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Via e-mail

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Discussion Draft on BEPS Action 10: Proposed Modifications to Chapter VII of the transfer pricing guidelines relating to low value-adding intra-group services

Comments by NERA Economic Consulting (Submitted 14 January 2015)

Dear Mr. Hickman,

In the context of the BEPS Action Plan, Working Party number 6 of the OECD has released on November 3, 2014, a discussion draft (the "Draft") of the proposed modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-Adding Intra-Group Services, issued under item 10 of the BEPS Action Plan. NERA wishes to thank you for the opportunity to provide comments on this document.

Introduction: Service charges and BEPS

Intra-group services of the kind that do not contribute significantly to fundamental risks of success and failure of a business ("low value-adding" services) tend to be some of the most scrutinized categories of intercompany transactions in some jurisdictions and are responsible for many instances of double taxation. Yet, based on our experience and on the fact that – due to their very nature – charges for these types of services tend to be close to the costs incurred to provide these services, we do not believe that intercompany transactions involving such low value-adding services constitute a significant opportunity for BEPS. As such, we support the OECD's position not to have developed specifically an action for service transactions under the BEPS Action Plan, even though certain member states or observing states were in favor of such an initiative. On the contrary, we believe that the current Transfer Pricing Guidelines ("TPG") and the arm's length principle are sufficient, if properly applied, to impede any such BEPS.

Conversely, we think that, as correctly pointed out in the Draft, one of the key issues revolving around low value-adding service transactions relate to the allocation of MNEs compliance efforts and tax administration audit resources, which today may be disproportionately dedicated to services, to the detriment of other transactions, structures or issues, such as intangibles, which (i) may show a far greater potential for BEPS, if inappropriately / wrongfully dealt with and / or (ii) which are genuinely complex and fact intensive.

Consequently, striking the right balance between a compliance burden and a fair and traceable enforcement of the arm's length principle seems to us to be one of the key issues related to service transactions. Certain bodies, such as the European Union Joint Transfer Pricing Forum, or member states, such as the USA, for instance, have already implemented methods or developed arguments that head in this direction. We note that within the U.S. Services Regulations that were finalized in 2009, the Service Costs Method ("SCM") allows to allocate costs of certain services that meet certain criteria with no markup, although such method is not being contemplated by the OECD in the current Draft.

Yet, some issues may be left unaddressed, while other new questions may arise from the new Draft language. Those are highlighted in the detailed comments we have on the particular sections of the Draft attached to this letter.

But, above all, there is a number of areas, that, we think, are associated with intercompany services charges, and which we discuss below.

Interaction with "high-value-adding" transactions and value chain analysis

We believe that a number of concerns of the member states or observers related to intra-group services, in fact, arise from an improper association of services with high-value-adding transactions. We believe that high-value-adding transactions, insofar as they provide businesses unique or valuable competitive advantages, should be addressed in Chapter VI instead.

Consequently, we believe that it would be worthwhile to mention that the value chain analysis and the functional analysis are the foundation for any transfer pricing analysis, as only these analyses allow to differentiate between high-value-adding transactions and medium / low value-adding services.

In light of this, the change from "*helpful*" to "*necessary*", with regard to the functional analysis, in §7.34 would be more than welcome. An additional reference to a value chain analysis could be added there as well.

Interaction between service charges and local costs of services

We also think that a revised Chapter VII should reflect the fact that intercompany services usually arise when the Group, as an integrated economic entity, has decided to incur some costs to obtain (or render) a service. In some circumstances, a bulk of these costs may be incurred in arm's length transactions (salaries, costs of services by external providers). In those situations, the cost of intercompany service may often be close to arm's length prices. In our opinion, this fact should be considered by tax authorities in the course of tax audits.

