NERA
ECONOMIC CONSULTING

Insights in Economics

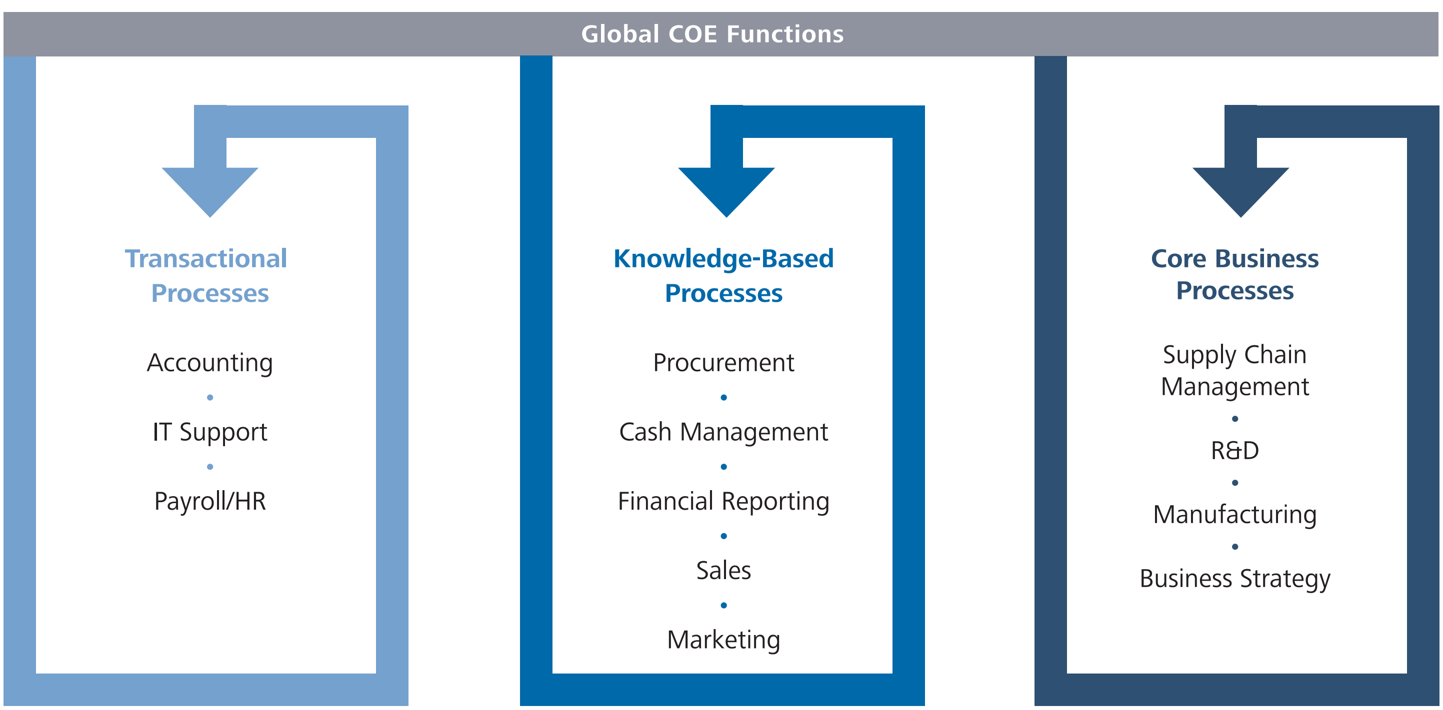
SEPTEMBER 2021

TRANSFER PRICING SOLUTIONS FOR **INTRAGROUP SHARED SERVICES**

Many multinational enterprises (MNEs) utilize centers of excellence (COEs) that are designed to expand the reach of critical expertise throughout the organization, without regard to geography or business unit. These COEs efficiently provide a broad range of low- to high-value intragroup services. The centralization of service providers helps them achieve economies of scale and cost savings when providing the same or similar services across a number of product lines or business units and geographies.

