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EU JOINT TRANSFER PRICING FORUM

**WORKING DOCUMENT ON INTRAGROUP CENTRAL
SERVICES FOR THE TAX ADMINISTRATION SUB-GROUP
MEETING IN MALTA**

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1. Background.

1. Previous contributions to this subject area are to be found in documents JTPF/001/2008/EN, JTPF/012/BACK/2008EN JTPF/014/REV2/BACK/2007/EN, JTP/022/BACK/2007/EN and (subject to comments) JTPF/18/2008 EN. These documents constitute the basis for the Sub-group work.
2. The purpose of this paper is to begin to summarise what has been agreed to date and to address those matters which require further input from the SUB-GROUP to assist in the preparation of a further document to be submitted to the full Forum for consideration.
3. At the Forum meeting of 5th June 2008 the minutes record support for the following statements and further actions.

1. In principle business costs must be deducted somewhere in the MNE group. The application of that principle however did not prevent Member States applying domestic tax rules to disallow some deductions or limit the amount of deduction claimed.

2. Specific topics within the intra group services area that could usefully be developed were:

- Defining a Standard Service
- Cost Base and Cost Plus
- Documentation and Evidence

Further detailed input is now sought from the sub group on these and related matters.

2. Defining a Standard Service.

4. Member States and MNEs recognise that services can be broadly segregated into two camps, standard and non standard services. The Forum appears comfortable with the assumption that a standard service (to be defined) is less high risk than non standard service and inherently unlikely to attract the attention of Member States auditors or require much attention from an MNE in any tax risk audit. The Forum wanted to concentrate on providing more definition around standard services and the implications of a service falling within that definition.

Q1 Does the SUB-GROUP wish to approach the issue of definition by

1. agreeing what they consider to be the criteria in deciding when any service, standard or non standard, has been provided at an arm's length charge

2. refining that definition to focus on the criteria in recognising when a standard service has been provided at an arm's length charge?

If the SUB-GROUP can agree the above approach can the following be agreed (essential a reaffirmation of the overarching OECD guidelines in recognising an arm's length service) in terms of the overarching principles to be applied when generally considering if a service has been provided?

- In accordance with OECD guidelines a service is recognised to be at arm's length when a service **has in fact been provided and the charge for that service is in accordance with the arm's length principle.**
- An arm's length service has been **provided** when the recipient of the service anticipates deriving economic or commercial value from the provision of the service and the service is one that the recipient would be willing to pay a third party for or perform the service itself.
- once it is determined that an arm's length service has been rendered **the arm's length charge** for that service should be that which would have been made and accepted between independent enterprises in comparable circumstances.

Q2. Based on the above principles is the SUB-GROUP prepared to recommend that in defining a standard service or routine service the following requirements should be met?

- The inherent nature of a routine service is such that it would not ordinarily attract the attention of tax administration auditors or demand much attention in a risk audit conducted by the tax department of an MNE.
- The service provided does not generate a significant amount of turnover for the provider nor does it attract a significant cost base compared to the costs of the business as a whole.
- The service is not being rewarded on an entrepreneurial basis – i.e. high risk high reward.
- The service does not constitute a major cost to the recipient in comparison to its overall administrative operating costs.
- When there is an opportunity for a service to create, further develop or modify an intangible it should always be classified as a non routine service.
- The service is not part of a bundle of standard services that cumulatively become a significant part of the core business and therefore not be considered any more as at low risk.
- The service is not one linked to the core business of the company. (The IRS Regs define that as a service that " would not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure of the business". ATO guidelines refer to "non core services which are not integral to the profit earning activities of the multinational group" as do New Zealand guidelines.)

5. To supplement an understanding of the practical implications of applying the above criteria in defining a standard service it could be useful to give an indicative list of standard services.
6. For example at OECD at 7.14 the following list may be considered as commonly supplied intra group services:

administrative: planning, coordination, budgetary control, financial advice, accounting auditing, legal, factoring computer services; financial services such as supervision of cash flows and solvency, capital increases, loan contracts ,management of interest and exchange risks and refinancing; assistance in fields of: production, buying, distribution marketing; personnel services: HR support ,recruitment, training. Additionally it is not unusual to see contract manufacturing, R&D and IP management provided intra group.