Tax auditors in recipient countries may challenge the appropriateness or the amount of costs charged to the local office by headquarters. Often these controversies arise in cases where headquarters providing services are located in one of high-cost countries and the recipient is located in a low cost country where, tax authorities may argue, identical services can be obtained at lower costs. Although, in certain instances, intra-group service charges may indeed be unrelated to the benefits received and/or have non-arm's length prices, we believe that more attention of tax administrations should be devoted to examining the decision making at the group level behind these service charges. The group as a whole decides to incur the cost of services, which typically, has a significant arm's length component (e.g., salaries), based on the cost-benefit considerations at the group level. Providing certain types of services on a centralized basis for the entire group may minimize the costs incurred by the group on the global scale and may increase efficiency of providing these services, as compared to performing these services locally or sourcing them from unrelated parties, and, therefore, service charges may be fully economically rational.

Based on our experience, we think that a major source of non-arm's length charges by MNEs acting in good faith in the context of indirect-charge systems relate to insufficiently precise allocation methods. Allocation methods that are based merely on financial keys and fail to reflect the level of resources available locally may, in fact, lead to the situations where local subsidiaries with significant resources to perform services for themselves pay more than their arm's length share for centralized services and hence subsidize the cost of services for other subsidiaries with limited resources.

Consequently, we believe that Chapter VII, and in, particular, section 7.2.2.2. on Indirect Charge methods could be more explicit in warning taxpayers from the consequences of the issue described above. It could mention best practices, such as:

- Examination of whether a charge is consistent with the functional profile of the company and is considered in the context of other transactions (in this regard, the language of §7.29 "*The compensation for services rendered to an associated enterprise may be included in the price for other transfers.*" is absolutely the key; perhaps it could be worthwhile to put more emphasis on it)

- The level of resources available locally: if not appropriately taken into account, group companies with significant local resources to perform services for themselves may end up economically subsidizing group companies with lesser local resources.

From this perspective, thoughtful, appropriately engineered systems of indirect cost charges must be established. Such systems may, for instance, incorporate adjustments to the allocation keys reflecting the level of local resources, so as to effectively allocate the costs incurred centrally to the subsidiaries according to the benefits received by them.

Conclusion: Achieving the potential of the simplified approach

Overall, we think that the draft prepared by Working Party N°6 is clearly headed in the right direction.

As mentioned previously, based on our experience and on the fact that – due to their very nature – charges for low value-adding services are very close to actual costs incurred, we do not think that service transactions indeed constitute a major opportunity for BEPS. The current TPG and the arm's length principle are sufficient, if properly used, to impede any such BEPS. The key issues for the low value-adding service transactions, in our opinion, relate to setting the right level of compliance requirements for taxpayers and allocating appropriate resources of tax administrations commensurate with the BEPS risk for these transactions compared to the BEPS risk of other types of transactions.

As such, the introduction of a "simplified approach", which is one of the major contributions of the Draft, is welcome, even though it raises a number of technical questions and it leaves some issues unaddressed, as discussed further in the appendix to this letter.

Yet, we do believe that the Draft will achieve its full potential only if the simplified approach is robust and accurate enough so as to be able to substitute the standard approach for most of the low value-adding services which are rendered at a number of MNEs by global or regional headquarters or by shared service centers. For an MNE, having to maintain simultaneously two different systems for intercompany service pricing, one under the simplified approach and the other under the standard framework would nullify the benefit of this initiative.

As such, from this perspective, we think it would be worthwhile to design the simplified approach so that MNEs would still benefit from the provisions of article §7.57 on regarding the "safe-harbor" profit mark-up when the services proved fall into the category of low value-adding services, even in cases when complex transactional structures prevent application of all of the conditions set out in article §7.45.

As mentioned, we think that the one of the furthest reaching elements of the simplified approach is in alleviating the documentation requirements and in transferring the burden of the proof from the taxpayers to the tax administrations. But as also mentioned, we do not think that the regulatory framework that currently applies to the low value-adding service transactions is significantly deficient. Hence we do not believe that the OECD may achieve much by improving this framework under Action 10. We think that tax administrations need to come to the conclusion that most MNEs do not use services to achieve base erosion and that all non-shareholder centralized costs are, by design, incurred for the benefit of the operating companies in the group.

