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Berger, Robyn Stacey

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TRANSFER PRICING CONSIDERATIONS FOR INTRA-GROUP SERVICES

A study of specific challenges which have caused disputes between taxpayers and tax authorities from a transfer pricing and international tax perspective

Robyn Stacey Berger
(509485)

A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

March, 2015

Abstract

The purpose of this thesis is to analyse issues which multinational enterprises ('MNEs') encounter when dealing with intra-group services rendered from group service centres. This thesis is based on recommendations from the Organisation for Economic Co-operation and Development ('OECD'), case law and by showing differences in the treatment of intra-group services in certain countries relating to transfer pricing.

Countries have different rules, regulations and approaches towards dealing with these issues, which have caused problems for MNEs operating in different countries.

Although, some countries refer to the OECD's recommendations[1] in their legislation, it seems as if there is a dissonance between what is dealt with in legislation and what is done in practice. The reason for this is that some issues occur because tax authorities or taxpayers do not follow the OECD recommendations, even though their country's legal source recommends they should. It is therefore very challenging to know whether theory is applied in practice.

Out of numerous widely disputed issues between tax authorities and taxpayers, arm's length pricing for intra-group services is one of the most common issues and remains a global transfer pricing challenge for taxpayers and tax authorities alike. Consequently, there is no category of transaction that has caused more disagreements between taxpayers and tax authorities than services.[2]

Key Words: Anti-avoidance, Arm's length Method, Arm's Length Price, Comparable Uncontrolled Price, Controlled Transaction, Cost Plus Method, Functional Analysis, Intra-Group Services, Multinational, OECD Guidelines, Profit Split Method, Resale Minus Method, Tax, Tax Avoidance, Transactional Net Margin Method, Transfer Pricing, Uncontrolled Transaction.

[1] Organisation for Economic Co-operation and Development (OECD), 2010. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TP Guidelines). Paris: OECD
[2] Allen, S., Wright, D. & Tomar, R., 2006. United States - Sec. 482 Services Regulations: Implications for Multinationals. *International Transfer Pricing Journal,* November/December, Para. 3.3

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree of examination in any other university.

_____

Robyn Stacey Berger
March 2015

Dedication

To my family and friends

With sincere thanks

For their love and encouragement

During the writing of this research report

Glossary of Terms and Abbreviations

AE	Associated enterprises are enterprises under common control. This will generally be the case where the same persons participate directly or indirectly in the management, control or capital of both enterprises.
Allocation key	An allocation key is used to allocate costs of a service provider among other related entities for the purposes of computing the arm's length fee under the Cost Plus Method using an indirect charge approach. The allocation key may be a quantity such as turnover, employee numbers, working hours or floor space.
APA	Advance Pricing Arrangement, is an arrangement in respect of certain specified transactions that determines in advance the appropriate criteria for determining transfer pricing. The agreement may be made by the taxpayer unilaterally with the tax administration or may be a bilateral or multilateral agreement involving the tax administrations of other countries.
ALP	Arm's Length Principle, is an international standard that compares the transfer prices charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances.
Art.	Article
Benefit Test	In considering the arm's length return for intra-group services the benefit to the recipient of the services, if any, should be taken into consideration. If no benefit is received by the recipient of the services this would indicate that no remuneration should be paid for the services.
BEPS	Base Erosion and Profit Shifting
Best Method Rule	A rule requiring the taxpayer to use the transfer pricing method that results in the most reliable measure of the arm's length price in the circumstances. The rule does not give priority to the same transfer pricing methods in all circumstances.
CCA	Cost Contribution Arrangement is an arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement sets out the responsibilities and risks of the participants and the nature and extent of the interest of each participant in the assets, services or rights resulting from the arrangement.
Centralized Services	Services performed by a headquarters or group service company on behalf of a number of entities in the group. Typical centralized services include accounting, legal services, pensions, payroll or tax.
Comparable Uncontrolled Transaction	A transaction between independent enterprises that is similar to the controlled transaction and takes place in similar circumstances.
Connected Persons	In the context of transfer pricing, connected persons are associated enterprises to which transfer pricing laws and regulations may apply. Connected persons are defined in terms of the control of one person over the other or two persons under the control of another person.

Co-ordination Centre	An enterprise, the only purpose of which is to coordinate the activities of associated enterprises, to do research or to carry out support activities for those enterprises.
CP	Cost Plus Method, evaluates the arm's length nature of an inter-company charge for tangible property or services by reference to the gross profit mark-up on costs incurred by the supplier of the property or services. It compares the gross profit mark-up earned by the tested party with the gross profit mark-ups earned by comparable companies.
CPM	Comparable Profit Method
CSA	Cost Sharing Arrangement, is the term used to describe a cost contribution arrangement between enterprises to share the costs and risks of developing intangible assets. The arrangement would normally set out the contributions of the participants and define their share in the results of the assets resulting from the arrangement.
CSP	Cost of Services Plus Method
CUP	Comparable Uncontrolled Price Method. A transfer pricing method comparing the price of the property or services transferred in the controlled transaction with the price charged in comparable transactions in similar circumstances.
CUSP	Comparable Uncontrolled Service Price Method
Direct Charge Method	A method of directly charging each recipient of intra-group services on a clearly identified basis, not involving apportionment of costs between recipients based on an allocation key.
Ed.	Edition
e.g.	Example
Group Service Centre	A special department within a parent company or regional holding company, or any other associated enterprise within a multinational group such as a group services company, providing services to associated enterprises.
GSM	Gross Service Margin Method
Head Office Expenses	Expenses of the head office of a legal entity, some of which may relate to an overseas branch of the same legal entity.
Id.	Idem, which means *'the same'*
i.e.	Id Est, which means *'in other words'*
Indirect Charge Method	A method under which fees for intra-group services are computed on the basis of apportionment of costs using an allocation key, with an appropriate mark-up.
Intra-Group Services	Services carried out by one entity in a multinational group for another entity or entities in the same group.
MNE	Multinational Enterprise
OECD	The Organisation for Economic Co-Operation and Development
OECD Guidelines	OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