Q3. Drawing on an OECD guidelines analysis provided at the annex in the annex of DOC: JTPF/001/2008/EN and written contributions can the SUB-GROUP endorse a list of services that are inherently likely to be standard services?

i.e.

Administrative services: group co-ordination activities pay roll, audit, legal, recruitment training, computer technical support, communication management; financial services: accounting treasury, management of foreign exchange fees; personnel services: recruitment, training, staff management and development trading related services: production, buying distribution, marketing support ;equipment maintenance procurement fees: IT software, IT hardware, trading contracts; group provision of: on call services, wider risk management issues, contract R&D, contract manufacturing, patent protection. (Would the SUB-GROUP like to invite Business to expand on this list?)

Q4. Finally an important drafting question is agreement in describing a service as "standard". In the future which word do you consider as appropriate to better express the concept: routine service, standard service, basic service, other?

3. Shareholder Activity/ Stewardship Activity

7. In considering the question of services two particular activities were highlighted Shareholder activity and Stewardship activity. Both these activities raise questions around definition and treatment.
8. The shareholder activity problem: a member of a MNE will carry out certain activities in its capacity as shareholder. For example that might be simply arranging shareholder annual general meetings, issuing shares in the parent company or, perhaps, keeping a watching brief on the performance of associated enterprises.

9. Taking the last example: a watching brief may not be directly beneficial to the associated enterprises concerned and they would not be prepared to pay for it. So whilst a cost may have been incurred centrally it is not a cost that could be charged out let alone charged out enhanced by a profit margin. However, it may be that, centrally, a proposal to rectify the poor performance of an associated enterprise, together with an implementation plan, is offered and accepted by that associated enterprise. That type of activity can be distinguished from shareholder activity. There is a direct benefit to the associated enterprise and the centre would look to cover costs and take some measure of reward.
10. Stewardship activities can cause some concerns in that they are not services that are readily reconcilable to third part service providers. Stewardship activity typically involves commercial management of the group as a whole or possibly specific business lines. The corporate nature of the services leads to difficulty in deciding whether or not the activity is not only for the benefit of the group or in fact is directly beneficial to specific associated enterprises.
11. The essential distinguishing feature, including how to correctly categorise a stewardship activity, between shareholder activity and other intra service provision is that the former does not provide a benefit to group associated enterprises and not a service an associated enterprise would be prepared to pay for (the benefit/ payment tests) and as such should not be charged out to those associated enterprises.

Q5 To clarify the issue of Shareholder activity is the SUB-GROUP prepared to provide commentary to highlight the link between shareholder activity and benefit provided as follows?

" Several shareholder activities are self evident and recognised as inappropriate in charging costs out to associated enterprises. For example activities related to the juridical structure of the parent company itself, such as meeting of shareholders of the parent issuing shares in the parent company and costs of the supervisory board; costs relating to reporting requirements of the parent company including the consolidation of reports, costs of raising funds for the acquisition of its participations. (Would the SUB-GROUP like to invite Business to expand on this list?)

A fundamental test to be applied in considering whether or not an activity may fall within shareholder activity, involving an associated enterprise, is whether or not the activity provides a benefit to that associated enterprise."

4. Cost base and Cost Plus

12. These sub headings are part of a wider set of considerations to determine an arm's length charge for a standard service.
13. The OECD guidelines advise " once it has been determined that an intra group service has been rendered, it is necessary, as for other types of intra-group transfer, to determine

whether the amount of the charge, if any, is in accordance with the arm's length principle."

14. In most cases, a service provider needs to make a clear and direct profit and the mark-up represents this profit. However conversely, in exceptional cases, situations can occur where at arm's length no mark-up would have been applied. For instance, the costs already included a profit element for the provider such as by way of an indirect return on investment for the parent by enhancing its global market position (and lead to possible economy of scales) or with regard to the overall value of its trademark. In these cases it would not be appropriate to have to include a mark-up between affiliates.

Q6 Does the sub group wish to address and elucidate when it would be appropriate to charge out costs only or costs and a margin or is it content to rely on existing OECD guidance at 7.29 -7.37.