Consequently, we think that reducing the number of incidences of double taxation with respect to intra-group services requires not only a change to the OECD transfer pricing guidelines, but moreover: (i) a genuine commitment of tax administrations to take a more "empathic" stance toward services, (ii) complementary guidance, potentially under Action 13 (documentation), and more importantly, under Action 14 (more effective dispute resolution). Indeed, we believe that improvements in the area of dispute resolution will be necessary in making MNEs and tax administrations converge on a globally accepted set of practices compliant with the arm's length principle.

Sincerely yours,

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Appendix - Detailed review of the language of theDraft

1. Treatment of transfer pricing costs and reassessments (§7.11)

The Draft introduces, in §7.11, a new language with regard to the treatment of tax compliance costs:

> *d) Costs relating to compliance of the parent company with the relevant tax laws [are an example of shareholder activity];*

This language as stated may be ambiguous and may have far-reaching consequences. Should one read this language as implying that transfer pricing costs, for instance, which arise because the parent is a parent (i.e. the company is not a stand-alone company but has to comply with transfer pricing regulations) should be borne by the parent company? Wording may need to be amended to clarify which costs should really be included in that category.

2. Definition of shareholder activities (§7.11)

The Draft introduces the following language:

> *e) Costs which are ancillary to the corporate governance of the MNE as a whole [are an example of shareholder activity];*

Yet, one definition of corporate governance which may be found and endorsed in the OECD public communications is the following: [1]

> *Procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.*

As such, corporate governance appears to be a very broad and vague term, which may be understood to include group-level strategic decision functions which go beyond the scope of what

[1] OECD Glossary of Statistical Terms, Original Source: European Central Bank, 2004, Annual Report: 2004, ECB, Frankfurt, Glossary

is usually understood by the shareholder activities. Consequently, we are concerned that such language introduces additional uncertainty for taxpayers.

3. Interaction between control & advisory services (§7.11)

There is usually a significant interaction between control and advisory services as, for certain services (e.g. internal audit), these two functions are much intertwined. The Draft does not provide additional guidance in this regard, and we believe this is the wisest approach to be taken there, as the application of the arm's length principle will directly derive from the careful considerations of the facts and circumstances. The reference to the arm's length principle in the following section of §7.11 below seems to be sufficient in this regard:

> *Whether the ["managerial and control (monitoring) activities related to the management and protection of the investment as such in participations] activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or to perform for itself.*

4. Applicability of the indirect-charge method (§7.27)

The Draft still includes the following language, in §7.27, from the previous version of Chapter VII:

> *When an indirect-charge method is used, the relationship between the charge and the services provided may be obscured and it may become difficult to evaluate the benefit provided. Indeed, it may mean that the enterprise being charged for a service itself has not related the charge to the service. Consequently, there is an increased risk of double taxation because it may be more difficult to determine a deduction for costs incurred on behalf of group members if compensation cannot be readily identified, or for the recipient of the service to establish a deduction for any amount paid if it is unable to demonstrate that services have been provided.*

Even though we think that technically, this language is not disputable, its inclusion in a revised version of Chapter VII might send the wrong signal to MNEs and tax administrations. As mentioned earlier, we do not believe that services and head office expenses, when appropriately handled and documented by taxpayers, are a source for BEPS. In order to avoid double taxation issues and to allocate resources of MNEs and tax administrations efficiently, OECD should promote indirect charge methods which, in practice, are often the only way to allocate the bulk of service charges. Consequently, we believe a right message would be sent out by taking out this language.

5. Methods: Cost Plus & TNMM (§7.33, §7.35 and §7.42)

The Draft makes reference to the Cost Plus method in a number of instances. Yet, in a number of practical situations, lack of the necessary data for both the independent and dependent transactions makes the Cost Plus method difficult to apply in practice, and, the Transactional Net Margin Method becomes the most appropriate method. Consequently, we think that references to the "Cost Plus method or TNMM" rather than the Cost Plus method alone can improve the Draft.