Such centralized structures may be particularly suitable for service firms and process-driven businesses. However, in practice, many businesses—ranging from extractive industries to consumer goods—have also implemented some form of a centralized organization. While the traditional shared service approach mainly focuses on transactional processes such as accounting or IT support, companies have moved toward a more integrated approach that includes complex, knowledge-based activities such as manufacturing and quality control, procurement, R&D, and the licensing of intangible property (IP). As shown in Figure 1, the COE can provide a "basket" of varied services, all of which offer potential for standardization and automation.

Figure 1. **COE Functions**



As the COE concept has proliferated among multinationals, the pricing of these intragroup services has come under increasing scrutiny by taxing authorities. In April 2019, the IRS Large Business & International (LB&I) Division added captive service providers to its list of compliance campaigns. The IRS may hold the view that excessive payments for services provided by a foreign captive COE subsidiary would inappropriately shift US taxable income to these foreign entities (many in lower tax jurisdictions) and erode the US tax base. Several non-US tax authorities have legislated an outright disallowance of intercompany management service fee deductions, irrespective of the relative size of these payments, even though comparable uncontrolled business models—franchising, licensing patents combined with technical services, and other independent business services providers—do exist and are used by many multinational enterprises.

Characterizing the nature of the relationship between the service provider and recipient—their functions, assets, and risk profiles; their roles and responsibilities; and ultimately, their contribution to joint value creation—forms the basis for an economically sound and defensible transfer pricing (TP) method. But it is equally important to value the realistic alternatives to the captive arrangements and attribute value to the originator of the COE structure and the entities that ensure the COE's financial success (including the multinational's headquarters and the service recipient entities).

NERA Economic Consulting's transfer pricing economists have examined complex services models and developed a suite of market-based pricing techniques and a range of approaches to help clients establish services structures and resolve tax disputes regarding the arm's length pricing for bundled intragroup services. These multiple corroborative methods are briefly discussed below and are followed by a stylized case study illustrating the application of the various methods.

Corroborative Methods and Analyses

Alternatives implicit in selecting whether to bundle compensation for a given service together with a related transaction involving tangible product or IP, as described in Treas. Reg. §1.482–9(m)(1), provide for a variety of inherently subjective outcomes relying primarily on how best method rule principles are applied. No single method is perfect. By applying multiple corroborative methods, each of which reflects a different way of analyzing the underlying economics of value creation, a transfer pricing result can be built and contrasted with a market result. The following are examples of methods and models typically employed to analyze and evaluate intragroup services.[1]

Services Cost Method (SCM)[2]

The SCM evaluates whether the amount charged for services in a controlled transaction is arm's length by reference to the total service costs with no markup. The SCM cannot be applied in certain categories of services; it can only be used for services that the taxpayer concludes, in its business judgment, do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, recipient, or both. For certain low-margin covered services, if the median of the comparables is a net cost plus markup of 7% or less, taxpayers can charge these services at cost.

Comparable Uncontrolled Transaction Method (CUT)[3]

The CUT method evaluates whether the amount charged in a controlled transaction is at arm's length with reference to the amount charged in a similar uncontrolled transaction. The reliability of the CUT method depends on the quality of the comparable transactions. The CUT method generally requires that the controlled transactions be compared with uncontrolled transactions for the same type of product or IP, in the same industry or market, and with similar profit potential.

Comparable Profits Method (CPM)[4]

The CPM evaluates whether the amount charged in a controlled transaction is at arm's length based on objective measures of profitability derived from uncontrolled taxpayers who engage in similar business activities under similar circumstances. Comparability depends on the relevant lines of business, the product or the service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets, and working capital), the size and scope of operations, and the stage in a business or product cycle.

Residual Profit Split Method (RPSM)[5]

The RPSM allocates the combined operating profit earned by affiliated parties engaged in a cross-border transaction through a two-step process, first by allocating the functional operating profit by the most appropriate of the methods specified above, and second by allocating the residual profit in proportion to each party's relative contributions of nonroutine IP. It may be a particularly well-suited solution to the valuation problems associated with intangibles and services bundled together.