15. The predominant tendency in practical application of the OECD methodologies is, in the first instance, to seek a CUP. It is however well documented that there are practical difficulties in ascertaining a CUP that complies with the five comparability factors described in OECD.
16. That general difficulty is compounded when in attempting to reconcile the intra group charge with the arm's length, the provision of an intra group service is not subject to a direct charge regime. Under a direct charge regime the associated enterprise is charged for specific services costs and benefits which are readily identifiable. The direct charge approach assists the application of the CUP methodology and as such is the preferred method of charge.
17. Often, however, MNEs are not readily able to apply a direct charge method either because the benefit of a provided service is not dedicated to just one associated enterprise or direct costs can not be established because they are embedded costs that cannot be disaggregated.
18. In this type of situation an indirect charging method may be deployed to establish the charge (costs and margin) to be applied to each associated enterprise that benefits from the service. This method relies heavily on the appropriateness of the allocation keys used. Routine application of such allocation keys as turnover, head count or time sheets, in the absence of clear evidence they are the most appropriate keys, is to be guarded against.

Q7 Does the SUB-GROUP wish to record they consider that, wherever possible, a CUP methodology should be used to establish the arm's length charge for a standard service? Further more MNEs should apply a direct charge approach and only in exceptional circumstances apply an indirect charging mechanism.

19. In practice and in the absence of a CUP, the cost plus is the most widely accepted methodology used in replicating an arm's length charge for intra-group services. Essentially this method establishes a cost base and applies a margin of mark up on those costs.
20. It is often said by taxpayers that the actual level of any mark-up on costs is of less concern to them than having the costs themselves in the appropriate entity for transfer

pricing purposes. Mathematically it is easy to see that this is true – once a service fee of 100 is in the correct entity, it is of lesser importance whether the fee with mark-up is 105 or 110. And yet taxpayers have often to spend considerable resources on calculating and justifying the amount of a mark-up.

21. Given this scenario one approach is to create an extensive but non exhaustive list of direct and indirect costs. Such a list could build on direct cost to include materials, labour, expenses and indirect costs: factory rent rates, supervision costs, depreciation, heating and lighting. Alternatively, using a best practice approach, a statement could be made to emphasise that a comprehensive cost base is a crucial element in the application of the cost plus methodology therefore the presence of a robust cost accounting system is essential.

Q8 Does the SUB-GROUP wish to provide a non exhaustive list of direct and indirect costs that would generally be reflected in make up of a comprehensive cost base or does it prefer to give more general guidance?

22. However, it would be remiss, in giving guidance on the concept of standard services, if a clear view on acceptable mark-ups is not also developed.
23. The issue of what "plus" to be applied to an agreed cost base is normally resolved by the application of the CUP methodology.
24. But certain elements of what is commonly known as a "safe harbour" approach is an opportunity to give more certainty to Business and produce audit resource savings for Member States tax administrations. The existing OECD guidelines on safe harbours conclude "the use of safe harbours is not recommended".
25. However, current OECD thinking seems to have developed to the point that a safe harbour type approach does have a role to play if it does not violate the arm's length principle and in developing any safe harbour based rule the following considerations need to be in evidence:
- A sound application of the of the arm's length principle with the compliance and administrative burden created is consistent with the application of a risk assessment approach in transfer pricing ;
 - definition of the services covered by the safe harbour rule;
 - how the safe harbour rule will be implemented (e.g. will compliance with the safe harbour rule mean less risk for the taxpayer of being audited on its service transactions; and / or less documentation requirements; and / or no transfer pricing adjustment; etc);
 - what method will apply and how (e.g. definition of the cost and definition of the plus if a cost plus method is used);
 - details of how the approximation of the “arm's length” range used in the safe harbour rule is determined and is to be updated.

- the arm's length principle relies on an analysis of the facts and circumstances of each specific case. It therefore follows that taxpayers that do not want to subscribe to a safe harbour rule remain free to demonstrate that a service charge that may be outside of a particular safe harbour range is nevertheless arm's length.

