key for human resources costs may be based on the number of employees in each associated enterprise. An example of an inconsistent allocation key is one that uses different bases for allocating expenses for services to associated enterprises in different tax jurisdictions.

58. [When choosing an allocation key, the taxpayer should consider the nature of the services and the use to which the services are put. For example if the services relate to human resource activities, the proportionate number of employees may be the best measure of the benefit to each group member. In addition, there are situations in which the proportion of services rendered to each beneficiary might not be easily identifiable with reference to the exact quantum of benefit attained or expected (for instance, in cases involving centralized advertisement campaign). In such cases, the allocation key or method would be an approximate value (e.g. proportional net sales of all the beneficiaries to allocate the cost incurred to implement the centralized advertisement campaign mentioned above) must be used for allocation.]

59. It should be noted that from a compliance perspective there is a trade-off between precision and simplicity. A complex allocation key may place an excessive compliance burden on MNEs with negligible improvements in allocating expenses within an MNE group. Any allocation method will benefit from having supporting evidence to justify that the method allocates expenses within an MNE group on an objective basis. Whether an allocation key is appropriate requires an analysis of an MNE group's facts and circumstances.

60. An allocation key should satisfy the following requirements:

- be measurable;
- be relevant to the type of services;
- reflect arm's length prices;
- be determined consistently within an MNE group; and
- be reflected in documentation.\

61. Examples of allocation keys include:

- Sales;
- Gross or net profit;
- Units produced or sold;
- Number of employees or full time equivalents (FTEs);
- Salaries and wages;
- Number of information technology users;
- Office spaces or factor space; and
- Capital.

62. The following non-exhaustive list contains allocation keys that are commonly used by MNEs for certain types of services:<sup>3</sup>

- Information technology: number of personal computers;
- Business management software; number of licences;
- Human resources: number of employees;
- Health and safety: number of employees;
- Staff training: number of employees;
- Tax, Accounting: sales or size of balance sheet;
- Marketing services: sales to independent customers; and
- Vehicle fleet management: number of cars.

63. These allocation keys are provided as examples and other allocation keys may be acceptable. In addition, more complex allocation keys may accord with the arm's length principle. The main issue is that the allocation key is applied consistently within an MNE group for the same types of services.

#### **Example 15**

Manufacturing Co, Distributor Co and Personnel Co are associated enterprises in an MNE group. Manufacturing Co is the parent company and is resident in Country A. Distributor Co is resident in Country B. Manufacturing Co is in the business of manufacturing sporting goods. Distributor Co's only business activity is to distribute Manufacturing Co's goods in Country B. Personnel Co is resident in Country C and provides human resources services for the group. The centralization of services is designed to exploit efficiencies of scale and the relatively lower labour costs in Country C. Assume that Personnel Co's total cost of providing human resources services to Manufacturing Co and Distributor Co is \$454,545. Assume that a 10 per cent mark-up is arm's length. The cost base includes direct and indirect costs in accordance with the accounting standards used in Country C. Therefore, the total service charge for human resources services provided to Manufacturing Co and Distributor Co is \$500,000. Manufacturing Co has 1000 employees and Distributor Co has 50 employees. These are full time equivalent employees. This MNE group uses an allocation key for attributing the human resource service charge on the basis of number of employees. This allocation

<sup>3</sup> See EU Commission, 'Guidelines on low value adding intra-group services' (Brussels, 25.1.2011 COM(2011) 16 final), Annex I 'List of intra-group services commonly provided that may or may not be within the scope of this paper'. There is no indication that these services are low value added services.

key is chosen as it reflects the expected benefits of the associated enterprises from the provision of intra-group human resources services. The cost to be allocated per employee is  $(\$500,000/1050)$  \$476.19.