Para.	Paragraph
PLI	Profit Level Indicator, a measure of a company's profitability that is used to compare comparables with the tested party. A profit level indicator may express profitability in relation to sales, costs/expenses, or assets.
Profit Shifting	Allocation of income and expenses between related corporations or branches of the same legal entity in order to reduce the overall tax liability of the group or corporation.
PSM	Profit Split Method, seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.
Related Parties	Related parties are entities under common management, control or ownership, or where one entity controls the other entity.
RPM	Resale Price Method, analyses the price of a product that a related sales company charges to an unrelated customer, i.e. the resale price, to determine an arm's length gross margin that the sales company retains to cover its sales, general and administrative expenses and still make an appropriate profit. The remainder of the product's price is regarded as the arm's length price for the transactions between the sales company and a related party.
Safe Harbour	A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime.
SCM	Services Cost Method
Sec.	Section
Shareholder Services	Services performed by a member of a multinational group (usually the parent company or a holding company) in its capacity as a shareholder, for example preparation of consolidated accounts.
TP	Transfer Pricing. The general term for the pricing of cross-border, intra-group transactions in goods, intangibles or services.
Tested Party	The tested party is the party in relation to which a financial indicator (e.g. mark-up on cost, gross margin or net profit) is tested when using the Cost Plus Method, Resale Price Method or Transactional Net Margin Method.
TNMM	Transactional Net Margin Method, examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction. This is compared to the net profit margins earned in comparable uncontrolled transactions.

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1. Introduction

1.1. Background

A multinational group is a conglomerate of multiple enterprises ('entities') working in various geographic regions at different sizes and scale of operations. The group is regarded as a collective unit that functions by mutual co-operation and assistance, focusing on increasing its efficiency and capital. In its effort to improve synergies and its market position, it is common for the ultimate parent company to render a range of services for all its group entities on a centralized basis.

Generally, a variety of services is provided by the ultimate parent company or through another company of the group whose primary purpose is to render such services. This is done for a number of reasons, ranging from cheaper labour and capital being available in various jurisdictions, to improving the efficiency or productivity of a group as a whole by avoiding the duplication of resources for each entity on a stand-alone basis. These services are commonly referred to as intra-group services.[3]

The main feature of a service is its intangible character. The sale/purchase of goods/property can be easily identified. Conversely, due to the intangible character of services, it is very difficult to identify the services actually received/rendered. In the case of goods, one is not required to substantiate the occurrence of the transaction and only one question needs to be addressed: whether the sale/purchase of goods/property is at arm's length. In the case of the provision of services the question of whether the service transaction has actually occurred also needs to be addressed.[4]

Plausibly, tax authorities are concerned that this issue may be open to exploitation by companies that adopt an aggressive tax planning approach. Hence, while a taxpayer's policy regarding intra-group service fees might be looked upon with some measure of scepticism by tax authorities, such policies can also be a very important tax planning tool, especially if compensation for intra-group services within an MNE can be adequately justified with suitable documentation prepared to fulfil the legislative requirements of the respective tax jurisdictions.

Moreover, group companies of an MNE involved in an intra-group service transaction with each other must consider the tax implications of both sides of the transaction. This means that each group company in its respective tax jurisdiction is obliged to satisfy the local tax authorities that it is paying or receiving an arm's length service fee for the relevant intra-group services. Consequently, taxpayers are well advised to consider a thorough and comprehensive approach to identify and evaluate intra-group services, in order to adequately meet the expectations of the tax authorities in their respective jurisdictions.

[3] Chapter VII of the OECD TP Guidelines, 2010
[4] Mitra, R. K., Hans, A. & Jain, A., 2014. Intra-group services and shareholder activities. *Transfer Pricing International Journal,* August , 15(8), pp.2

The universally used global principle to regulate the appropriate transfer price is the *arm's length principle*.[5]

According to the arm's length principle, the price should be what two independent entities in their commercial or financial relations would have set in an open market under comparable transactions and circumstances.[6] The principle gives room for interpretation and MNEs should follow their local country's legislation to find the appropriate arm's length price however, different countries' legislation or lack of legislation is not always unanimous which creates grey zones for MNEs as countries have distinct approaches towards transfer pricing.[7] Even though MNEs may use the OECD and other regulatory bodies for supplementary guidance, this is not adequate, since these are not the laws of the country and therefore not reliable legal sources.

The fundamental hindrance with the OECD's recommendations is that there is no widespread legal compliance, since countries have the option to exclude or dismiss the proposed recommendations. There could be many other factors as to why countries have different interpretations: unclear recommendations from the OECD; subjective opinions from governments, tax authorities and courts; protectionism; language barriers; accounting standards; the differences in the legal value of the OECD recommendations; and probably other factors.

1.2. Purpose and approach

The purpose of this thesis is to analyse issues which MNE groups encounter when dealing with intra-group services rendered from a group service centre. This thesis is based on recommendations from the OECD, case law and by showing differences in the treatment of intra-group services in various countries, relating to transfer pricing.

1.3. Research method and design

The research method used in this thesis is primarily qualitative, comprising the analysis of various documentary sources of data. Relevant international case law, various countries' tax legislation, the OECD's recommendations, as well as the views of recognised legal and tax experts that have been published in technical journals and textbooks have been used to explain the grounds and fundamentals of service transactions.

The purpose of this thesis is to analyse the relevant legal frameworks and important guidelines which affect the practitioners work in establishing the transfer price for intra-group services. This thesis will touch upon international and transfer pricing practices followed in different jurisdictions and will not analyse the fundamental laws of each country's legislation. As there are different legislations included

[5] Chapter I – Para 1.6 of the OECD TP Guidelines, 2010
[6] Id
[7] Levey , M. M. & Wrappe, S. C., 2007. *Transfer Pricing: Rules, Compliance and Controversy*. 2 ed. Chicago: CCH, Para. 510

in this thesis the word legislation will therefore be referred to laws, regulations and codes of the countries which it concerns.

1.4. Delimitations

The research will only analyse cross border transactions and the problems occurring when two jurisdictions are involved and not transfer pricing within a country. The research does not cover the following aspects:

- No general information and facts regarding transfer pricing as a whole;
- No detail regarding the transfer of intangible property;
- No detail addressing except incidentally whether services have been provided in a cost contribution arrangement ('CCA') and if so appropriate arm's length pricing;
- Value Added Tax and indirect taxes;
- Double Tax Agreements; or
- Customs duty consequences.

1.5. Outline of thesis

This thesis consists of 8 chapters, where the first is this introductory chapter which introduces the background and significance of the research and the research method used.

The purpose of chapter 2 provides a basic understanding of what is meant by management fees and intra-group services. Furthermore, it provides typical categories of services that would be regarded as intra-group services.[8] Finally this chapter introduces the main issues which practitioners tend to find problematic in practice.

Chapter 3 illustrates how one would determine whether intra-group services have been rendered. The OECD identifies services as being beneficial or non-beneficial and whether an entity would be willing to pay for a service or perform the same service in-house.

