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**Intra-Group Services - DRAFT**

**Introduction**

1. This chapter considers the transfer prices for intra-group services. The chapter also considers the circumstances in which tax authorities may provide taxpayers with the option of using a safe harbour for low-margin administrative services or for minor expenses. If a taxpayer chooses to use a safe harbour option for intra-group services that meet the requirements of the safe harbour, the tax authority agrees to not make a transfer pricing adjustment for those services.
2. Under the arm's length principle, if a chargeable intra-group service has been provided to associated enterprises, arm's length transfer prices should be charged to group members receiving an economic benefit from the services. The test for determining whether chargeable intra-group services have been provided between associated enterprises is whether any associated enterprises have received an economic benefit from the services. Economic benefit exists if an independent entity in the same circumstances would be willing to pay for the services or perform the activity itself. This principle is called the benefit test and is considered in below.
- 3.

enterprise benefitting from the service is paying an arm's length price for the services. The tax authority of the service-

other services. Simplified transfer pricing approaches may be used for low margin services (see paras. 66–78) while a full transfer pricing analysis may be required for other services.

### The benefit test

9. The benefit test is used to determine whether a member of the MNE group has received a chargeable service from an associated enterprise. The benefit test has two requirements both of which must be satisfied. Firstly, the associated enterprise receiving the service must gain an economic benefit or anticipate gaining an economic benefit from the service. Secondly, the associated enterprise must demonstrate that an independent entity in the same or similar circumstances would have been prepared to pay for the services or perform the services itself.

10. [There are three methods of considering benefits: singular, dual and general. In a singular method, the test only analyses the benefit for one party, whereas the dual method considers the benefit for both parties. The general method considers the benefits for the whole MNE. Many developed countries have adopted a singular approach, focussing on the benefit for the recipient only. However, this approach can cause problems for services rendered by a MNE service centre, since it does not take into consideration the benefit for the whole of the MNE. Centralization of services may be more efficient and save costs for the MNE as a whole, but not necessarily provide a specific benefit for a specific recipient.]

11. An examination of the facts and circumstances will be required to determine whether the benefit test has been satisfied for a service. The level of detail covered by such a factual examination, and the amount and nature of documentation required to demonstrate satisfaction of the benefit test, should be based on the materiality of the service charges. The topic of appropriate documentation for intra-group service charges is discussed in paragraph 5.9(r) of the Commentary.

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14. Some intra-group services may involve a higher level of risk such as research and development services, which may fail to deliver the expected benefits. Intra-group research and development services comply with the arm's length principle if an independent party in the same or similar circumstances would have been expected to pay an independent party for the research and development services in the same or similar circumstances. It is important to note that enterprises engaging in research and development cannot always be expected to provide significant benefits due to uncertainty. Nevertheless, provided the recipient associated enterprise anticipates an economic benefit from the research and development, a service has been provided and the benefit test is satisfied. A separate issue is determining the appropriate remuneration for these services. If the risk of research and development is borne by the service recipient, a transfer price must be paid to the service provider irrespective of whether the anticipated benefits are realized. On the other hand, if the risk is borne by the service provider, then payments would only be warranted if the research and development is successful.

**Service activities for the specific requirements of an associated enterprise**

15. Associated enterprises may request the provision of specific intra-

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### **Non-chargeable services**

20. Certain intra-group service activities provide a benefit only to the parent company and therefore fail the benefit test for subsidiaries. Charges for these services must be borne exclusively by the parent company and cannot be allocated to associated enterprises. Nevertheless, it is emphasised that a determination of whether an intra-group service has been provided to a particular associated enterprise depends on an analysis of the facts and circumstances of each case. The following section deals with four situations in which the benefit test is failed for one or more associated enterprises.

#### *Shareholder activities*

21. Shareholder activities provide an economic benefit only to the parent company of an MNE group [or any shareholder holding shares in the parent company]. Accordingly the cost of shareholder activities must be borne exclusively by the parent company in an MNE group. Other associated enterprises cannot be charged for shareholder activities. Shareholder services performed by an associated enterprise on behalf of its parent company should be charged to the parent company on an arm's length basis.

