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## **EU JOINT TRANSFER PRICING FORUM**

### **BUSINESS CONTRIBUTION ON COST ALLOCATIONS**

**Meeting of 27-28<sup>th</sup> November 2008**

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## **1. Structure of this paper**

This paper is drafted in various sections:

### ***Section 2: Background***

This section explains the background to this paper, including:

- The issues raised by business members and the objective of this paper
- The proposed framework for attribution of costs related to intragroup central services rendered
- The correlation with previous work performed by business members and/or member states on this topic.

### ***Section 3: Key principles***

This section describes the three main principles both from the member states perspective as from the business perspective that underpin the work performed with regards to the attribution of costs relating to the services rendered within an MNE.

### ***Section 4: Proposed procedure to charge for intragroup central services***

This section describes the procedure to charge for intragroup services rendered. It indicates at a high level what steps are required to come to a full attribution of costs related to services rendered. This section houses the majority on the work performed to date. The more technical detailed work performed will be part of these steps.

- For example the work performed regarding the definition of shareholder services will be applicable in step 4b-i *Identification and attribution of shareholder costs*. This paper provides a high level definition and how, once identified, shareholder costs are attributed.
- Also the work performed on defining standard services can be seen as the more detailed technical work of step 4b – iii: *Identification and attribution of cost to be allocated to a group of entities using an allocation key*. This paper will not describe the definition of a standard or non-standard service, however if an allocation key is used to allocate costs resulting from services rendered, such a distinction could possibly be applied.

### ***Section 5: High level overview of the procedure***

This section provides an example to illustrate how the proposed procedure works in practice.

## **2. Background**

- 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, JTPF/022/BACK/2007/EN and (subject to comments) JTPF/18/2008 EN. These documents constitute the basis for the Sub-group work.
- The purpose of this paper is to document in more detail a proposal made in Malta by the business members of the sub group.
- At the meeting of the Sub-group on the 23rd of September, 2008 the business members of the subgroup made a proposal to the Sub-group for a practical solution to the attribution of the costs related to intragroup central services.

### **2.1. Introduction**

- An MNE is defined as a group of companies, which are tax resident in several different countries. Mainly, the objective of an MNE is to be economically active and to achieve profits for its shareholders.
- In order to achieve profits, both external transactions (transactions with suppliers, customers, financial institutes, etc.) as well as internal transactions (between the group members) are required.
- An MNE structure will typically involve centralised services functions, which provide a benefit to a number of group companies and in rendering these services an MNE incurs costs. Within an MNE these costs are to be attributed to the beneficiaries of the services rendered. An MNE makes a best effort to match the attribution of the costs incurred to the benefits received by the entities of an MNE.

If a particular country does not agree to the proposed attribution, a potential double taxation issue arises. This is the main concern raised by the business members.

### **2.2. Issues raised by business members - Potential double taxation**

- As indicated, in attributing costs related to services rendered, an MNE generally makes a best effort to attribute the costs to the beneficiary of the associated service rendered.
- To the extent the tax authority in a country disagrees with the benefit of a particular service rendered and therefore with the associated attribution of the costs, these costs will not be included in the annual tax return of that particular entity. Therefore these costs will not be treated as business costs for the purpose of calculating the taxable income.

- The MNE is left with no alternative than to re-attribute the costs (i.e. deem another beneficiary) either to another entity within the MNE or to bear the costs itself.
- It is unlikely that the country that gets the costs re-attributed will accept the attribution of these costs since it was the MNE itself that at a first instance indicated a different entity as the benefiting entity for the service rendered. The same applies if the costs remain at the service providing level.
- As a consequence it is likely that the costs get “trapped” between the country that has rejected the initial attribution and the country to which the costs are re-attributed.
- This leads to non-attribution of costs that should be treated as appropriate business costs. This will lead to double taxation.
- In practice the attribution of costs will include multiple entities in a large variety of countries. The issue described above will be compounded by the number countries involved, thus becoming a major issue.

### **2.3 Objective of this paper**

- The objective of this paper is to address issues raised by the business members and to provide a framework for discussion. The framework does not only address the issues raised by the business members but also address the previous work performed regarding the charging for costs relating to intragroup central services rendered (e.g. defining shareholder costs and definition of standard services).
- This paper will not cover a potential mark-up or safe harbour. Once a principle is established regarding the attribution of costs, the issue of a mark-up can be addressed separately. Charges including a potential mark-up are expected to follow the same procedure as described in this paper.