Chapter 4 examines the criteria used to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means that the charge of intra-group services should be that which would have been made and accepted between independent entities in comparable circumstances. The purpose of this chapter is to give readers a brief understanding of the different methods used for allocating costs of services as well as an understanding of how to value

[8] Hamaekers, H., March/April 2001. Arm's Length - How Long? *International Transfer Pricing Journal,* Para. 13.1

remuneration for intra-group services. This is particularly a problem for taxpayers since countries seem to have different views on how to apply charging methods and different valuation methods.

The purpose of chapter 5 is to investigate how different countries approach the treatment of intra-group services from a transfer pricing perspective. The research will examine various OECD member countries and thereafter explore various developing countries' views.

Chapter 6 summarizes and analyses relevant parts of case law and comments and comparisons of the cases. The purpose of this research is to illustrate the problems taxpayers have when pricing services rendered from a central location in the group. The focus is not to illustrate the countries but merely the fact that countries have different approaches towards intra-group services and the OECD TP Guidelines.

Chapter 7 summarizes the recently published OECD Discussion Draft on the proposed modifications to Chapter VII of the OECD TP Guidelines. These proposed modifications have been developed in connection with Action Point 10 of the Action Plan on Base Erosion and Profit Shifting ('BEPS'). The proposed modifications seek to achieve a necessary balance between appropriate charges for low-value adding services and the need to protect the tax base of countries in which entities are established that pay service fees.[9]

Chapter 8 concludes on the findings of this research thesis and aligns the findings with the purpose of the research. It discusses recommendations as to what taxpayers should think about if they encounter such problems described in the purpose of this thesis and how further research may solve them.

[9] OECD, 2014/2015, *Discussion Draft of the Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services,* 3 November 2014 – 14 January 2015, Paris: OECD

2. A basic understanding of intra-group services

2.1. Introduction

Before delving into the nuances of intra-group services from a transfer pricing[10] perspective, it would be helpful to have an understanding of what is meant by intra-group services and management fees.[11] The discussion below illustrates the OECD approach to describing intra-group services.

2.2. The concept of intra-group services

An intra-group service is a service performed by one member of an MNE group for the benefit of one or more related members of the same group. In some cases, intra-group services may be performed by a parent company or a sister company for one or more related parties. In a transfer pricing context, such intra-group services become significant when they are rendered to related parties located in different tax jurisdictions. Intra-group services have become a large and important segment of the global economy and of these transactions a significant part is between members of an MNE group.

The OECD Transfer Pricing Guidelines state that nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, co-ordination and control functions for the whole group.[12] There are different functions within an entity and many of them are ancillary to the entity's main business but nonetheless essential for the entity's business operations.

Services can be acquired directly or indirectly from a specifically designated group member (a group service centre), or from a related company in the MNE group; or from an independent entity; or perform the service in-house by itself.[13] For example, some services such as legal and accounting services can be brought in from an outside source while central auditing or training of personnel is usually provided within the MNE.[14]

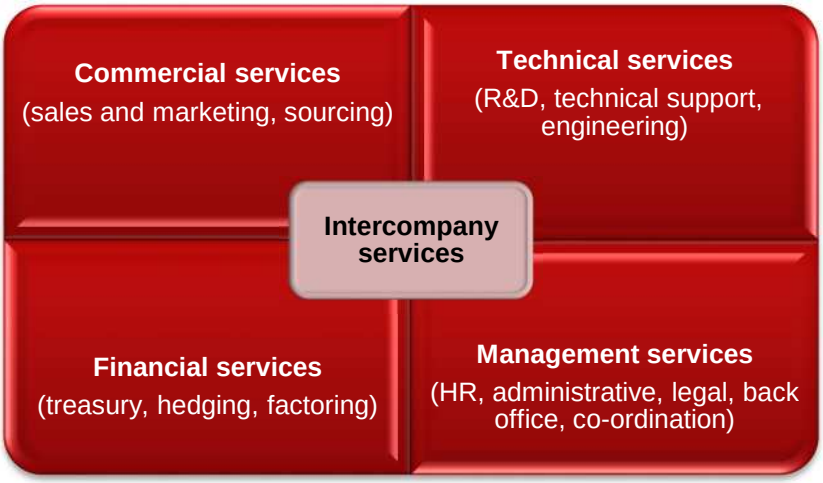
Services are often centrally provided within MNEs and create benefits for both service providers and service recipients, such as:

[10] Transfer pricing is the pricing for transfers of physical goods, intangible property and services between members of an MNE group. The pricing between two related entities affects both income and costs and therefore affects the entity's taxable profit. Ever since entities have expanded across borders and formed MNEs, the risk for tax planning and tax avoidance has become higher. Countries have different taxation, which give MNEs the possibility of setting the price that provides the best net profit for the whole MNE group. This has made countries more interested in regulating transfer pricing to protect their country's own tax base.
[11] In the transfer pricing arena, while the term 'management fees' is extensively used in common parlance to describe the compensation paid for intra-group services, the term is not defined in the transfer pricing rules found in the OECD Guidelines, nor in the US transfer pricing regulations. Having said that, in general, management fee is often used as a generic term to describe any charge between related parties, in the context of intra-group services.
[12] Para 7.2 of the OECD TP Guidelines, 2010
[13] Hamaekers, H., March/April 2001. Arm's Length - How Long? *International Transfer Pricing Journal,* Para. 13.1
[14] Para 7.2 of the OECD TP Guidelines, 2010

- More selective and strategic contribution from the headquarters management because they are no longer entangled by the administrative work;
- Better management information, provided more consistently across the organization as a whole;
- More efficient resourcing through economies of scale in staffing and facilities; and
- Greater efficiency and professional provision of the services through service streamlining and simplification.

2.3. Typical services

In general, the categories of services that could be regarded as intra-group services include the following:



Some of the intra-group services rendered in this context could be referred to as routine in nature. Routine services are an important category of services and include basic administration, finance or support services. The important characteristic of a routine service is that the service is simple and often very straightforward but it should not be presumed that all administration, finance or support services falls into this category of services.