Income Method[6]

Income-based valuation approaches determine the present value of projected future cash flows attributable to the bundled intangibles, which can be expressed and implemented as a royalty rate for the use of these intangibles.

In addition, there are many statistical techniques that can be used effectively to split the value of services and IP in conjunction with the traditional TP methods.

To illustrate the application of corroborative methods to price intragroup bundled services, we created a stylized case study based on several real TP controversy cases with which NERA has assisted. These cases have occurred in a varied set of industries including automotive components, beverages, business office services, and financial instruments trading.

Stylized Case Study

The case study is based on several NERA projects for US and European multinational clients. As illustrated in Figure 2, a large multinational diversified business services company develops and delivers services to third parties under a global-hub-and-local-entity operating model (the Group). The multinational comprises three related party groups: the COE, local operating entities, and the parent company.

COE Entity

The COE provides a bundle of routine and non-routine services to the parent company headquarters and legal owner of intangible property (the HQ). The COE contributes to the development of the Group's marketing and technology intangible property (Group intangibles or IP)[7] under a contractual services arrangement with the HQ. Under this arrangement, the COE develops valuable IP by virtue of its centralized position and its ability to leverage the scope and scale of the Group's strategic resources. Finally, the COE performs routine management functions such as IT deployment, HR, legal, and financial analysis that the local operating entities require, pay for, and use to conduct their day-to-day operations.

Local Operating Entities

As licensees of the Group intangibles, the local operating entities have access to and benefit from the Group intangibles. The local operating entities also contribute to the development of intangibles suited to local needs through local marketing and product development, sales and business development, communication, and strategy functions. Together with the IP licensed from HQ, such elements contribute to the success of the local operational entities.