26. To help define the safe harbour rule JTPF members should be invited to send information in order to conduct an appropriate study to evidence the range by comparables and the agreed range should be updated on a regular basis (e.g. every 3 years).
27. As an indicator of what currently might be the outcome of the application of a standard service definition linked to some sort of safe harbour mark up rule is that a standard service would attract, variously, a mark-up of between 3%- 10% to arm's length charge.

Q9. Is the development of some sort of safe harbour rule something that the SUB-GROUP wishes to progress? Would the sub-group suggest avoiding the use of the words "safe harbour"? What words do you consider as appropriate to better express the concept developed in the previous paragraphs?

28. Issues around CUP and cost plus methodologies have been examined in arriving at an arm's length charge in standard services. Is there a case to be made for deploying the other pricing methods or would the suitability of the application of other methods e.g. profit split of itself indicate that a service is not standard?

Q10 Does the SUB-GROUP wish to make any comment on the application of other methodologies in relation to standard services?

Documentation and Evidence

29. Once an agreed approach to standard services has been developed and subsequently applied by the taxpayer the need to call for documentation or other evidence would be greatly reduced. A result of classifying a service as standard should mean that the tax administration does not need to audit this particular aspect of the taxpayer's affairs: the tax administration could still audit whether the services charged qualify for the safe harbour rule and whether the safe harbour rule was correctly applied (e.g. whether the cost base and allocation keys are correct). On the other hand, for service charges that qualify for the safe harbour rule, there would be no need to discuss whether the transfer pricing method is the right method (to the extent the method applied is consistent with the one in the safe harbour rule) and there would be no need to make a search for comparables (to the extent the profit element applied is consistent with the one in the safe harbour rule). Of course, a tax administration would not give up any of its usual rights under such a system. But a significant amount of compliance effort will have been saved for both parties.
30. The taxpayer does though have a responsibility to be able to demonstrate, when services are provided, that arm's length principles have been complied with, either in accordance with any safe harbour rule, or under wider transfer pricing rules.
31. However, the need for documentation should take into account any risk assessment approach and be balanced by the compliance costs and administrative burdens, especially, when documents are solely prepared for compliance with tax provisions.

32. Evidence would need to establish that a service had in fact been carried out and that the price of the service was recorded at arm's length for tax purposes. But the evidence necessary to do this should be set and construed in the light of the low risk and routine nature of the service.
33. The SUB-GROUP will be aware that by resolution of the Council, on the 27 June 2006, adopted a code of conduct on transfer pricing documentation. That resolution may provide some guidance of the standard of evidence required and supporting documentation needed to support the proposition that a standard service has been supplied.
34. The code does not specifically mention services but does set down certain principles on which SUB-GROUP may wish to draw. Inter alia those principles are:
- A risk assessment approach to documentation i.e. Breadth and depth of documentation commensurate with complexity of transaction and potential tax at risk.
 - It is optional to keep documentation in format described
 - The extent of documentation required differs between MNE and SMEs
 - Compliance cost and administrative burden to be guarded against
 - No likelihood of penalty if good faith record kept
35. Documentation needs to address the following fundamental topics.
- References to any relevant EUTPD filings.
 - A narrative to give some overall context of the nature of the service provided from the perspective of the provider and the benefit of the service from the perspective of the recipient.
 - Description of all intra group service transactions with the associated enterprise concerned to include details of the service provider, the anticipated benefit and price. This description to be based on a functional analysis at an appropriate level of detail.
 - Copy of all formal and informal agreements relating to the service provided. If no documentation a description of what each of the parties understands is to be provided at what cost.
 - Details of any evidence that is relied on in setting an arm's length charge including: OECD methodology applied; the composition of any cost base; if allocation keys are used a description of on what they are based and why they are considered appropriate; evidence or documentation that is relied on in setting any mark up on costs; evidence of the billing arrangements
 - alternatively if service provided but no cost charge out or costs charged out with out mark up the reasons for that
 - if a safe harbour rule applied a reconciliation of the service to the requirements of that rule

- Description of and reasons for any amendment to prior tax treatment of intra group services.

Q11 Does the SUB-GROUP wish to recommend a prescriptive list of documentation required or alternatively give some guidance and non exhaustive examples?