Many services are often linked to a transfer of property, either tangible or intangible property. For example when a contract manufacturer provides a service for the MNE it is transferring goods to the distributors or when a support centre is providing a technical service, the service is connected to intangible property in the form of know-how. In these situations the OECD recommends MNEs to use the principle of segregation and separation which means that the service and the property should be priced separately. Thus, the OECD prefers transparency in the transactions.[15]

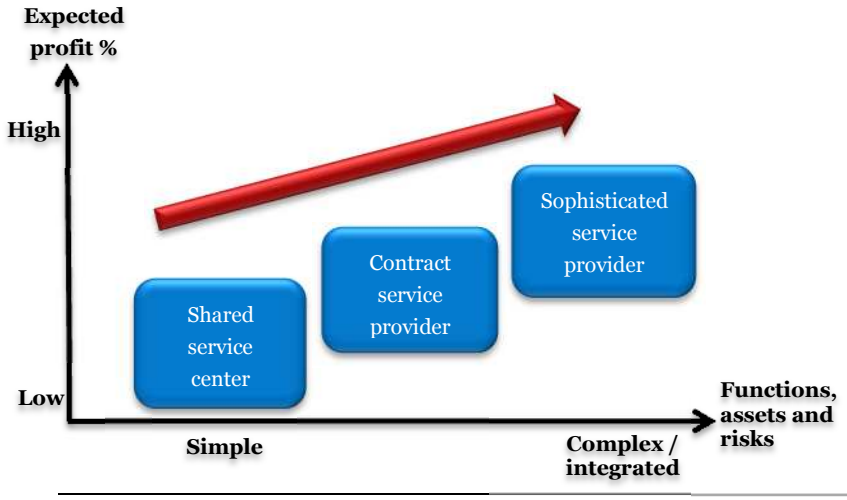
[15] Para 7.3 of the OECD TP Guidelines, 2010

2.4. Service providers' business models

Service providers can range from a shared service centre providing centralized support services for the benefit of group companies to a contract service provider performing activities on a contract basis for a principal company with the intention that developed intangibles are owned by the principal company, to sophisticated service providers that perform specialised services and are likely to own valuable intangibles (intellectual property management and marketing companies). An entity rendering accounting and administrative services is as much a service provider as a dredging company engaged to assist with laying the foundations for a port or building site is, as a centre of excellence can be. Thus, modelling service providers offers a very diverse and broad range of possibilities.[16]

Table 1: Service Providers' Functions

Functions	Sophisticated service provider	Contract service provider	Share service centre
Investments in assets used to render services	Typically high	Typically low	Can be low – high
Human resources	Higher compensation	Lower compensation	Depends on services rendered
Valuable intangibles	X		
Routine intangibles	X	X	X
Invoicing and collection	X	X	X
General administrative functions	X	X	X
Market risk	X		
Forex risk	X		
Bad debt risk	X		
Liability risk	X	X	X



[16] Bakker, A., 2009. *Transfer Pricing and Business Restructurings Streamlining all the way.* Netherlands: IBFD, pp 34

2.5. Main issues

Practitioners tend to find the area of services problematic with specific attention to two main issues:

- Firstly, whether intra-group chargeable services have in fact been rendered. The first issue has another two components attached. The first component is whether the services have been rendered i.e. occurrence and the second component is the subsequent benefit accruing from it.

- The second issue is how to determine an arm's length consideration for such services (in accordance with the benefit received).

With respect to the second issue, in general, taxpayers have experienced fewer disputes with tax authorities. The reason for this is that taxpayers are able to provide a comprehensive set of documents, including the cost charge mechanism (whether direct or indirect), details of cost components, constituents of the total cost pool, identification and segregation of non-chargeable costs, allocation drivers etc., to the satisfaction of the tax authorities.

It is primarily with respect to the first issue that tax authorities aggressively scrutinize the available documentation with taxpayers and require them to substantiate the receipt of services and the consequent benefits accrued to the taxpayer. One can subsequently substantiate the occurrence of an event with the aid of documents generated in the course of providing services, i.e. emails correspondences, reports, presentations, memos, circulars etc. Addressing the second component, i.e. benefits accruing to the recipient of the services, remains a challenge.

The Davis Tax Committee ('DTC') which is a tax review committee and chaired by Judge Dennis Davis was appointed on 17 July 2013 to inquire into the role of South Africa's tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. On an international front, the DTC is required to address concerns about BEPS[17], especially in the context of corporate income tax, as identified by the OECD and G20. The DTC set up a BEPS Sub-committee which prepared an interim report addressing BEPS in South Africa.

Since South Africa re-joined the global economy after democratic elections in 1994, there has been amplified interest in South Africa which has encouraged its citizens to actively participate in and become reintegrated into the global economy. The intensified global trade competition and the movement of capital in the world have encouraged South African residents, both individuals and corporations, to make significant investments offshore and to look for ways of minimising their global tax exposure. It is, however, difficult to reach solid conclusions about how much BEPS actually occurs in South Africa and what exactly the tax gap is.

[17] Even though there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting which focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates.

Due to South Africa's economic standpoint the DTC has acknowledged that intra-group services have become an issue and has noted that it is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services is made available to the tax administration.[18]

Reference is made below to data from the South African Reserve Bank ('SARB') which suggests the measure of payments directed offshore as verified by the Bank.[19]

Table 2: Non-goods payments for calendar years 2008 to 2011

	2008 R	2009 R	2010 R	2011 R	Grand Total R
Copyrights, royalties and patent fees	9,193,024,882	9,972,557,798	10,218,632,767	11,753,572,186	41,137,787,633
Legal, accounting and management consulting services	19,907,138,985	26,404,401,495	26,567,916,347	29,086,527,270	100,965,984,097
Advertising and market research	2,514,255,525	2,079,309,530	2,322,484,579	2,376,620,700	9,292,670,334
Research and development	1,190,891,326	1,465,932,525	1,881,655,361	1,194,421,583	5,732,900,794
Architectural, engineering and technical services	9,502,199,748	13,261,681,931	9,140,177,372	9,580,166,654	41,484,225,705
Agricultural, mining and other processing services	1,357,914,436	1,372,840,085	1,534,995,130	2,360,485,454	6,626,235,105
Grand Total	**43,665,424,902**	**54,556,723,364**	**50,665,861,555**	**56,351,793,847**	**205,239,803,668**
% Movement		**24.94%**	**-7.13%**	**11.22%**	

From the table above it seems as though 50% of payments relate to legal, accounting and management consulting services. The above trend depicts that in 2008 just after the financial crisis, outflows increased by approximately 25%. Even though the South African economy did not feel the full effect of the outcome of the financial crisis, it seems uncharacteristic that legal, accounting and management consulting services increased by almost R6.5bn (an increase of 32.6%).[20]

The increase is further echoed by the contribution table below which demonstrates that since 2008, legal, accounting and management consulting services increased disproportionately in relation to the other non-goods payments.[21]

Table 3: Non-goods contribution to overall payment flows

	2008	2009	2010	2011
Copyrights, royalties and patent fees	21.1%	18.3%	20.2%	20.9%
Legal, accounting and management consulting services	45.6%	48.4%	50.5%	51.6%
Advertising and market research	5.8%	3.8%	4.6%	4.2%
Research and development	2.7%	2.7%	3.7%	2.1%
Architectural, engineering and technical services	21.8%	24.3%	18.0%	17.0%
Agricultural, mining and other processing services	3.1%	2.5%	3.0%	4.2%

[18] Davis Tax Committee (DTC) Interim Report, 2014. Addressing Base Erosion and Profit Shifting in South Africa. South Africa: DTC, pp 11
[19] Id, pp 20
[20] Id, pp 21
[21] Id, pp 22

It is evident from the studies performed that the occurrence of these non-goods transactions is not limiting to specific industries or sub industries.