HQ Entity

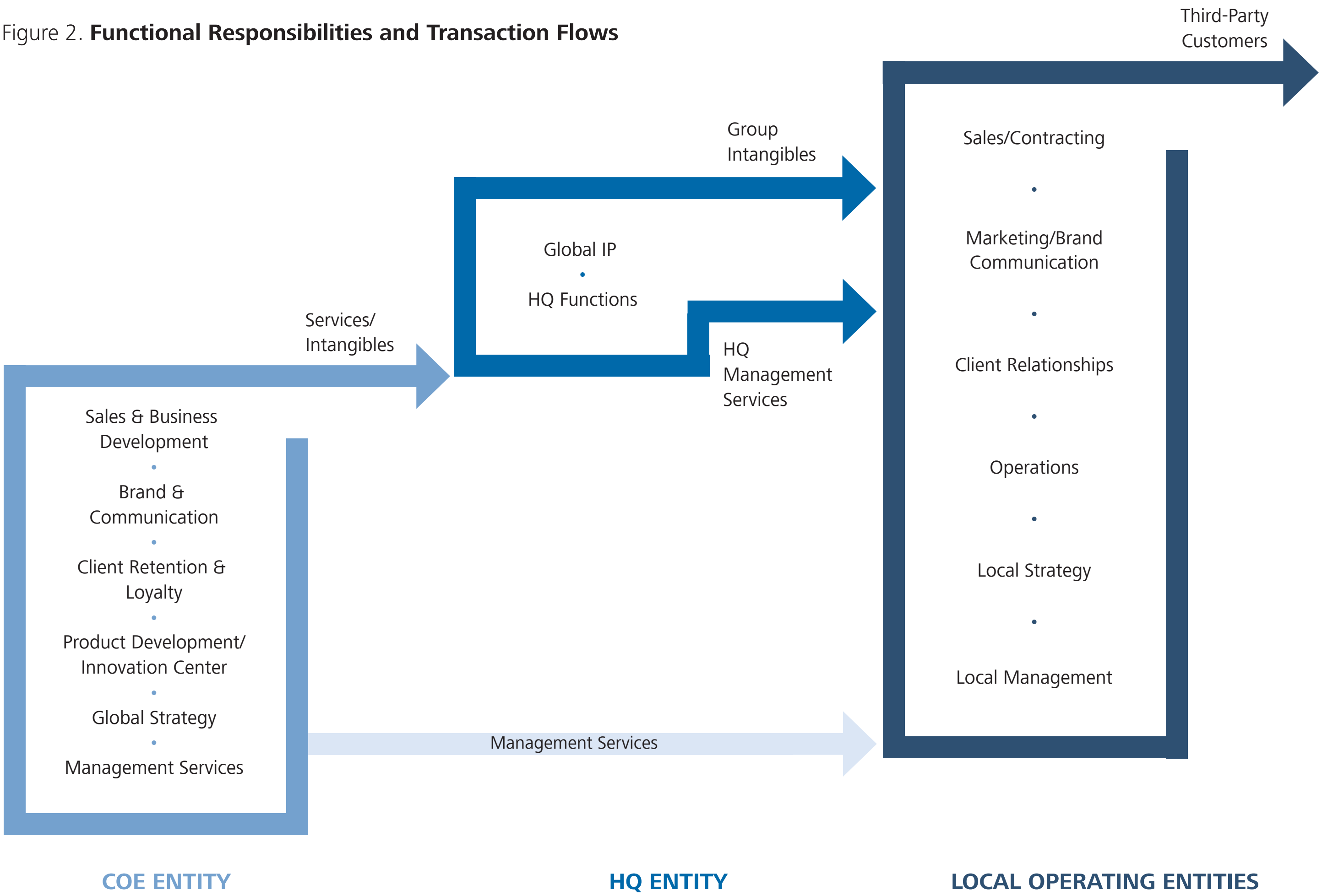
The HQ acts as a franchisor, providing the local operating entities with a bundle of HQ services, strategic services, and IP. Examples of these HQ services can be global marketing and sales, annual plans and pricing guidelines, centralized procurement and pricing discounts, and consolidated accounting and IT support. The HQ also licenses the Group's IP, such as trademarks and proprietary process know-how to the local operating entities. The HQ incurs costs associated with its shareholder activities that cannot be charged as they do not provide an allocable benefit.

In this stylized case, we focus on three intercompany transactions that, if established to be accurately described or delineated in substance and form, require arm's length pricing determinations using a variety of transfer pricing methods:

- Royalty payments (or franchise fees) made by the local operating entities to the HQ;
- Management service fees charged by COE to local operating entities; and
- HQ's payment to COE for developing the IP.

Applying multiple methods to analyze these transactions and the challenges and considerations encountered in arriving at an arm's length pricing conclusion are discussed below.

Figure 2. **Functional Responsibilities and Transaction Flows**



Application of Corroborative Transfer Pricing Methods

Royalty Payments (or Franchise Fees) Paid by the Local Operating Entities to HQ

Application of the CUT method to determine royalties based on licensing agreements or franchise arrangements is appropriate as long as the required comparability criteria are satisfied. Any differences between the IP developed by the Group and potentially comparable IP licensed between third parties can create ambiguity in whether the application of the CUT alone will provide a reliable arm's length result. Third-party licenses often have marked differences in contracting terms with respect to exclusivity and duration of license, stage of intangibles' development, uniqueness of the property, risks incurred, and the associated services provided. Unless the CUTs are internal CUTs between the tested parties and uncontrolled parties covering identical IP, adjustments to account for these differences can be imprecise. However, CUTs can still provide a reference point with respect to compensation rates for similar IP.

As a corroborative method, the Income Method can be used to value the IP and estimate royalty rates to test the reasonableness of the third-party CUTS. Applying this method typically requires quantifying cash flows attributable to all categories of non-IP assets provided by the HQ to the local operating entities and identifying appropriate discount rates to reflect the riskiness of various components of the bundled intangibles.