## **3. Key principles**

Three key principles underpin the proposal:

- A. An MNE is a commercial enterprise with the objective to realise a profit. As such a MNE will incur costs to carry on its business; including rendering intragroup central services<sup>1</sup>. It is not in the interest of the MNE to incur any costs that do not directly or indirectly provide a benefit to the MNE. It is a key principle that all costs incurred by a MNE are incurred for business or commercial purposes.

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<sup>1</sup> Services that are often performed at various levels of the organization, but also routinely and commonly performed at the head office level for the benefit of the entities within the MNE.”

- B. Following the first principle, these costs are incurred for the benefit of one, many or possibly all of the entities within the MNE and it is ultimately only a question of determining which specific entity should bear which costs and how these costs should be attributed
- C. If costs are attributed within an MNE (i.e. attributed to the entity where the benefit of the costs resides), it should be accepted that these costs are for the account of that particular entity. The fact that the costs are attributable to an entity should in no way affect the qualification of the local legislation on the general deductibility of the costs.

#### **4. Proposed procedure to charge for intragroup central services**

In determining how to appropriately charge for intragroup central services this Proposal recommends the use of the following steps:

- a) Identification of all costs related to intragroup central services rendered (total cost base);
- b) Identification and attribution of the total cost base to different pools of costs:
  - i. Identification and attribution of “Shareholder Costs”;
  - ii. Identification and attribution of “Costs directly attributable”;
  - iii. Identification and attribution of cost to be allocated to a group of entities using an allocation key.

These steps are discussed further below.

##### **a) Identification of all costs related to intragroup central services rendered**

This step involves the identification of all costs incurred in relation to intragroup central services rendered.

An MNE does not incur costs unless these costs will provide benefits. The benefit will be either at the shareholder level (benefit due to the participation) or at the local entity/operating company level (commercial benefit).

This proposal includes cost related to activities that are typically performed at a central (head) office such as (but not limited to):

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>• Compliance activities</li> <li>• Finance activities<br/>(treasury, tax, finance&amp;controlling)</li> <li>• Human Resources</li> <li>• Information technology activities</li> <li>• Legal services</li> </ul> | <ul style="list-style-type: none"> <li>• Strategy and Business Development Services</li> <li>• Contracting and Procurement</li> <li>• Investor relations</li> <li>• Insurance department</li> <li>• Marketing/ Public Relations/Corporate Communications</li> </ul> |
|--|---|

- Engineering
- Technical Services
- Corporate affairs
- Internal Audit
- Accounting
- IP management
- Global Property Services
- Quality Services
- Corporate Security
- Company Secretary Services

As a result of this step the total amount of costs to be attributed is defined.

Total Costs = All Costs Incurred by an MNE
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### b) Identification and attribution to different pools of costs

Once all cost related to the intragroup central services rendered are identified the costs will be further analysed and divided into three pools of costs:

- i. Shareholder Costs,
- ii. Costs directly attributable, and
- iii. Cost to be allocated to a group of entities using an allocation key.

<u>Total Costs</u>
Shareholder Costs / Costs Directly Attributable / Costs to be Allocated

We outline below the identification and attribution of these separate pools of costs.

#### i.) Identification and attribution of Shareholder Costs

##### *Identification*

To help define whether an activity is a pure shareholder activity, the following questions should be considered:

*“Is the performed activity potentially of benefit to the operating unit(s) and would an independent company have been willing to pay for it or perform it themselves?”*

- If **yes**: the costs will be attributed to the benefiting operating company/(ies); or
- If **no**, this would likely constitute a shareholder activity.

Shareholder costs are, according to the OECD Guidelines, those costs incurred solely because of a Holding Company’s ownership interest in one or more other group members (i.e. in its capacity as shareholder). Shareholder Costs include but are not limited to costs of managerial and control activities related

<u>Total Costs</u>
Shareholder Costs
Costs Directly Attributable / Costs to be Allocated

to the management and the protection of the investment, compliance costs, portfolio management and new Business decisions, investment decisions, monitoring investments, reporting requirements of the parent company and other Holding Company Activities.

Further details on the different types of shareholder costs will be provided in Appendix A to this proposal<sup>2</sup> and includes a further refinement by way of discussing examples.

***Cost of a mixed nature***

In certain instances, the costs incurred relating to a service rendered can be of a mixed nature, i.e. the costs are partly attributable to the shareholder and partly attributable to other entities of the MNE.

In applying this procedure the shareholder costs related to that activity would be identified under step 1. The remainder of the costs related to that activity would be identified under the two following steps (Identification of Costs Directly Attributable and Identification of Costs to be allocated). Subsequently, the costs will be allocated as identified and outlined in this proposal.

***Attribution:***

Shareholder costs are to be attributed to the benefiting Shareholder.