An industry cluster of particular interest is the state-owned or controlled entities which have been identified as significant players in cross border trade as well as posing potential transfer pricing risk. Recent research has indicated that there are at least 650 state-owned MNEs globally, representing an important emerging source of Foreign Direct Investment ('FDI') and there are more than 8,500 foreign affiliates spread across the globe, bringing them in contact with a large number of host economies.[22]

The enormity and pervasiveness of cross border non-goods transactions are apparent. This causes a threat to the fiscus insofar as tax revenue and is an indication that prohibited tax base migration through avoidance schemes and practices could be taking place. The DTC is of the opinion that the magnitude of the transactions, although always expected to be large, is material and constant reviews in respect of assurance interventions should become standard practice.[23]

[22] United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2011, Non-equity modes of international production and development, Switzerland: United Nations (UN)
[23] DTC Interim Report, 2014. Addressing Base Erosion and Profit Shifting in South Africa. South Africa: DTC, pp 24

3. Determining whether intra-group services have been rendered

3.1. Introduction

The OECD Guidelines provides a basis for determining whether a service has been rendered. Under the arm's length principle, when one group member performs an activity for one or more group members, it will be regarded as a service rendered if, and only if, the activity provides the respective group member with economic or commercial value that might conceivably enhance the recipient's commercial position.[24] It also provides a simple way to ensure that a legitimate service is being rendered by considering whether an independent entity in comparable circumstances would be willing to pay for the same service conducted by another independent entity or would have performed that service in-house.

If the activity is not one for which the independent entity would have been willing to pay or perform for itself, the activity ordinarily should not be regarded as a chargeable intra-group service under the arm's length principle.[25]

Some intra-group services are performed by one member of an MNE group to meet an identified need of one or more specific members of the group. In such a case, it is relatively straightforward to determine whether a service has been provided.[26]

This standard involving willingness to pay or existence of a benefit as enunciated in the OECD Guidelines is by far the most important factor that determines whether a related party service recipient would pay for an intra-group service and therefore whether the service provider can justify a charge for the provision of the intra-group services. The objective of the benefit rule is not only to determine the quantum of the benefit but also the relative proximity of the benefit derived to the intra-group service rendered.

The OECD Guidelines also identifies certain services or activities that are deemed to be non-beneficial for the recipient thereof. As a result, those activities cannot be regarded as chargeable intra-group services. The main categories of non-beneficial services identified in the OECD Guidelines are mentioned below:

[24] Para 7.6 of the OECD TP Guidelines, 2010
[25] Para 7.6 of the OECD TP Guidelines, 2010
[26] Para 7.8 of the OECD TP Guidelines, 2010



3.1.1. Shareholder activities

The current definition given by the OECD TP Guidelines on what constitutes a shareholder activity was reached after a couple of deliberations in past decades.

It is, in general, an accepted principle that shareholder services should not bear a charge, as the benefits from shareholding activities ought to be received by the provider of the services rather than the recipient. A shareholder activity is distinguishable from the broader term 'stewardship activity' used in the 1979 Report.[27]

Typical examples of shareholder activities include the following:

- 'Costs of activities relating to the juridical structure of the parent company itself, such as parent company shareholder meetings, issuing of shares in the parent company and supervisory board costs;
- Costs relating to reporting requirements of the parent company including the consolidation of reports; and
- Costs of raising funds for the acquisition of its participants.'[28]

It is interesting to analyse the evolution in the definition of shareholder activity. Historically, the OECD has been entrusted with the responsibility to provide guidelines on core tax issues which have a global impact. The first guidelines issued by the OECD in relation to the treatment of intra-group services were issued in 1979 and provided, among other things, the concept of central co-ordination and managerial activities.[29] However, the guidelines did not provide a clear methodology on how to treat the costs of such activities.

Since the 1979 guidelines provided no clear methodology on this, and the member countries had different views on the treatment of such centralized activities, the OECD came up with the 1984 Report on 'The allocation of central management and service costs'.[30] Although the report provided a broader definition of benefits, it failed to bring a consensus on the treatment of central co-ordination and managerial costs, because it provided two extreme approaches on how to deal with them.

[27] Para 7.9 of the OECD TP Guidelines, 2010
[28] Para 7.10 of the OECD TP Guidelines, 2010
[29] Organisation of Economic Co-operation and Development (OECD), 1979. *OECD Report on Transfer Pricing and Multinational Enterprises* (OECD TP Report), Paris: OECD
[30] Organisation of Economic Co-operation and Development (OECD), 1984. *OECD Report on Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (OECD TP Report), Paris: OECD

Considering the non-consensus between the member countries and at the same time keeping itself in pace with the economic evolution taking place, the 1995 Guidelines shifted from an 'activity-centric' approach to a 'comparable circumstances' approach.[31] The 1995 Guidelines did not focus on whether a particular centralized activity would classify as a chargeable/non-chargeable service. Instead, it looked at testing the service recipient's 'willingness to pay' a third party under comparable circumstances.

Like the OECD, for decades the US Regulations have witnessed significant deliberations on how to deal with central co-ordination and managerial services. With the US as the largest economy in the world, their regulations should be examined for guidance on the treatment of centralized managerial services, which has remained a controversial issue worldwide.[32]

The 2010 Guidelines suggest that if an activity has been performed merely for the benefit of the owner it does not necessarily mean that it is a shareholder activity for which an allocation is not warranted. This is because there may be activities performed for the interest of the owner which conform to the shareholder activity definition provided in Para. 7.9. of the 2010 Guidelines, but which could nevertheless be regarded as chargeable based on surrounding facts and circumstances of the case. In such cases, the OECD Guidelines advise that whether the activities fall within the definition of shareholder activities as defined in the OECD Guidelines is to be determined based on whether under comparable facts and circumstances, the activity is one that an independent entity would have been willing to pay for or to perform for itself.