22. Shareholder activities are activities that are carried out by or on behalf of a parent company [or any shareholder] and relate to the parent company's role as the ultimate shareholder of the MNE group. These activities may be carried out by the parent company or on its behalf. Shareholder activities include:

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*Passive association*

29. Benefits to members of an MNE group may arise that are incidental to an associated entity's membership of the MNE group; the incidental benefits are attributable to entity's passive association with the MNE group. The incidental benefits of association with an MNE group are not a chargeable service for members of the MNE group. For example, independent enterprises transacting with an enterprise that is a member of an MNE group may be willing to provide goods or services to it at prices that are below the prices charged to independent buyers. These discounts may be provided because the independent supplier hopes that it will be able to generate future sales to other group members if it provides favourable pricing and good service. Moreover, the associated enterprise may be viewed by the independent supplier as a low risk customer that is unlikely to default on any trade credit. It is emphasised that in this situation the independent enterprise has made an assumption on credit risk as it cannot take legal action against the parent company if the subsidiary defaults as the parent has not provided the enterprise with a formal guarantee. Under these circumstances, the associated enterprise's membership of the MNE group does not result in a chargeable service being provided to the associated enterprise by the MNE group. The key feature of this type of incidental benefit is that it is passive and cannot be attributed to an overt action taken by another member of the MNE group. In contrast, if a member of an MNE group provided a formal guarantee of an associated enterprise's trade credit, the formal guarantee may be a service a chargeable service provided that an independent entity would have been willing to pay for a formal guarantee in similar circumstances. Another example of a situation in which a chargeable service may occur is where an associated enterprise is able to get additional discounts from an independent supplier on condition that other MNE group members commit to additional purchases from that supplier.

30. The passive association of an associated enterprise with its MNE group may improve the associated enterprise's credit rating. An associated enterprise that is part of an MNE group may be able to receive a higher credit rating from lenders on the basis of its membership in the MNE group. If the associated enterprise were assessed on a stand-alone basis it would be expected to receive a lower credit rating from the lender. In this case, the associated enterprise has received an incidental benefit from being its passive membership in the MNE group. In this situation there is no chargeable service. This incidental benefit cannot be subject to a service charge from other group members. On the other hand, if the parent company provided a lender with a formal guarantee for a loan made to an associated enterprise, the parent would be actively seeking the advantage of a lower finance charge for the associated enterprise and the guarantee would accordingly qualify as a chargeable service for transfer pricing purposes requiring the payment of an arm's length guarantee fee.

31. There are other situations in which one associated enterprise may provide an intra-group service to another associated enterprise under circumstances where that service also gives rise to benefits being received by other members of the MNE group other than the primary beneficiary of the service. Whether follow-on benefits to other group members may support the payment of service fees by the incidental beneficiaries depends on the facts. The determination of whether a service fee should be paid by the incidental beneficiaries of the service depends on whether an independent party in the same circumstances would have been willing to pay for the intra-group service. In some cases, the incidental follow-on benefits that an associated enterprise receives may be remote and would fail the benefit test as an independent party would not be willing to pay for the service.

**Example 7**

Motorcycle manufacturing MNE X has an associated enterprise that serves as a distribution company in Country A, which is incurring losses. The Parent company's marketin

members but incidentally provide benefits to other group members. Examples could be analysing the question of whether to reorganize the group, to acquire new members, or to terminate a division. These activities could constitute intra group services to the particular group members involved, for example, those members who will make the acquisition or terminate one of their divisions, but they also may produce economic benefit for other group members not involved in the decision by increasing efficiencies, economies of scale or other synergies. The incidental benefits ordinarily would not cause th

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group is required to allocate the cost of the centralized promotion prospectively on the basis

sales income from sales of minerals to independent customers. Under this arrangement Crimson agrees to provide ancillary services to the staff of Violet Co on the use of the know-how. Assume that a functional analysis has been carried out by Crimson Co and appropriate comparables have been identified in setting the 3 per cent royalty fee. In addition, the comparables provide the same or similar ancillary services, the fees for which are embedded in the royalty fee. In this situation, Crimson has been fully remunerated for the provision of know-how and any ancillary services in the 3 per cent royalty fee. It would be inappropriate for the tax authority in Country A to claim that the royalty payment only applies to the licence arrangement and that Crimson Co is required to receive a further payment for the provision of ancillary services. The fees for the ancillary services are embedded in the transfer price of the know-how. Consequently, it would be inappropriate for any additional service charges for training to be imposed on the associated enterprise.