On this basis, the allocation key results in the following allocation of the human resources service charge:

- Manufacturing Co: 1000 employees, \$476,190.00
- Distributor Co: 50 employees, \$23,809.50

## Safe harbours

64. It is often burdensome and costly to determine arm's length prices if an associated enterprise provides a range of intra-group services. A practical alternative for a tax authority is to provide taxpayers with the option of using a safe harbour for certain low margin services, provided it results in an outcome that broadly complies with the arm's length principle. The safe harbour rates may be based on acceptable mark-up rates for services. Several countries provide a safe harbour option for certain services. The advantages of a safe harbour are that it provides certainty for taxpayers and tax authorities. In addition, safe harbours reduce the costs of complying with transfer pricing requirements in a country. Moreover, any additional tax revenue that a tax authority may receive from a transfer pricing adjustment of such services may be outweighed by the administrative costs of applying the arm's length principle to such services. Accordingly, providing a safe-harbour enables tax authorities to use their resources to concentrate on transfer pricing reviews in which the tax revenue at stake is more significant. The downside of a unilateral safe harbour is that the service-provider's country may not provide for a safe harbour and insist on a higher mark-up than the safe harbour mark-up and result in double taxation. If a bilateral or multilateral safe harbour is available, they are to be preferred as they reduce the risk of double taxation.

65. This chapter sets out two safe harbours that may be used by tax authorities:

- Low-value services that are unconnected to an associated enterprise's main business activity. This safe harbour is usually available for low-margin services as they are considered to have an insignificant effect on an associated enterprise's profits and do not provide it with competitive advantages in connection with its main business activity. The rationale for a safe harbour is that there may be difficulties in finding comparable transactions for low-margin services; and the administrative costs and compliance costs may be disproportionate to the tax at stake. In addition, the safe harbour provides taxpayers and tax authorities with certainty.
- Minor expenses safe harbours are for situations in which the costs of services provided or received are relatively low, the tax authority may decide to agree to not adjust the transfer prices provided they fall within the acceptable range. The rationale for this safe harbour is that the cost of a tax authority making adjustments is not commensurate with the tax revenue at stake and therefore the taxpayer cannot be expected to incur compliance costs to determine more precise arm's length prices.<sup>4</sup>

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<sup>4</sup> These two safe harbours are based on the safe harbours in the Australian Taxation Office's Taxation Ruling 1999/1 Income Tax: International transfer pricing for intra-group services, paras. 77-87.

**Low-margin services safe harbour**

66. Low-margin services are services which are not part of an MNE group's main business activities from which it derives its profits. They are low-margin services that support the associated enterprise's business operations. A determination of an associated enterprise's low-margin services would be based on a functional analysis of the enterprise. The functional analysis would provide evidence of the main business activities of an associated enterprise and the way in which it derives its profits.

67. This analysis may involve a consideration of:

- the main functions performed by the associated enterprise;
- whether the services are connected directly to these functions;
- whether the services have a significant effect on the associated enterprise's profits;
- whether the services affect the associated enterprise's competitive position;
- whether valuable intangibles are involved;
- the time factor;
- the level of risk involved;
- the relative value of the services.

68. The following services are examples of low-margin services:

- human resources services;
- accounting services;
- tax compliance services; and
- data processing

69. For an associated enterprise that is a distributor and marketer of an MNE group's products, marketing services would fail to qualify as administrative services as they are directly connected to the enterprise's main business activity.

70. The following services are examples of services that would fail to qualify as low margin services:

- services connected with main business functions performed by an MNE group such as: extraction and exploration services by a resources enterprise; manufacturing services; construction services; and financial services;
- services that result in the creation and enhancement of valuable intangible property;
- marketing and distribution services;
- strategic management services.

71. The determination of whether services qualify as low-margin services may require a case-by-case analysis of the key business activities of an MNE group. For example, assume that an MNE group is a manufacturer and distributor of motorcycles. If the MNE group provided training to the staff of associated enterprises on work safety, the training would not be part of the MNE group's central business of manufacturing and distributing motor cycles.

