OECD releases new guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final 2015 reports under its Action Plan on Base Erosion and Profit Shifting (BEPS).

The report on Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation* (the Final Report), contains revisions to section D of Chapter I of the OECD Transfer Pricing Guidelines, guidance on commodity transactions, revisions to Chapter VI of the OECD Transfer Pricing Guidelines regarding intangibles, revisions to Chapter VII of the OECD Transfer Pricing Guidelines regarding low value-adding intra-group services, revisions to Chapter VIII of the OECD Transfer Pricing Guidelines regarding cost contribution arrangements, and scope of work for guidance on the transactional profit split method.

This Alert discusses the revisions to Chapter VII of the OECD Transfer Pricing Guidelines on intra-group services. The main focus of the revision is the new Section D containing additional guidance with respect to an elective, simplified transfer pricing approach for low value-adding intra-group services. In addition, the guidance introduces some changes and clarifications to other paragraphs of Chapter VII.1

The OECD describes the guidance as being intended to achieve a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payor countries.
Key features of the new guidance include:

- A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the Multinational Enterprise’s (MNE) core business, not requiring or creating valuable intangibles and not involving significant risks.
- A list of services that would typically meet the definition. The services listed generally are back-office services.
- An elective simplified approach to determine arm’s length charges for low value adding services, including:
  - A process for determining the costs associated with low value adding services
  - Ability to use general allocation keys
  - Simplified benefits test
  - Standard 5% mark-up
- Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach.
- The ability for tax administrations to include a threshold above which the simplified approach may be denied. Further work on the threshold will be performed as part of step two mentioned below.

Implementation will take place in two steps. As step one, a large group of countries have agreed to endorse the elective simplified mechanism by 2018.

The second step looks to ensure other countries that the elective simplified mechanism will not lead to base-eroding payments. It will entail further work in relation to a potential threshold above which the elective simplified mechanism will not apply and other implementation issues.

Finally, the revised guidance encourages tax administrations to limit to the profit element in charge any withholding taxes on low value adding services.

A previous discussion draft was issued in November 2014. The final guidance contains minor changes and clarifications.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final transfer pricing guidance under Actions 8-10 will be addressed in the webcast on 12 November at 10am EST.

Detailed discussion

Background
Chapter VII of the OECD Transfer Pricing Guidelines examines “issues that arise in determining whether services have been provided by one member of an MNE group to other members of that group and, if so, in establishing arm’s length pricing for those intra group services.” Broadly, the chapter then goes on to consider if a service has been provided and what, for tax purposes, the intra-group charge for such a service should be in accordance with the arm’s length principle.

As part of the OECD Action Plan on BEPS, Action 10 directed the OECD to develop transfer pricing rules to provide protection against common types of base eroding payments, such as management fees and head office expenses. This revision of Chapter VII is a part of the OECD work under Action 10 and has as a key feature an elective simplified approach for low value-adding services. As a first step, a large group of countries will endorse the simplified approach by 2018, and further work will be conducted to provide comfort to other countries that the new approach will not result in base-erosion payments. This work will include design of a threshold above which the simplified approach will not apply and other implementation issues of concern to those other countries.

Key areas of new guidance and changes to existing guidance

Standard definition of low value-adding intra-group services
As the simplified approach can only be applied for low value-adding services, the new Section D of the Proposed Revised Chapter VII begins by defining such category of intra-group services as “services performed by one member of an MNE group to other members of that group and, if so, in establishing arm’s length pricing for those intra group services.”

Broadly, the chapter then goes on to consider if a service has been provided and what, for tax purposes, the intra-group charge for such a service should be in accordance with the arm’s length principle.

- Are of a supportive nature
- Are not part of the core business of the MNE group
- Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles
• Do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk.

Examples of low value-adding services included in the guidance focus on typical back office activities including: human resources, accounting, accounts receivable and payable processing, information technology services (to the extent they are not part of the principal activities), monitoring and compilation of health and safety data, internal and external communications, tax related activities, legal services and general administrative services.

Similarly, examples of services that do not qualify focus on core activities of MNEs or those that involve significant intangibles or risks, such as research and development (R&D), manufacturing, sales and marketing, extraction, exploration and processing of natural resources, insurance and re-insurance and financial transactions. It also excludes the services of corporate senior management and purchasing and procurement relating to raw materials and other materials used in the production process. The last exception is an addition compared to the discussion draft issued in November 2014.³

An example illustrates clearly how an activity can be a low value-adding service for one MNE, but a core activity for another. In the example, performing a credit risk analysis is low value add for a distributor of shoes, but a core activity for an investment banking group performing such an analysis for counterparties involving financial derivatives.

**Simplified charge mechanism for low value-adding intra-group services**

The simplified approach for determining arm’s length charges for low value-adding intra-group services is elective for taxpayers, but should be applied as far as practical on a consistent basis either group-wide or on a regional or divisional subgroup. Where a country has not adopted the simplified approach, and as a consequence the MNE group complies with the local requirements in that jurisdiction, such compliance would not disqualify the MNE group from the application of the simplified approach to other countries.

