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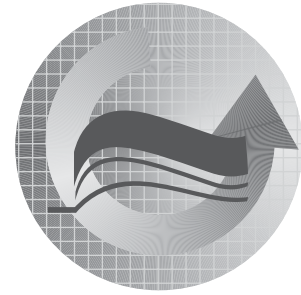
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Action Plan 8-10 Aligning Transfer Pricing Outcomes with Value Creation – Focus on Low Value – Adding Intra-Group Services

Taxation is at the core of countries' sovereignty and fiscal policy, but the interaction of domestic tax rules in some cases leads to gaps and frictions. When designing their domestic tax rules, sovereign states may not sufficiently take into account the effect of other countries' rules. Transfer pricing rules are used by the countries to attribute fair share of revenue of multinational enterprises (MNEs), in the respective jurisdictions. However, the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD¹, 2013), has clearly identified that these existing rules, may not always plug the loopholes for such fair attribution. The Action 8-10 of the BEPS Actions Plan aims to provide guidance to align these rules, such that each jurisdiction taxes on an arm's length basis (i.e. a fair basis) the value created by various entities in an MNE group.

Intra-group services have in reality emanated from the strategic imperatives of MNEs to operate globally in a seamless manner, but is sometimes perceived by tax authorities as a tax planning tool used by MNEs for effectively lowering taxable income in a particular tax jurisdiction. The tax authorities look at this transaction as a profit shifting technique and scrutinise the inter-company affairs strictly to determine if any profits are shifted from a high tax country to a low tax country.

OECD BEPS project on value creation
OECD has issued Actions 8-10 of the BEPS Action Plan in order to address the issue of misalignment between the outcomes of allocation of profits and the economic activity that produced such profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that the transfer pricing outcomes are aligned with value creation, as existing international standards for transfer pricing can be misapplied and may result in allocation of profits not in sync with the economic activity of the enterprise in the MNE group.

Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations. In order to address this, the Actions 8-10 provide that risks contractually assumed by a party that cannot in fact exercise meaningful

1. Organisation for Economic Cooperation & Development

and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. The guidance ensures that pricing methods will allocate profits to the most important activities, the aim being to allocate benefits to the ones contributing to such benefits.

Summary

- a. The guidance ensures that:
 - o Actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
 - o Contractual allocations of risk are respected only when they are supported by actual decision-making, and ability of the enterprise to control and bear the risk;
 - o Capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to 'cash boxes' i.e. cash rich entities without relevant substance;
 - o Tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.
- b. The guidance helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.

Contractual Arrangement vs. Conduct of Enterprises

The revised guidance ensures that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, not on contractual terms, including contractual assumption of risk, that are not in practice performed.

The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct. In combination with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction.

The guidance thus, provides a basis for any transfer pricing analysis, as also, it addresses some of the key BEPS challenges: allocating risks on paper does not in itself shift profits. Further, the need for transparency requirements coupled with the alignment of attribution of value and the creation of value will provide a holistic approach to tackling BEPS behaviour.

Basic concept of intra-group services

Intra-group services play an important part in the allocation of costs across the jurisdictions. An intra-group service is a service performed by one member of a multinational group for the benefit of one or more related members of the same group. The OECD Transfer Pricing Guidelines state that generally every MNE provides a range of services to its affiliates in order to benefit

from economies of scale or to avoid duplication of services, or both. Typically, these intra-group services are technical, financial, administrative and commercial in nature. However, they may also include management, co-ordination and control functions within the group. Intra-group services typically strategically allow the MNE group to operate globally in a seamless fashion.

There can also be group-servicing centres, such as a shared service centres or a centralised management, central auditing, or financing advice that provide these services across the group. In a transfer pricing context, such intra-group services become significant when they are rendered to related parties located in different tax jurisdictions.

The transfer pricing methodology of such MNE groups needs to be analysed so as to be consistent with international standards regarding the allocation of income and costs among related parties.

There is no specific mention of intra-group services (though there is for cost sharing arrangements) in Indian transfer pricing provisions [i.e. sections 92 to 92F of the Income-tax Act, 1961 or Income-tax Rules, 1962]. The law is still evolving in India and therefore reliance is placed on, and useful inferences have been drawn from international tax practices followed in some other developed countries, along with the OECD Transfer Pricing Guidelines, 2010.

Intra-group service activities may vary considerably among MNE groups, as does the extent to which those activities provide a benefit, or expected benefit, to one or more group members. Each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the board of directors and senior management

of the parent company may make all important decisions concerning the affairs of its subsidiaries and the parent company may carry out all marketing, training and treasury functions.

OECD has identified two fundamental issues:

- a. Whether intra-group services have in fact been provided
- b. Whether any charge is required for the same? If yes, what?