In other words, to evaluate services rendered by a parent as a shareholder to its subsidiary for the parent's own interest but which confers added value on the subsidiary beyond what can be regarded as routine support one must exercise some value judgement before eliminating it as a non-chargeable service. Therefore, any service that resembles activities cannot be eliminated outright. As noted above, the underlying test in all cases should be whether an independent entity in comparable circumstances would be willing to pay for it or perform it in-house. Once this is determined, inclusion or exclusion as a service rendered can be defensible.

3.1.2. Duplicative services

In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party.[33]

Duplicative services are those that a group member offers to any other member which can be regarded as duplicate (i.e. the service is already performed by the recipient or by an arm's length party on its

[31] Organisation for Economic Co-operation and Development (OECD), 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (OECD TP Guidelines). Paris: OECD
[32] Mitra, R. K., Hans, A. & Jain, A., 2014. Intra-group services and shareholder activities. *Transfer Pricing International Journal,* August , 15(8), pp.3
[33] Para 7.11 of the OECD TP Guidelines, 2010

behalf). In that case, no intra-group services should be regarded as being rendered by the group member. The OECD Guidelines indicates that there is no added commercial value provided by such services, and thus they cannot be regarded as being rendered for the benefit of the related party.

At the same time the OECD Guidelines also recognize that there may be some exceptions, such as temporary circumstances or an opportunity to eliminate critical business risk. Other instances in which critical business risk is eliminated would come into play when seeking a second legal opinion or performing an external audit to avoid a risky or erroneous business decision. When a valid business reason exists, these duplicative expenses may be regarded as intra-group services.

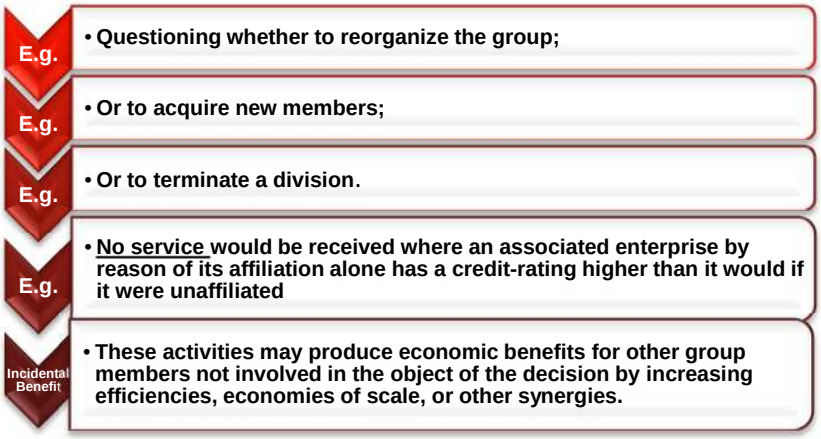
The questions of whether an expense is for the benefit of the parent can be a difficult one to resolve in practice. This is because almost any parent activity that relates to a subsidiary can benefit the subsidiary, thereby becoming potentially subject to an allocation between these two categories. Consequently, it may not always be easy to ascertain in practice where the line is drawn between shareholder/stewardship activities[34] for which an allocation is not to be made, and non-shareholder/non-stewardship activities benefiting the subsidiary for which an allocation is to be made. Wherever these activities fall within the definition of shareholder/stewardship activities is determined based on all the surrounding facts and circumstances of the case and, more importantly, based on the principle as to whether under comparable facts and circumstances, the activity is one that an independent entity would have been willing to pay for or to perform for itself.

3.1.3. Incidental benefits

There are some cases where an intra-group service performed by a group member such as a shareholder or co-ordinating centre relates only to some group members but incidentally provides benefits to other group members.[35] No charge should be made since the received benefit is not one which an independent entity would want to pay for under the same circumstances. Typical incidental benefits are due to reorganization in the MNE (e.g. acquire new group members or terminate a division) which incidentally becomes efficient to one or more of the MNE's member's business.

[34] Although the OECD proposes a regulatory formalization in terms of the distinctions between stewardship expenses and shareholder activities, the rationale for such a distinction is not very certain, as neither type of expense should precipitate a reallocation.
[35] Para 7.12 of the OECD TP Guidelines, 2010

Below are some typical examples of incidental benefits.



3.1.4. Passive association benefits

There are some cases where an intra-group service creates an incidental benefit for the recipient due to its membership (i.e. affiliation) in a larger MNE. These types of benefits are similar to incidental benefits, but are called affiliation benefits since an MNE member receives benefits solely because of its membership without contributing anything itself. An example could be when the MNE has a good reputation due to global marketing and public relation campaigns which benefits the entity indirectly just by being a member of the MNE. It is important that affiliation benefits are not mixed up with active promotions that the MNE carries out for the purpose to enhance profit making for certain members of the MNE. This should be determined on a 'case by case' basis, based on every situations own facts and circumstances.[36]

3.1.5. On-call services

Another issue arises with respect to services provided 'on-call'. The availability of such services generally requires the existence of a support group of some sort and an understanding between the group members about the nature of the assistance being provided in any field of operation whenever required and on-call basis. For example a parent company or a group service centre may be available to provide assistance with regard to legal, finance, technical or tax issues at any time.

The question to be considered here is whether the availability of such services is itself a separate service for which an arm's length charge (in addition to any charge for services actually rendered) should be determined. The justification provided in the OECD Guidelines for considering such availability as a separate service rendered is that it is common knowledge that independent entities incur so-called stand-by charges to ensure availability of those services when the need for them arises. An example of that service is the appointment of a legal, technical or financial service provider on a retainer basis.

[36] Para 7.13 of the OECD TP Guidelines, 2010

These services are not necessarily a standard requirement and may vary in terms of amount, frequency and importance from year to year. Therefore, one must ascertain the potential need of the stand-by service option for the recipient of the services. In cases where the service requirement is remote or could be easily procured from other sources without an on-call service option, the availability of that option is redundant and hence unjustified. Therefore, to evaluate whether an on-call service is rendered, one must consider the benefit that the on-call arrangement offers to the group over a period of several years, given the erratic nature of the occurrence of those service needs (rather than only for the year of taxation under consideration).[37]

3.2. In summary

It is essential to justify the intra-group services from the perspective of an independent entity, considering whether an entity would be willing to pay for the service in question or perform the same service in-house. Thereafter, a valid segregation or aggregation of the costs should be conducted and the charging or otherwise for those services rendered should be based on the above-mentioned principles.