**ii.) Identification and attribution of costs that are directly attributable**

***Identification***

Costs that can directly be attributed (also referred to as costs for specific services) are costs incurred in relation to services undertaken for the specific benefit of an entity.

Total Costs
Shareholder costs
Costs Directly Attributable
Costs to be allocated

***Examples:***

- An example is the request by an entity of the MNE for a specific piece of software on the local server. The price of the software is directly attributable to the service recipient (the requesting entity).
- A further example is the attribution of costs related to IP Registrations. An IP registration is handled centrally at the Head Office however the associated costs can be directly attributed to the entity for which the IP is registered.

***Attribution***

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<sup>2</sup> Appendix A will be provided at a later stage

- Costs that fall in this cost-pool are to be attributed directly to the beneficiary of the related services.

### **iii.) Identification and attribution of costs to be allocated to a group of entities**

#### ***Identification***

Costs to be allocated to a group of entities (also referred to as costs for general services) by default are all costs that do not fall in either of the previous cost categories, i.e. costs that are not identified as shareholder costs or costs that are not identified as costs that can be directly attributed to a specific beneficiary (i.e. there is a group of entities that benefit from the service).

Total Costs
Shareholder costs
Costs Directly Attributable
Costs to be allocated

In order to allocate these costs the first step is to identify the group of entities that benefit from these services. Once the beneficiaries are identified, the indirect costs will be allocated between these entities using an allocation key. As such the allocation key forms the basis for calculating and determining the volume of cost allocation per beneficiary. The allocation key selected represents the best estimate of the benefits received by the entities for the services rendered and associated costs.

In the allocation of costs related to services rendered a distinction could be made between standard and non-standard services rendered.

From the three identification and attribution steps, as described under b, all costs incurred related to the intragroup central services rendered are attributed between the entities of the MNE:

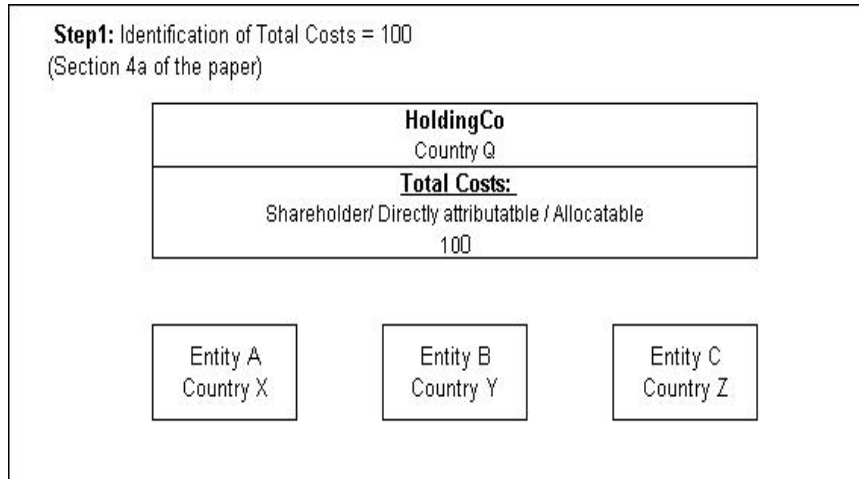
- Either to the shareholder as “Shareholder Costs”;
- To Specific Beneficiaries as “Cost directly attributable”; or
- Costs allocated between beneficiaries based on an allocation key.



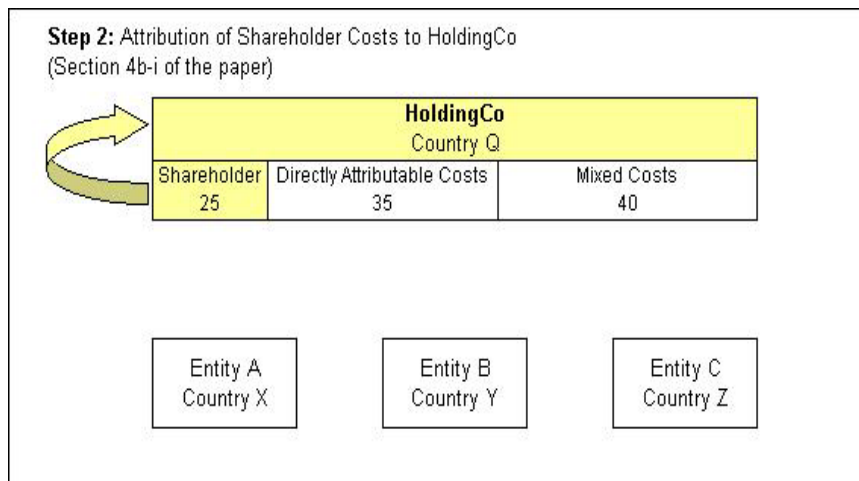
## 5. High Level Illustration of the procedure