The non-IP assets include plant, machinery, and even human capital used by the HQ and the COE to provide strategic services.

As a corroborative approach to applying the franchise business CUTs, the CPM is often used to test whether the operating margin earned by the local operating entities accurately reflects the level of their value contribution to the Group's success. Applying the CPM in this context assumes that the controlled franchisee does not have any intangibles of its own and that it does not have access to any other valuable IP or services. Whether the franchisor captures the entire residual profit or only a portion of it ultimately depends on the relative bargaining power of the parties and the terms of contracts into which they enter.

If technology CUTs and franchisee CUTs are unavailable or unreliable, a profit-split-based solution can be used to determine the license fee for the Group's IP. A properly structured profit split method enables the determination of the arm's length compensation to each related party based on a split of profits, in line with their respective functions, risks and assets, and contributions to value created. In addition to capitalized cost-based profit split factors, other methods, including relative contributions to revenue or gross margin, can be used when costs are not reliable indicators of value created.[8]

The complementarity of the Group's IP and the HQ and strategic services and the identification of all parties that contribute to either the IP or the services, are important considerations in the selection of TP methods. In cases where there is a high degree of complementarity between the COE's services and its contribution to the joint development of Group IP, methods other than the RPSM (such as CUT and/or CPM) are more difficult to apply in determining the local operating entity's arm's length payment to HQ. The Group intangibles may have certain unique features and are characterized as key success factors for the Group's financial growth. The local operating entities may also contribute to the development, enhancement, maintenance, protection, and exploitation (DEMPE) functions of the Group IP. In such cases, the appropriate method would be one that splits profit between all three parties: HQ, COE, and the local operating entities.

In addition to the traditional transfer pricing methods described above, TP regulations in the US permit the use of "unspecified methods."[9] For instance, conjoint models can be used effectively to split total revenue between strategic services and tangible goods that are both present in a single sale to a customer. By unbundling the services component, it is possible to place a value on the standalone strategic services. Used mainly in patent infringement and damage assessment analytical work for consumer-facing multinationals, NERA economists have uniquely adapted and applied conjoint analysis techniques for transfer pricing disputes.

Management Service Fees Charged by COE to Local Operating Entities

Even the seemingly simpler of the three intercompany transactions in the case study can raise a number of interesting questions and may require an examination of multiple transfer pricing methods: (1) management service fees charged by the COE to the local operating entities, and (2) HQ's payment for the COE's IP development services.

Typically, the CPM would be applied to set an arm's length profit on the cost of providing routine services although certain services could also be eligible for SCM. In our case study, the COE performs several services on behalf of operating entities, including routine back-office services such as IT deployment, HR, legal, and financial analysis, and certain services that could be characterized as strategic, such as centralized procurement or analysis of customer preference data.

The accurate delineation of a COE's services into routine and strategic service components is often the source of contentious disputes between taxpayers and tax authorities. Characterization of the nature of services into routine and nonroutine services is a key part of pricing determination and needs to be based on a value chain analysis, including a detailed review of the functions, assets, and risks as well as related intangible-creating activities. In addition, any duplicate services, services that provide an indirect and remote benefit, and benefits resulting from passive association need to be identified and excluded. MNEs need to provide simple, lean descriptions of the nature of the services and the COE's organizational control over decision-making with respect to performance metrics and cost of services. The correct application of the CPM is hampered by these limited descriptions of controlled parties and the equally limited descriptions in public databases of comparable third-party service providers. Neither the OECD Guidelines nor US TP regulations provide any clear quantitative metrics to demarcate the nature of the services as strategic or routine. Naturally, whether arising in the context of an APA negotiation or audit disputes, the taxpayer and taxing authority have diverging views on characterizing the COE's services.