[37] Para 7.17 of the OECD TP Guidelines, 2010

4. Determining an arm's length charge

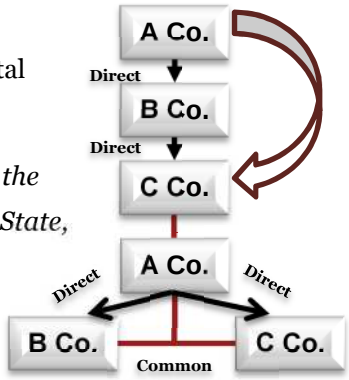
4.1. Introduction

The previous chapter illustrates how one would determine whether intra-group services have been rendered. Once it is determined that an intra-group service has been rendered, it is necessary, as for other types of intra-group transfers, to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means that the charge for intra-group services should be that which would have been made and accepted between independent entities in comparable circumstances. Consequently, such transactions should not be treated differently for tax purposes from comparable transactions between independent entities simply because the transactions are between entities that happen to be associated.[38]

Article 9(1)(a)(b) of the OECD Model Tax Convention on Income and Capital ('OECD MTC') defines an associated entity as follows:

'An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,

Or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State…'[39]



The purpose of this chapter is to give readers a brief understanding of the different methods used for allocating costs of (a) service(s) as well as an understanding of how to value remuneration for intra-group services. This is particularly a problem for taxpayers since countries seem to have unique views on how to apply charging methods and different valuation methods.

4.2. Methods used for allocating costs of intra-group services

The 2010 OECD TP Guidelines states that a direct charging mechanism should be applied wherever possible.[40] In many cases a direct charging mechanism is not possible or may result in extreme administrative costs. In such cases, an indirect cost method may be applied however this method may be accompanied by some significant tax risks.[41]

According to the 2010 OECD TP Guidelines, direct charging based on a service-level agreement is seen to be of great practical convenience for tax authorities as it allows the service performed and the basis

[38] Para 7.19 of the OECD TP Guidelines, 2010
[39] Organisation for Economic Co-operation and Development (OECD), 2010. *Model Tax Convention on Income and on Capital.* Paris: OECD, Article 9(1), pp 10
[40] Para 7.21 of the OECD TP Guidelines, 2010
[41] Para 7.23 of the OECD TP Guidelines, 2010

for the payment to be clearly identified.[42] But in many cases direct cost methods are very difficult to apply and a system of indirect charges must be deployed.[43] This charging based on costs originating from the service provider to the service recipients will make use of cost allocation and appropriate apportionment methods which often necessitate some degree of estimation or approximation, as a basis for calculating an arm's length charge.[44] Any indirect cost method should be sensitive to the commercial features of the individual case, contain safeguards against manipulation and follow sound accounting principles. It should be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.[45]

4.2.1. Direct charge method

Under the direct charge method, associated entities are charged for specific services. In those circumstances, the expenses of the specific support group responsible for the service rendered can be directly attributed to the services being rendered (in terms of hours, travel expenses, etc.). The OECD Guidelines maintains that MNEs should be able to adopt direct charging arrangements where similar services are also rendered to unrelated parties. It is not phrased, however, as being mandatory, as the Guidelines use the term 'encouraged'. Even though the direct charge method is preferred by tax authorities, it is difficult to apply in practice especially for group service centres.[46]

4.2.2. Indirect charge method

The indirect charge method is regarded as a second choice and should be used when direct charging is not possible. Indirect charging is suitable in situations when the rendered service cannot be quantified except on an approximated or estimated basis and where separate recording and analysis of service activities for each recipient would involve a disproportionate administrative burden. For example, in centralized marketing campaigns it is difficult to estimate the actual benefit for each member of the MNE, since it is difficult to determine how much of the sold goods are derived from a specific campaign. In these situations, the indirect charging method would make an estimated split of the costs between the recipients, which would be calculated with reference to what an independent entity would be prepared to accept.[47]

When the indirect charging method is used, the MNE uses an allocation key to allocate the recipients' proportionate share of the costs. The type of allocation key used in indirectly charged arrangements may depend on the nature and usage of the service. Typical allocation keys are based on turnover, heads (staff employed), production, or on some other basis.[48] The importance is that the allocation key reflects the benefit of the arrangement.[49] For example, it is difficult to allocate the correct amount of usage of centralized computer services for each recipient. In this situation, an appropriate

[42] Para 7.20 of the OECD TP Guidelines, 2010
[43] Para 7.22 of the OECD TP Guidelines, 2010
[44] Para 7.23 of the OECD TP Guidelines, 2010
[45] Para 7.23 of the OECD TP Guidelines, 2010
[46] Para 7.24 of the OECD TP Guidelines, 2010
[47] Para 7.24 of the OECD TP Guidelines, 2010
[48] Para 7.25 of the OECD TP Guidelines, 2010
[49] Para 7.27 of the OECD TP Guidelines, 2010

allocation key could be based on heads using a computer in each receiving entity. This will give the recipients a portion of the overall computer usage, which will be the basis for allocating the costs.[50]

There are problematic scenarios when the services are too obscure, since it makes it difficult to estimate the recipient's actual benefit and in some situations the recipients cannot even relate the charge to a specific service. In these situations, it may be difficult for the taxpayer to prove to the tax authority that the service(s) has contributed a benefit to the recipient, especially in countries which have a very strict approach towards transfer pricing and to the indirect cost method.[51]

Indirect charging is based on approximation which makes it easily manipulated. This method should therefore be based on sound accounting principles and be charged according to reasonably expected benefits for the recipient.[52] Indirect charging is therefore only allowed when the taxpayer can prove the following:[53]

1. That the foreseeable benefit is reasonable and identifiable;
2. That the charging method of costs are proportionate with the recipients' actual or reasonable expected benefit;
3. That the chosen allocation key follows sound commercial principles in each particular situation;
4. That there has not been any manipulation and measures have been taken against it; and
5. That the calculations have been considered according to sound accounting standards.

4.2.3. In summary

The applicability and acceptance of the direct cost method supersedes that of the indirect cost method and in cases where the former can be used, the latter is generally not regarded as an acceptable methodology by tax authorities. In general, the direct charge method is of great practical convenience to tax authorities because of the clear correspondence between the resulting charge and the benefit provided to the payer. It is for this very reason that the OECD favours a direct cost method for specific services wherever possible.

4.3. Calculating an arm's length consideration

Having identified the cost base and the basis of allocation to various group companies, the next question is how much the remuneration of the service should be.