Divergent practices are observed on this issue from country to country.

Low value-adding intra-group services

The OECD *vide* its edition of BEPS in 2015 has introduced a new section on intra-group services. Part D of this section provides specific guidance on 'low value-adding intra-group services'. The primary focus of this chapter is to arrive at an arm's length charge to be made within the MNE group with regards to low value-adding intra-group services. The intention of the OECD is to bridge the gap between the risk analysis conducted by the MNE group with respect to allocation of costs for intra-group services.

The purpose of introducing this new section is to:

- a. Simplify the classification of intra-group services which command a very limited profit mark-up on costs;
- b. Assist in allocation of such costs;
- c. Authenticate the same with robust documentation;
- d. Provide a simplified approach for determining arm's length price for such low value services, including a simplified benefits test.

OECD has addressed this issue as a number of countries have indicated that excessive charges

for intra-group management services and head office expenses constitute a challenge. Primarily, the countries considering the implementing the approach may do so in combination with the introduction of a threshold. Further, if the payments for low value-adding intra-group services exceed this threshold, then the tax administrations may perform a full transfer pricing analysis to identify the benefit test.

In an MNE group, it is not uncommon that one group entity may provide 'Non-integral services' to another group entity. These services are activities or services which are not the principal business activities of the group entity providing and receiving such services. The 'non-integral services' could be in the form of provision of administrative assistance such as developing accounting or business function manuals and guidelines, assistance in legal, taxation, regulatory compliances, etc. provided by one group entity to another group entity; such activities not being the principal business activity for both these entities.

These guidelines propose an elective, simplified approach which:

- o Specifies a wide category of common intra-group services which command a very limited profit mark-up on costs, as in essence these are low value-adding intra-group services;
- o Applies a consistent allocation key for all recipients for those intra-group services; and
- o Provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.

The approach aims to guarantee payer countries that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Moreover, the approach aims to guarantee that no overpricing takes

place due to general agreement on the categories of costs included in the cost base and general agreement on the moderate mark-up of 5% that should be charged. Finally, the transparency of the approach makes clear to payer countries whether intermediary companies, that may have no or low functionality and may aim to inflate the intra-group service charges, have been interposed.

Definition

Low value-adding intra-group services are:

- o Of a supportive nature
- o Not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group)
- o Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
- o Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

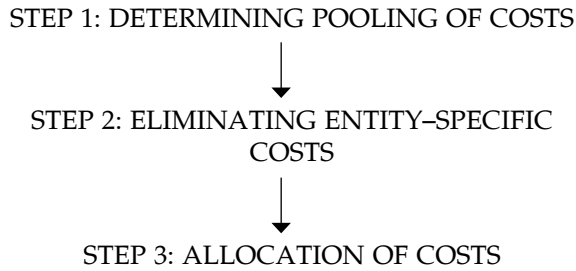
Following services are excluded from its ambit:

- o Services constituting the core business of the MNE group
- o Research and development services
- o Manufacturing, production, sales, marketing and distribution activities
- o Financial transactions
- o Services of corporate senior management

The above-mentioned services may not qualify as low value-adding intra-group services because in their specific context they create significant risk or unique and valuable intangibles.

The key elements or principles of the approach developed in this guidance are depicted below:

STEPS OF A SIMPLIFIED APPROACH



Benefits of a simplified approach

The simplified approach proposed by OECD is premised on the proposition that all low value-adding service costs incurred in supporting the business of MNE group members should be allocated to all the members. The revenue authorities prefer a benefit test for allocation of costs to the matching revenue w.r.t. to the services provided. The simplified approach may lead to reduction in compliance effort for determining arm’s length services. It shall also lead to increased certainty of the tax liability in the respective jurisdictions for the MNE group. Further, the certainty will help to reduce compliance risks to a greater extent. MNE groups may elect to adopt the simplified method at the level of a sub-holding company and apply it on a consistent basis across all subsidiaries of that sub-holding company.

Allocation of pool of costs

The direct and indirect operating costs for rendering the service, as well as wherever relevant, the appropriate part of the overheads (e.g. general and administrative costs, etc.) should be pooled according to category of services, on an annual basis, i.e. aggregating a pool of all costs incurred by all members of the group in performing each category of low value-adding intra-group services. However, while pooling the costs together, certain costs like pass-

through costs or in-house activity costs which are incurred solely for the entity and not for the MNE group as a whole, need to be excluded. All the costs incurred by various members of the MNE group are pooled together, so that a member of the group can eliminate those costs which are incurred only for the benefit of one of the members of the MNE group. Further, it can also be ensured that no costs are left out from the pooling of costs, before allocation.