### **Calculating arm's length consideration**

43. For both direct and indirect charging methods, the transfer pricing methods in this

in uncontrolled transactions such as quantity discounts and contractual terms which may provide extended periods for payment of services rendered and associated guarantees.

46. If there are material differences between controlled and uncontrolled service transactions, reasonably accurate adjustments are required. If such adjustments cannot be made, the CUP method will be inapplicable as the comparables will be unreliable. While comparable service transactions between independent parties may take place, it is unlikely that the critical information on these transactions (such as the prices charged, functions performed, assets used and risk borne by the parties) will be available for comparison. This type of information on uncontrolled transactions is often confidential and unlikely to be publicly available.

#### **Example 10**

Grain Co and Shipper Co are associated enterprises. Grain Co is resident in Country A and produces wheat for export. Shipper Co is resident in Country B and carries on a business of providing grain shipping services. Shipper Co provides grain shipping services to four independent enterprises and approximately 60 per cent of its business is made up of performing shipping services to these independent customers and 40 per cent of its business is performing shipping services for Grain Co. In this situation it is likely that Shipper Co would be able to use the CUP method as it has internal comparables to use in setting its transfer prices for Grain Co. The reliability of the comparables depends on a comparability analysis. Assume that there is a high comparability in terms of the type of service provided, the volume of transactions, the contractual terms and the economic conditions. In this case, Shipper would be able to use the internal comparables in setting its transfer prices for shipping services provided to Grain Co.

#### **Example 11**

Assume the same facts as Example 7, except that 90 per cent of Shipper Co's business is providing shipping services for Grain Co. The remaining 10 per cent of its business is providing shipping services on an ad hoc basis to independent customers. Assume further that the independent customers only use Shipper Co in times of acute shortage of shipping capacity by other independent shipping enterprises. In these situations, shipping services may be more costly than when there is no shortage. In this situation, the comparability analysis is likely to lead to the conclusion that the comparables need to be adjusted for the significant differences between the controlled and uncontrolled transactions which would affect the shipping charges. The main differences on the facts are the volume of business (90 per cent of volume originates by Grain Co and 10 per cent by independent entities) and the regularity of providing grain transporting services that must be taken into account as they would be expected to have a material effect on the transportation charges. Moreover, Grain would be expected to benefit from a significant quantity discount. If reasonably accurate adjustments cannot be made to the uncontrolled transactions as material differences exist between the controlled and uncontrolled transactions, the CUP method will be unreliable and should not be used.

#### **Cost Plus Method**

47. In practice, it is often the case that the CUP method is inapplicable. In this situation, an MNE group may consider using the Cost Plus Method which is less dependent on similarity between the controlled and uncontrolled service transactions than the CUP. As stated at para.



6.2.15.1., the financial ratio considered under the Cost Plus Method is the gross profit mark-up. The aim of the Cost Plus Method is to set the appropriate cost plus mark-up on cost base so that the gross profit in a controlled services transaction is appropriate in light of the functions performed, risks assumed, assets used and market conditions. The Cost Plus Method focuses on the service provider as the tested party. The Cost Plus Method is used to determine arm's length service charges based on the gross profit mark-up on costs earned by comparable independent service providers. The Cost Plus Method is often used for determining transfer prices for services.

48. Although the Cost Plus Method is less dependent on similarity between the controlled and uncontrolled services under the CUP method, the services in controlled transactions and comparable uncontrolled transactions should be similar. If material differences arise between the controlled transactions and the comparables, adjustments are required provided they are reasonably accurate.

49. The cost base of service for controlled and uncontrolled transactions should be comparable. The application of the Cost Plus Method depends on ensuring that the cost base of the associated enterprise and the comparables is the same as there is the possibility of differences between the cost bases arising from the use of different indirect expenses in the cost base. A list of the types of direct and indirect costs are set out below at para. 54. The profit mark-up is the gross margin that an independent enterprise providing services in the same or similar circumstances to independent customers could expect to record. Differences between the cost bases can arise from the use of different indirect expenses in the cost and may make the Cost Plus Method unreliable.