6. Agency costs and pass-through entities (§7.36)

The Draft preserves the language from the previous version of Chapter VII with regard to agency costs, in §7.36 in particular:

> *It is important in applying the cost-plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves*

We think that it is important in benchmarking the profit of related agents, commissionaires, pass-through entities, purchasing companies, etc. to ensure that the cost structure of the related entity to which the return benchmarked by a PLI is applied is similar to the cost structure of comparable independent parties from which the PLI is derived, and to ensure comparability, adjustments may have to be made.

7. Reference to Option Realistically Available (§7.43)

The draft makes reference, in paragraph §7.43, to the consideration of Option Realistically Available in the context of research arrangements. We believe such analysis should be indeed at the cornerstone of every transfer pricing analysis and think this reference is very much welcome and could be further generalized to all types of arrangements and transactions.

8. "Intra-company" transactions (§7.52)

The Draft seems to be adding some confusion in §7.52:

> *The cost pool should exclude costs that are attributable to an in-house activity that benefits solely the company performing the activity*

As a matter of fact, it is often the case that some departments within a headquarters company provide services to other group companies ("type A services"), while other departments provide services only to the departments within the headquarters, but not to other group companies ("type B services").

Under the arm's length principle, the appropriate cost base for type A services should include the share of type B services cost required to provide the service.

We would argue that this should be explicitly stated in the Draft.

9. Scope of the "simplified approach (§7.46, §7.47, §7.48)

It would neither be possible nor desirable to establish a comprehensive list of services which should or should not qualify for the approach. As such, we fully support the approach of the Draft to set defining principles for the scope, potentially complemented by - non-binding - examples which may be helpful to shed some light of the intent and purpose of the regulation.

Reference to the core business

As mentioned in the Draft, it is paramount that the simplified approach does not apply to the services that relate to the core business of the Group (which, by definition rely on unique and valuable intangibles and/or lead to the creation of unique and valuable intangibles, involve the assumption or control of substantial or significant risk and give rise to the creation of significant risk). However, the determination of whether a particular service is related to the core business of a Group may, by itself, be a delicate and complex question.

We believe it is worthwhile to make reference at this stage to the necessity of the Value Chain Analysis that should be used to determine which services may be considered core or non-core.

Concept of "Supportive nature" and low value-adding services

We believe the guidance should be made clearer with regard to what should be understood as "supportive nature". For instance let's consider a global headquarters providing financial services for its operating subsidiaries that go beyond the compilation of data and information gathering, which are listed as examples of low value-adding service. Should such services qualify for the application of the simplified approach? Equally, other services that are excluded from the list of services of a "supportive nature" may very well include services that are indeed of a low value-adding nature. Value chain analysis should enable to identify these services.

We believe that the scope of the simplified approach should make reference to the fact that low value-adding services, for the purpose of section D of the revised Chapter VII be indeed… low value-adding.

In order to meet the objectives of reducing the compliance burden on taxpayers, the simplified approach should be designed so as to be applicable to the full range of headquarter services for a maximum of MNEs. As such, for a MNE, having to maintain simultaneously two different systems, one under the simplified approach and one under the standard framework of Section A and B would be burdensome and would nullify the benefit of the initiative. We believe that the aim of the guidance should be to have the standard approach restricted only to (i) services provided by group companies other than headquarters / Shared Service Centers or to (ii) integrated groups where low and high value-adding services or other transactions may be intertwined.

List of excluded and likely included services

As such we think that:

- The list of likely included services should make a broader reference to financial support services and global marketing services.