The guidance under the simplified approach states that the taxpayer will select one or more allocation keys, depending on the nature of the service, to allocate costs among members of the group. The allocation of the costs in the cost pool should be such that it must benefit multiple members of the group. A consistent approach needs to be followed for identifying the allocation keys.

The simplified approach advocates that the same reasonable allocation key will be used from year to year, unless the facts and analysis justifies a change of such key. The aim being to simplify the determination of an arm’s length charge for such services year to year, as a change in the allocation key may lead to complexities.

The OECD has provided certain allocation keys for illustration purpose only:

| Type of services | Allocation Key |
|-----------------------------|--|
| Services related to people | Share of total group headcount |
| IT services | Share of total users |
| Fleet Management services | Share of total vehicles |
| Accounting support services | Share of total transactions / total assets |
| General cases | Share of total turnover |
| | |

The guidance provides that a mark-up equal to 5% of the relevant cost as a standard charge may be charged for all low value-adding intra-group

services. The simplified approach envisages a standard set of mark-up for all the low value adding intra-group services falling within the ambit of the definition of the category of services. Each of the group members shall levy/charge the same standard set of mark-up, leaving all the complexities of benchmarking out of the ambit of controversy and further analysis.

Concept of threshold

Another proposal by the OECD is adoption of a threshold limit in order to further analyse and scrutinise the intra-group services wherever the threshold is exceeded. The revenue authorities may arrive at a reasonable threshold, transactions below which may not be analysed in detail. A threshold may be set based on not absolute monetary value but on fixed financial ratios, i.e. percentage of intra-group services to total costs/turnover, etc. which can be a more scientific factor for adoption of simplified approach. The threshold probably provides a check on any erosion of tax base.

Documentation

Documentation is the key for demonstrating adherence to the arm’s length principle. Preparation and maintenance of the evidences for demonstrating that the intra-group services are primarily low value-adding would be the basis for adopting the simplified approach. The next stage would be to document the benefits derived from such service and quantify the same in terms of value.

The MNE group electing for application of this simplified methodology needs to prepare and maintain the following information and documentation within the group:

Low value-adding services:

- Description of the categories of low value-adding intra-group services provided to dovetail the same within the definition;

- Identity of the beneficiaries
- Commercial rationale for the provision of services
- Benefit test

Allocation Key

- Description and selection of an allocation key with the reasonable rationale
- Calculations showing the determination of the cost pool and mark-up
- Calculations showing the application of the specified allocation keys

Formal Agreements

- Written contracts or agreements for the provision of services and any modifications to those contracts and agreements reflecting the agreement of the various members of the group to be bound by the allocation rules of this section;
- Such written contracts or agreements could take the form of a contemporaneous document identifying the entities involved, the nature of the services, and the terms and conditions under which the services are provided.

Country-by-Country reporting

In order to give effect to Actions 8-10, under Action Plan 13², a three-tiered standardised approach to transfer pricing documentation has been recommended.

Tier 1 – Master File

The MNE group shall provide the tax administrations with high-level information regarding their global business operations and transfer pricing policies in a “master file”. It is the aim of the guidance that such data shall be available to all relevant tax administrations.

2. Transfer Pricing Documentation and Country-by-Country Reporting, 2015

Tier 2 – Local file

Further, a detailed transactional transfer pricing documentation shall be provided in a “local file” specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions.

Tier 3 – Aggregation of information

Further, large MNEs will need to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Taken together, these three documents (master file, local file and Country-by-Country Report) will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

Conclusion

This holistic approach to tackle BEPS behaviour of MNEs is supported by the transparency requirements agreed under Action 13. Transfer pricing analysis depends on access to relevant information. The access to transparent documentation provided by Action 13 will enable Actions 8-10 to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the Country-by-Country Report will enable better risk assessment practices by providing information about the global

allocation of the MNE groups’ revenues, profits, taxes, and economic activity.

The work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes are better aligned with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules are intended to be achieved without the need to develop special measures outside the arm’s length principle. Finally, the interaction with Action 14 on dispute resolution will ensure that the transfer pricing measures included in this guidance will not result in double taxation.

The implementation of the guidance is required to be made diligently so as to maintain the level of confidentiality and revelation of trade secrets, etc. and at the same time, also make suitable disclosures in law to avoid erosion of tax base.

In summary, the revisions respond to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorising the non-recognition of transactions which make no commercial sense. Though India is a part of G20 countries, how far this guidance shall be actually implemented and adopted; and whether it will assist India in protecting its share of taxes, only time will tell; and one also needs to factor in how other countries respond to this guidance.

In essence, transfer pricing needs to be viewed from an end-to-end perspective throughout the value-chain, to correctly attribute value and correspondingly attribute revenue and cost, to the various legal entities involved in the complete value-chain, to bring harmony in such attribution.