50. It is likely that it will be difficult to find comparables for low-value administrative services as independent enterprises would be less likely to provide these types of services for large enterprises. While the appropriate mark-up for the Cost Plus Method should be based on available comparables from independent service providers, as a matter of simplicity it may be appropriate to use the safe-harbour option for administrative services considered below. The cost of finding appropriate comparables for the purposes of the cost plus method may be disproportionate to the tax liability at stake and thus the safe harbour provides a compromise that limits compliance costs and imposes an appropriate fixed mark-up. In addition, the task



comparable independent marketing enterprises has revealed they are making a net profit to costs of providing services of 3-8 per cent. Country A accepts the range of indicative comparables. The comparables are marketing enterprises which are listed on the stock exchange in Country A and provide similar marketing services to those provided by Service Provider. In this situation, Service Provider's net profit of 5 per cent is within the arm's length range of net profit to the cost of providing the services. The service provider is treated as making a net profit of \$5,000 from providing intra-group services to an associated enterprise.

### **Profit Split Method**

55. The Profit Split Method may be used for services (see 6.3.13.1-18. for more details on the Profit Split Method). The Profit Split Method is a two-sided analysis which applies to the profits of two or more associated enterprises engaging in controlled transactions. Moreover, the Profit Split Method is usually used when both sides to controlled transactions contribute significant intangible property. The aim of this method is to allocate profits on the basis that independent enterprises would have used in comparable independent transactions. Under the Profit Split Method the profit derived from controlled transactions is allocated between the associated enterprises. These profits au-fitoem( T)-1v.l4( T)-thld b03(i)-2(s)C(r)-1(a( us)-1(e)e8p2(n)2(s)71w

enterprise and to recharge the costs it incurs in doing so to group member. In this situation Subsidiary Company is operating as an agent. Subsidiary Company charges the service costs charged by Independent Company to group members on the basis of full time employee equivalents in the group. The charge is on a flow through basis of

61. Examples of allocation keys include:

- Sales;
- Gross or net profit;
- Units produced or sold;
- Number of employees or full time equivalents (FTEs);
- Salaries and wages;
- Number of information technology users;
- Office spaces or factor space; and
- Capital.

62. The following non-exhaustive list contains allocation keys that are commonly used by MNEs for certain types of services:<sup>3</sup>

- Information technology: number of personal computers;
- Business management software; number of licences;
- Human resources: number of employees;
- Health and safety: number of employees;
- Staff training: number of employees;
- Tax, Accounting: sales or size of balance sheet;
- Marketing services: sales to independent customers; and
- Vehicle fleet management: number of cars.

63. These allocation keys are provided as examples and other allocation keys may be acceptable. In addition, more complex allocation keys may accord with the arm's length principle. The main issue is that the allocation key is applied consistently within an MNE group for the same types of services.

#### **Example 15**

Manufacturing Co, Distributor Co and Personnel Co are associated enterprises in an MNE group. Manufacturing Co is the parent company and is resident in Country A. Distributor Co is resident in Country B. Manufacturing Co is in the business of manufacturing sporting goods. Distributor Co's only business activity is to distribute Manufacturing Co's goods in Country B. Personnel Co is resident in Country C and provides human resources services for the group. The centralization of services is designed to exploit efficiencies of scale and the relatively lower labour costs in Country C. Assume that Personnel Co's total cost of providing human resources services to Manufacturing Co and Distributor Co is \$454,545. Assume that a 10 per cent mark-up is arm's length. The cost base includes direct and indirect costs in accordance with the accounting standards used in Country C. Therefore, the total service charge for human resources services provided to Manufacturing Co and Distributor Co is \$500,000. Manufacturing Co has 1000 employees and Distributor Co has 50 employees. These are full time equivalent employees. This MNE group uses an allocation key for attributing the human resource service charge on the basis of number of employees. This allocation

<sup>3</sup> See EU Commission, 'Guidelines on low value adding intra-group services' (Brussels, 25.1.2011 COM(2011) 16 final), Annex I 'List of intra-group services commonly provided that may or may not be within the scope of this paper'. There is no indication that these services are low value added services.

key is chosen as it reflects the expected benefits of the associated enterprises from the provision of intra-group human resources services. The cost to be allocated per

**Low-margin services safe harbour**

66. Low-margin services are services which are not part of an MNE group's main business activities from which it derives its profits. They are low-margin services that support the associated enterprise's business operations. A determination of an associated enterprise's low-margin services would be based on a functional analysis of the enterprise. The functional analysis would provide evidence of the main business activities of an associated enterprise and the way in which it derives its profits.