- The language in the list of likely included services might be edits as follows:

    - *Training and employee development: <u>to the extent that no high-value know-how is attached to such training</u>*

    - *Information technology services where they are not part of the principal activity of the group, for example installing, maintaining, <u>exploiting</u> and updating IT systems.*

10. Identification of recipients (§7.51)

The Draft provides the following language:

> *An MNE group electing to adopt this simplified method would apply […] in all countries in which it operates. This simplified method is premised on the proposition that all low value-adding service costs incurred in supporting the business of the MNE group members should be allocated to those members.*

We believe that this language may be confusing as the premise that all MNE group members benefit from the centralized services may not always be true.

We think that the Draft should provide that the simplified approach would only be applicable in case the above premise is acceptable, conversely the MNE would have to segment its group companies in baskets where the premise would be acceptable.

However, in any case, sections §7.57 on profit mark-up, and §7.60 and §7.61 on benefit test and documentation should be applicable for Low Value-Adding Services.

11. Profit mark-up (§7.57)

As an introductory comment, we want to stress the fact that, even though the mark-up is usually the most prominent aspect in a transfer pricing system for service transactions and will often draw the attention of tax auditors, the key issue with regard to services is the deductibility of the cost of services by themselves, while the discussion on the profit mark-up is secondary.

Yet, we think it is a great step forward to propose a safe-harbor for low value-added services, and more generally to design solutions which may lower the compliance burden associated with "vanilla" comparable searches for low value-adding services.

We believe it should be explicit that the safe harbor profitability range in the Draft is expressed in terms of operating margin, computed according to IFRS (or US GAAP) and considering all direct and indirect costs, including depreciation & amortization, SG&A, etc. For instance, server costs should be included in the cost of IT services (please refer to section 7 above for additional details).

The range of 2 – 5% seems reasonable to us given the actual nature of services considered in the Draft. Yet, as we suggest to broaden the range of the profit margins considered to be within the safe harbor under the simplified approach to the range of 0 – 7% to make this markup consistent with the one prescribed for the SCM application in the U.S. regulations. We think that the profit element attached to services is of secondary importance compared with the question of the deductibility of the cost base.

A refinement with a range of profit markup differentiated by geography of the provider might be a reasonable option as well. We would like to stress the fact that databases from where financial data are drawn for the comparable searches have experienced huge progress in terms of detail and comprehensiveness since 1995, when the last version of Chapter VII was drafted. We believe that in the future, this trend will continue and will allow for a more accurate determination of what independent providers of low value-adding services might earn, by geography.

Yet, we think that the paragraph §7.57 should be applicable only to the extent that it is reasonable to expect that this profit level should allow to achieve a result reasonably close to the arm's length profit level, which would be determined under the standard approach. As such, in certain situations, such as pass-through entities, where the portion of internal costs is minimal, the application of a 2% mark-up on costs may result in widely inappropriate results.

The Draft should also provide for the fact that this section may be specifically updated in the future.

12. Burden of proof, documentation and reporting (§7.60, §7.61)

We think that one of the furthest reaching elements of the simplified approach is the provision of the simplified requirements for documentation and consequently, alleviating the compliance burden for taxpayers acting in good faith, which is much welcome.

Yet, we think the language in §7.60 could be even clearer, if changed from

> *The documentation and reporting discussed in section D.3 below should provide sufficient evidence that the benefits test is met given the nature of low value-adding intra-group services*

To

> <u>*Except in case of frivolous application or blatant evidence that this approach does not provide arm's length results, it will be presumed by tax administrations that*</u> *the*

> *documentation and reporting discussed in section D.3 below* <u>*provide*</u> *sufficient evidence that the benefits test is met given the nature of low value-adding intra-group services*

Conversely, in §7.61, it may be useful to add that the expenses incurred by the service provider, if those were audited by a statutory auditor and confirmed to take place, have to be considered by tax administrations in the course of their audit.

Furthermore, we believe that it would be very useful to add that, even if, in the course of an audit, it appears that the "simplified approach" was in fact not applicable (for example, because the services provided were not low value-adding and/or the premises of article §7.45 were not satisfied), then – to the extent that the taxpayer acted in good faith, penalties will not be imposed.