The approach consists of the following steps:

• Application of the benefits test. While the service must provide a benefit, a key advantage of the simplified approach is that where the MNE group has followed the guidance of the simplified approach on documentation and reporting, this should provide sufficient evidence that the benefits test is met. Thus, the taxpayer need only demonstrate that assistance was provided rather than being required to specify individual acts undertaken that give rise to the costs charged. A single annual invoice describing a category of services should suffice to support the charge, and correspondence or other evidence of individual acts should not be required.

• Determination of cost pools:
  – Step 1: On an annual basis, calculate a pool of costs for each category of low value-adding services incurred by group members that conduct these services. The cost pool should include direct and indirect costs and where relevant overhead costs.
    i. The cost pool should separately identify pass-through costs as no markup will be applied for these costs.
    ii. The cost pool should exclude costs attributable to an in-house activity benefitting solely the company conducting the activity, including shareholder activities.
  – Step 2: Identify and remove from the cost pool costs relating to services performed solely on behalf of one other group company. These costs are set aside and basically treated as a separate cost pool to be allocated directly to the beneficiary of the service.

• Allocation of low value-adding service costs benefitting several group members using allocation keys:
  – Similar to the general guidance on services, the allocation keys should reflect the expected level of benefit.
An allocation key should be applied consistently across a type of service.

- Application of a 5% mark-up on all costs in the cost pool, with the exception of pass-through costs.

**Documentation that taxpayers should prepare and submit in order to qualify for the simplified approach**

An MNE group electing application of the simplified methodology would need to prepare the following information and documentation and make it available upon request to the tax authorities:

- A description of the categories of low value-adding intra-group services provided, the (expected) benefits of such services and the reasons substantiating that such services constitute low value-adding services; the rationale for the provision of services within the context of the MNE business; a description of the selected allocation keys and the reasons substantiating that such allocation keys result in outcomes that reasonably reflect the benefits received; and the profit mark-up used

- Written contracts or agreements for the provision of services and any modifications to those contracts and agreements

- Documentation and calculations presenting the determination of the cost pools and the application of the specified allocation keys. This should include a detailed listing of all categories and amounts of relevant costs, including costs for services provided solely to one group member

- Calculations showing the application of the specified allocation keys

Compared to the discussion draft issued in November 2014, the final guidance includes a specific statement that “It is essential, however, that reliable documentation is provided to the tax administration to verify that the costs have been incurred by the service provider.”

**Withholding Tax**

Another addition compared to the November 2014 discussion draft is the inclusion of guidance encouraging tax administrations to limit any withholding taxes on low value adding services to the profit element in the charge. While the application of this section will typically depend on the specific local legislation and potential tax treaty provisions, the comment has an important signaling function.

**Clarifications of the meaning of shareholder activities and duplicative costs**

In addition to the new guidance on low value-adding services, the new guidance also contains changes in the general sections on services. It provides additional examples regarding costs related to shareholder activities, including costs related to stock exchange listings of the parent company; financial reporting and audit costs carried out in the interest of the parent company or related to consolidated financial statements; costs related to investor relations such as communication strategy; costs related to compliance of the parent company with tax laws; and corporate governance costs.

Duplicative activities in general do not constitute an intra-group service. The revised guidance makes clear that any consideration of potential duplicative activities should analyze the nature of services in detail. As an example, the fact that a company performs marketing services in-house and also is charged for marketing services from a group company would not of itself determine duplication, since marketing is a broad term covering many levels of activity.

**Implications**

The revised Chapter VII of the OECD Transfer Pricing Guidelines contains important guidance with respect to an elective, simplified transfer pricing approach for low value-adding intra-group services. This simplified approach has both similarities and differences relative to the report on low-value-adding intra-group services issued by the EU Joint Transfer Pricing Forum and to existing regulations in certain countries.

Global businesses will want to evaluate the implications of the guidance for their intra-group service arrangements. The new guidance could provide them an opportunity to alleviate the administrative burden with respect to such services.
Webcasts on BEPS outcomes

EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10am EDT
- New Reporting under BEPS Action 13 - 20 October, 10am EDT
- Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
- Permanent Establishment Developments and BEPS Action 7 - 5 November, 10am EST
- Transfer Pricing and BEPS Actions 8-10 - 12 November, 10am EST
- Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10am EST
- Financial Payments and BEPS Actions 2 and 4 - 3 December, 10am EST
- Dispute Resolution and BEPS Action 14 - 10 December, 10am EST

For more information and to register for the webcast series, [click here](#).

Endnotes

1. Section D is the sole part of the guidance reflected in this chapter that should be considered part of the transfer pricing outcomes following from Actions 8-10 of the BEPS Action Plan as endorsed by all BEPS Associate Countries.


For additional information with respect to this Alert, please contact the following:

**Ernst & Young Belastingadviseurs LLP, Transfer Pricing, Rotterdam**
- Ronald van den Brekel  +31 88 4079016  Ronald.van.den.Brekel@nl.ey.com

**Ernst & Young (Australia), Transfer Pricing, Melbourne**
- Jean-Paul Donga  +61 3 9288 8065  Jean.Paul.Donga@au.ey.com

**Ernst & Young LLP, Transfer Pricing, Houston**
- Kelly Hales  +1 713 750 8141  Kelly.Hales@ey.com

**Ernst & Young Advisory Services (Pty) Ltd, Transfer Pricing, Johannesburg**
- Michel Verhoosel  +27 11 502 0392  Michel.Verhoosel@za.ey.com
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CMS860

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com