67. This analysis may involve a consideration of:

72. A safe



- a restriction on the relative value of the service expense (e.g. less than 15 per cent of total expenses of the associated enterprise receiving the services);
- a fixed profit margin;
- the requirement that the same profit margin is used in the other country, and
- the documentation requirements that are expected.

74. An example of a safe harbour for services is set out below.

For inbound intra-group services:

- the total cost of the services provided is less than 15 per cent of the total deductions of the associated enterprises in a jurisdiction for a tax year;
- the transfer price is a fixed profit mark-up on total costs of the services (direct and indirect expenses);
- documentation is prepared to establish that the safe harbour requirements have been satisfied.

75. For outbound intra-group services:

- the cost of providing the services is not more than 15 per cent of the taxable income of the associated enterprise providing the services;
- the transfer price charged is based on a fixed profit mark-up on the total costs of the services (direct and indirect expenses);
- the same profit margin is used in the other country, and
- documentation is created to establish that these safe harbour requirements have been satisfied.

#### **Example 17**

Assume that Subsidiary Co is resident in Country A and receives marketing services from its parent company, Parent Co which is resident in Country B. The total direct and indirect cost of providing the services is \$500,000. Subsidiary Co decides to use the safe harbour option, as the costs of preparing a comprehensive transfer pricing analysis for such services and determining the arm's length margin would be excessive given that the services are low margin services. Subsidiary Co does not acquire other services from associated enterprises and its total deductible expenses are \$10 million. The total charge for services of \$537,500 is below the \$750,000 threshold and the expense is 5.37 per cent of its total deductible expenses and thus below the 15 per cent threshold.

Accordingly, the maximum transfer price Subsidiary Co can deduct for the services rendered by Parent Co under the safe harbour option is \$537,500. A transfer price up to this amount will be deductible by Subsidiary Co provided the documentation requirements are satisfied.

76. Safe harbours may have unintended consequences and should be carefully considered before they are implemented. If in the above example, a full transfer pricing analysis concluded that the arm's length cost plus margin is 5 per cent. In that case, the service charge would have been \$525,000. By using the safe harbour, Subsidiary Co has been able to claim \$537,500 as a deductible expense in Country A for intra-

hand, if the tax authorities in Country B are not aware of the safe harbour, they would require arm's length services income of \$525,000 to be reported, which is \$12,500 less than what was claimed as a deductible expense at the level of Country A. To avoid this result, it is material that safe harbour requirements consider this and the matching of income and costs is required.

## Appendix

The following list of potential intra-group services is based on the list of intra-group services set out in Annex I 'List of intra-group services commonly provided that may or may not be within the scope of this paper' of the EU Commission, 'Guidelines on low value adding intra-group services' (Brussels, 25.1.2011 COM(2011) 16 final)

- Information technology services:
  - building, development and management of the information system;
  - study, development, installation and periodic/extraordinary maintenance of software;
  - study, development, installation and periodic/extraordinary maintenance of hardware;
  - supply and transmission of data; and
  - back-up services.
  
- Human resource services:
  - legislative, contractual, administrative, social security and fiscal activities connected to the ordinary and extraordinary management of personnel;
  - selection and hiring of personnel;
  - assistance in defining career paths;
  - assistance in defining compensations and benefit schemes (including stock option plans);
  - definition of personnel evaluation processes;
  - training of personnel;
  - supply of staff for limited period;
  - coordination of the sharing of personnel on a temporary or permanent basis; and management of redundancies.
  
- Marketing services:
  - study, development and coordination of the marketing activities;
  - study, development and coordination of the sale promotions;
  - study, development and coordination of the advertising campaigns;
  - market research;
  - development and management of Internet websites;
  - publication of magazines handed out to clients of the subsidiary (even if concerning the whole group).
  
- Legal services:
  - assistance in the drafting and reviewing of contracts and agreements;
  - ongoing legal consultation;
  - drafting and commissioning legal and tax opinions;
  - assistance in the fulfilment of legislative obligations;
  - assistance in the judicial litigation;
  - centralized management of relationship with insurance companies and brokers;

- tax advice;
- transfer pricing studies; and
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- purchasing services and sourcing raw materials;
- cost reduction management;
- packaging services.

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