72. A safe harbour may contain the following requirements:

- identification of the service within the scope of the safe-harbour;
- a fixed profit margin;
- an assumption that the same gross profit margin is accepted in the other country; and
- the documentation requirements.

### **Example 16**

Manufacturing Co, Distributor Co and Services Co are associated enterprises. Manufacturing Co is resident in Country A and carries on the business of manufacturing goods. Distributor Co is resident in Country B and is a distributor of goods purchased from Manufacturing Co. The MNE group decides to centralize its human resources function in Services Co in Country C in order to obtain cost savings through economies of scale and the relatively low labour costs in that country. The total cost of human resources services provided to Distributor Co is \$100,000 under a direct charging system and the agreed mark-up for this function is 7.5 per cent in Country C, therefore Distributor Co is charged \$107,500 by Services Co under a direct charging system for human resources services. Distributor Co has total deductions of \$2 million which includes the services costs for Services Co.

Country B provides an administrative safe-harbour for inbound and outbound intra-group services with a gross profit mark-up of 7.5%, and the total expenses claimed under the safe harbour cannot exceed 15 per cent of the taxpayer's total deductions. Distributor Co chooses to use the safe harbour for low margin administrative services and claims a deduction of \$107,500. Distributor Co has documentation that it received human resources services from Services Co and that it used the administrative services safe harbour.

On the facts, Distributor Co would be entitled to use the administrative services safe harbour as the human resources are less than 15 per cent of its total expenses and the mark-up on services is within the accepted range. On the basis that Distributor Co's main business activity is distributing goods, human resources services would qualify as administrative services.

### **Minor expense safe harbour**

73. In the minor expense safe harbour option, a tax authority agrees to refrain from making a transfer pricing adjustment if the total cost of either receiving or providing intra-group services by an associated enterprise is below a fixed threshold based on cost and a fixed profit margin is used. The aim is to exclude from transfer pricing examinations, services for which the charge is relatively minor. The rationale is that the costs of complying with the transfer pricing rules would outweigh any revenue at stake. It also considers the potential administrative savings for a tax authority by avoiding transfer pricing examinations of minor expenses. An important requirement is that the same fixed profit margin should be used for in-bound and out-bound intra-group services for a country. The safe harbour provides taxpayers and tax authorities with certainty. The minor safe harbour may contain the following requirements:



- a restriction on the relative value of the service expense (e.g. less than 15 per cent of total expenses of the associated enterprise receiving the services);
- a fixed profit margin;
- the requirement that the same profit margin is used in the other country, and
- the documentation requirements that are expected.

74. An example of a safe harbour for services is set out below.

For inbound intra-group services:

- the total cost of the services provided is less than 15 per cent of the total deductions of the associated enterprises in a jurisdiction for a tax year;
- the transfer price is a fixed profit mark-up on total costs of the services (direct and indirect expenses);
- documentation is prepared to establish that the safe harbour requirements have been satisfied.

75. For outbound intra-group services:

- the cost of providing the services is not more than 15 per cent of the taxable income of the associated enterprise providing the services;
- the transfer price charged is based on a fixed profit mark-up on the total costs of the services (direct and indirect expenses);
- the same profit margin is used in the other country, and
- documentation is created to establish that these safe harbour requirements have been satisfied.

### **Example 17**

Assume that Subsidiary Co is resident in Country A and receives marketing services from its parent company, Parent Co which is resident in Country B. The total direct and indirect cost of providing the services is \$500,000. Subsidiary Co decides to use the safe harbour option, as the costs of preparing a comprehensive transfer pricing analysis for such services and determining the arm's length margin would be excessive given that the services are low margin services. Subsidiary Co does not acquire other services from associated enterprises and its total deductible expenses are \$10 million. The total charge for services of \$537,500 is below the \$750,000 threshold and the expense is 5.37 per cent of its total deductible expenses and thus below the 15 per cent threshold.

Accordingly, the maximum transfer price Subsidiary Co can deduct for the services rendered by Parent Co under the safe harbour option is \$537,500. A transfer price up to this amount will be deductible by Subsidiary Co provided the documentation requirements are satisfied.