HoldingCo Q renders intragroup Central services to Entity A, B and C. The allocation of the costs incurred related to the services rendered follows the proposed process:

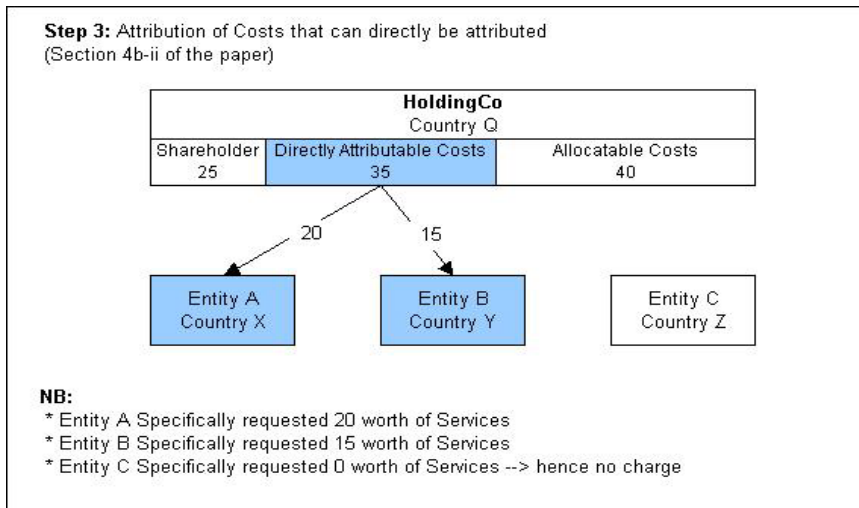
- Step 1: Identification of all costs related to services rendered [100]



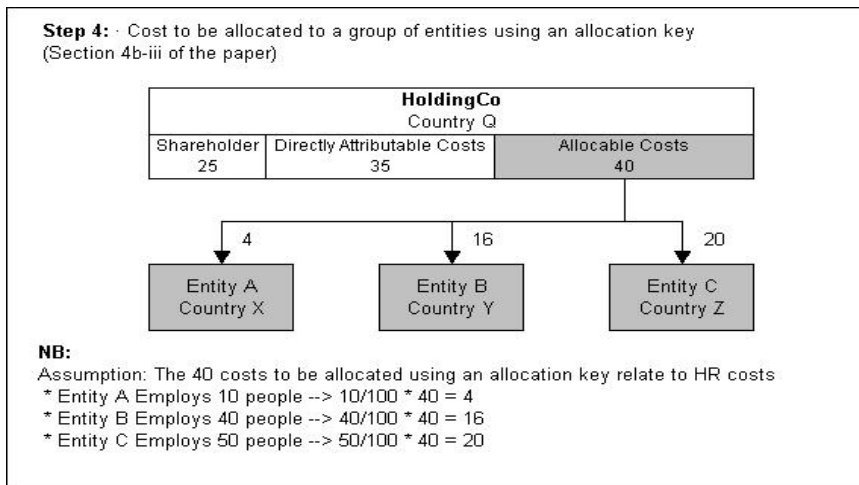
- Step 2: Identifying Shareholder costs [25]



➤ Step 3: Allocating Directly Chargeable costs



➤ Step 4: Allocating Indirect Chargeable Costs



The overview below illustrates that **all cost** associated with the central intra group services are attributed to an entity

<b><u>Total Cost Identified</u></b>	<b><u>100</u></b>		
<b><i>Costs Allocated to:</i></b>			
<b><u>HoldingCo</u></b>		<b><u>Entity B</u></b>	
Shareholder	25	Shareholder	0
Direct Charge	0	Direct Charge	15
Mixed Costs	0	Mixed Costs	16
<b>Total:</b>	<b>25</b>	<b>Total:</b>	<b>31</b>
<b><u>Entity A</u></b>		<b><u>Entity C</u></b>	
Shareholder	0	Shareholder	0
Direct Charge	20	Direct Charge	0
Mixed Costs	4	Mixed Costs	20
<b>Total:</b>	<b>24</b>	<b>Total:</b>	<b>20</b>
<b><u>Total Costs Allocated</u></b>	<b><u>100</u></b>		

Subsequently the attributed costs will be included in the tax returns. Whether or not the deduction will be allowed in a country is governed by local legislation.