The corroborative method to a CPM is simply telling the essential business story—the commercial and economic substance in the Group's operating structure—using value chain analytical tools. As a basis for establishing facts and presenting the CPM and corroborative methods, NERA uses a value chain analysis to help separate and value routine and nonroutine services. The value chain analysis examines the realistic alternatives to the captive service provision arrangement and characterizes their substance, DEMPE functions, and relational dynamics between the parties.

An analysis of relational dynamics goes well beyond interpreting the terms of the intercompany agreement. In many cases, a MNE's intercompany agreements do not have all of the terms, conditions, and legal provisions as do agreements with third parties. Intercompany agreements between COEs and operating entities or HQ entities are simpler by design and intention and often omit the intercompany pricing terms.[10] Substance over form and conduct puts additional pressure on the use of COEs, especially in low-tax jurisdictions requiring multinationals to provide evidence of real risk-taking and control over the business's performance.

HQ's Payment to COE for Development of IP

As discussed, when there is a high degree of complementarity between the COE's services and its contribution to the joint development of Group IP, a CPM focusing on the provision of a service is unlikely to be the best method when the COE performs significant DEMPE functions. In this case, a profit split method structured to determine the split of profits derived from the use of Group IP between the HQ and the COE may be indicated to determine arm's length compensation for the COE's contributions to the development of Group IP.

Conclusion

Complex services models often include a centralized COE and typically provide a "bundle" of services that can be a mix of routine or low-value services and high-value-added and strategic services. In addition, the knowledge and services of management may be combined with the provision of certain intangibles, such as rights to use a trademark or documented processes and know-how.

Perhaps to state the obvious, to establish and successfully defend a centralized COE structure, companies need to have meaningful substance and conduct (i.e., a dedicated team of COE professionals who are responsible and accountable for providing a real and measurable benefit to the operating entities). The pricing of bundles of services and the provision of intangibles by the COE requires a detailed understanding of the business's value chain and the extent to which these services play an important role in it. Accurate delineation of risks and identification and quantification of operating entities' contribution to value creation are particularly important and need to be documented for potential disputes.

Applying multiple corroborative methods that take into account the unique nature of such services, facts and circumstances of the operating and business model of the multinational, and potentially comparable market-based evidence, are needed to establish and defend arm's length pricing for such bundled intragroup services and intangibles.

In addition, transfer pricing outcomes should be reviewed from the perspective of both parties to prevent a situation in which either party to the controlled transaction is left with an extreme profit result. Such a two-sided analysis should be performed to determine whether the arrangement makes economic sense to both parties.

Notes

1 Several of these transfer pricing methods are also recommended by the OECD's 2017 Transfer Pricing Guidelines and as such, would be applicable in a situation where the related party(ies) are registered and operate in OECD countries.

2 Treas. Reg. § 1.482–9(b).

3 Treas. Reg. § 1.482–4(c).

4 Treas. Reg. § 1.482–5.

5 Treas. Reg. § 1.482–6(c)(3)(i).

6 Treas. Reg. § 1.482–7(g)(4).

7 The Group intangibles may include trademarks, trade dress and trade names, other marketing intangibles, system tools/processes, documented and undocumented technical or operational know-how and IT software intangibles that can be transferred through a license.

8 The profit split principles could be applied to establish a mechanism for calculating variable royalty or franchise fees to compensate HQ commensurate with annual market-based remuneration, accounting for fluctuating valuations depending on the business cycle and other market circumstances.

9 Treas. Reg. § 1.482–4(d).

10 For example, written agreements between related parties will often not elaborate on the treatment of potential exposures and degree of market risks assumed.

NERA
ECONOMIC CONSULTING

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For more than six decades, we have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real-world industry experience to issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. Continuing our legacy as the first international economic consultancy, NERA serves clients from major cities across North America, Europe, and Asia Pacific.

NERA Transfer Pricing Experts

Dr. Niraja Srinivasan
Director
Washington, DC: +1 202 466 9290
niraja.srinivasan@nera.com

Nihan Mert-Beydilli
Associate Director
Los Angeles: +1 213 346 3035
nihan.mert.beydilli@nera.com