76. Safe harbours may have unintended consequences and should be carefully considered before they are implemented. If in the above example, a full transfer pricing analysis concluded that the arm's length cost plus margin is 5 per cent. In that case, the service charge would have been \$525,000. By using the safe harbour, Subsidiary Co has been able to claim \$537,500 as a deductible expense in Country A for intra-group services without incurring the costs of a full transfer pricing analysis (which may have exceeded \$12,500). On the other

hand, if the tax authorities in Country B are not aware of the safe harbour, they would require arm's length services income of \$525,000 to be reported, which is \$12,500 less than what was claimed as a deductible expense at the level of Country A. To avoid this result, it is material that safe harbour requirements consider this and the matching of income and costs is required.

## Appendix

The following list of potential intra-group services is based on the list of intra-group services set out in Annex I 'List of intra-group services commonly provided that may or may not be within the scope of this paper' of the EU Commission, 'Guidelines on low value adding intra-group services' (Brussels, 25.1.2011 COM(2011) 16 final)

- Information technology services:
  - building, development and management of the information system;
  - study, development, installation and periodic/extraordinary maintenance of software;
  - study, development, installation and periodic/extraordinary maintenance of hardware;
  - supply and transmission of data; and
  - back-up services.
- Human resource services:
  - legislative, contractual, administrative, social security and fiscal activities connected to the ordinary and extraordinary management of personnel;
  - selection and hiring of personnel;
  - assistance in defining career paths;
  - assistance in defining compensations and benefit schemes (including stock option plans);
  - definition of personnel evaluation processes;
  - training of personnel;
  - supply of staff for limited period;
  - coordination of the sharing of personnel on a temporary or permanent basis; and management of redundancies.
- Marketing services:
  - study, development and coordination of the marketing activities;
  - study, development and coordination of the sale promotions;
  - study, development and coordination of the advertising campaigns;
  - market research;
  - development and management of Internet websites;
  - publication of magazines handed out to clients of the subsidiary (even if concerning the whole group).
- Legal services:
  - assistance in the drafting and reviewing of contracts and agreements;
  - ongoing legal consultation;
  - drafting and commissioning legal and tax opinions;
  - assistance in the fulfilment of legislative obligations;
  - assistance in the judicial litigation;
  - centralized management of relationship with insurance companies and brokers;

- tax advice;
  - transfer pricing studies; and
  - protection of intangible property.
- Accounting and administration services:
  - assistance in the preparation of the budget and operating plans keeping of the mandatory books and accounts;
  - assistance in the preparation of periodical financial statements, annual and extraordinary balance sheets or statements of account (different from the consolidated financial statement);
  - assistance in compliance with fiscal obligations, such as filing tax returns, computing, and paying taxes, etc.; data processing;
  - audit of the account of the subsidiary; and management of the invoicing process.
- Technical services, for example:
  - assistance regarding plant, machinery, equipment, processes, etc.
  - planning and executing ordinary and extraordinary maintenance activities on premises and plant;
  - planning and executing ordinary and extraordinary restructuring activities on premises and plant;
  - transfer of technical know-how;
  - providing guidelines for the products' innovation;
  - production planning to minimize excess capacity and meet demand efficiently;
  - assistance in planning and implementing capital expenditure;
  - efficiency monitoring; and
  - engineering services.
- Quality control services:
  - providing quality policies and standards of the production and provision of services;
  - assistance in obtaining quality
  - certifications; and
  - development and implementation of client satisfaction programs.
- Other services:
  - strategy and business development services in case there is a connection with an existing or to be established subsidiary;
  - corporate security;
  - research and development;
  - real estate and facility management;
  - logistic services;
  - inventory management;
  - advice on transport and distribution strategy;
  - warehousing services;

- purchasing services and sourcing raw materials;
- cost reduction management;
- packaging services.

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