[50] Para 7.25 of the OECD TP Guidelines, 2010
[51] Para 7.27 of the OECD TP Guidelines, 2010
[52] Para 7.23 of the OECD TP Guidelines, 2010
[53] Hamaekers, IBFD database, General information on transfer pricing, Para. 10.11.4

4.3.1. Important aspects when pricing services

The remuneration of a service shall according to the OECD Guidelines be based on the arm's length principle. There are many factors to consider when determining the appropriate remuneration. The fundamental basis is that the remuneration reflect all important aspects such as characteristics of the property or service concerned, functions performed, risks assumed and assets used, contractual terms, economic circumstances (aspects of the market: geographic level, position, competition, government regulation, supply and demand, costs of production, substitute goods) and business strategies (risk aversion, market penetration, new product development etc.).[54] These aspects should be analysed from the perspective of the provider and the perspective of the recipient. Thus, the arm's length analysis will be based on what an independent provider would be willing to accept as a reasonable price and how much an independent recipient would be willing to pay under comparable facts and circumstances.[55]

The arm's length price could be found through open market valuation or by using a cost-orientated method or profit-orientated method. Open market valuation is when the price is found by comparing the prices of the controlled transaction with the price of an uncontrolled transaction in an open market. Cost-orientated methods are based on the calculation of all direct and indirect costs relevant to the service transaction, plus a possible profit element added to the charge. Profit-orientated methods examine the profits arising from a particular transaction.[56]

When services are rendered from a centralized source the OECD recommends that MNEs perform a functional analysis of the various members of the group to establish the relationship between the services rendered and the members' activities. This analysis will determine which assets and resources have been used and what risks have been assumed.[57] It is also important to consider what beneficial impact the service will have for the recipient(s), both the immediate impact and the long term effect, since some costs will only show a benefit on a longer term and not if they are analysed immediately. For example, costs for marketing activities might be very high in the beginning but very low if it is analysed over a long period of time (i.e. several years). Thus, tax authorities will demand that the taxpayer can show reasonableness behind its charge, which means that it should be what an independent entity would have done under comparable facts and circumstances.[58]

4.3.2. Open market valuation

As stated above, open market valuation is a comparison of prices in an open market. The open market price is found through the comparable uncontrolled price method ('CUP method'). It is essential when applying the CUP method that there are no material differences between the compared transactions and the entities undertaking those transactions, which could affect the price in an open

[54] Para 1.19-1.37 of the OECD TP Guidelines, 2010
[55] Para 7.29 of the OECD TP Guidelines, 2010
[56] Para 74 Chapter III of the OECD TP Report, 1984
[57] Para 7.32 of the OECD TP Guidelines, 2010
[58] Para 7.32 of the OECD TP Guidelines, 2010

market. Nevertheless, material differences may be acceptable if these differences could be eliminated through reasonable accurate adjustments.[59] To apply the CUP method to a transaction, certain factors have to be comparable between the two transactions. The following provides a list of the main comparable factors when using the CUP method:

- Nature and quantity of the product;
- Geographical market conditions;
- Contractual terms;
- Sales volume;
- Time;
- Market level; and
- Functions performed and risks assumed.

These comparable factors can be either compared through an internal CUP method or an external CUP method.

The internal CUP method is a comparable transaction between one party to the controlled transaction and an independent party.[60]

The external CUP method is between two independent entities, neither of which is a party to the controlled transaction. The external CUP method is difficult to apply in practice since it is almost impossible to find a comparable independent transaction which fulfils all comparability factors.[61] The internal CUP method is preferred by the OECD since it shows more reliability than the external CUP method.

The CUP method can only be used when direct charging is applicable. Accounting, auditing and legal services are typical services where the CUP method could be used, especially if these services are rendered to independent parties.[62] There are many situations where it is rather difficult to use the CUP method as service transactions are often unique and linked to the transfer of intangible property (e.g. R&D) or tangible property (e.g. contract manufacturing) or aggregated together with other transfers of services (e.g. package deal of services).[63] One thing is for certain, if an entity could apply the CUP method to a service transaction it would reflect the most accurate arm's length price.[64]

[59] Para 3.25 of the OECD TP Guidelines, 2010
[60] Hamaekers, IBFD database, General information on transfer pricing, Para. 7.2
[61] Para 3.24 of the OECD TP Guidelines, 2010
[62] Hamaekers, IBFD database, General information on transfer pricing, Para. 13.5.2
[63] Para 7.31 of the OECD TP Guidelines, 2010
[64] Para 2.16 of the OECD TP Guidelines, 2010

4.3.3. Cost-orientated methods

As stated above, the remuneration through a cost-oriented method includes all direct and indirect costs and should normally include a profit element.[65] The cost-oriented methods are not as sensitive toward transactional differences as the CUP method, and are therefore more easily applied.[66] There are two cost-oriented methods which are mentioned in the OECD TP Guidelines: The cost plus method and the resale price method.

The cost plus method is the most common cost-orientated method used for services.[67] This method, calculates all the direct and indirect costs, plus an appropriate profit mark-up which is added to the costs.[68]

The resale price method is applied where the service is resold to another party without adding substantial value to the service (i.e. not changing the service by adding new features).[69] The remuneration is calculated by using the price from the resale, minus an appropriate resale margin and is typically used for services which are sold through an agent or through an intermediate.[70]

4.3.3.1. Determining a remuneration using the cost plus method

There are two steps in determining the remuneration through the cost plus method. The first is to calculate its cost base and to see what functions have been used in the transaction. The second part is to compare these functions to transactions in the open market, so that the entity can determine the appropriate mark-up.[71]

4.3.3.2. The cost base

There are three broad categories of costs and expenses in an entity:

- Firstly, there are direct costs for producing a product or service such as raw materials;
- Secondly, there are indirect costs for production, which even though are closely related to the production process may be common to other numerous products or services for e.g. costs of a repair department that services equipment, used to produce different products; and
- Finally, there are operating expenses which relate to the entity as a whole for e.g. expenses for administrative, general and supervisory activities.[72]

There are two kinds of methods used when determining the costs in a cost orientated valuation. The first is the gross margin method, which generally include direct and indirect costs of production. The

[65] Para 80 Chapter III of the OECD TP Report, 1984
[66] Para 2.16 and 2.34 of the OECD TP Guidelines, 2010
[67] Para 7.31 of the OECD TP Guidelines, 2010
[68] Para 2.32 of the OECD TP Guidelines, 2010
[69] Para 2.22 of the OECD TP Guidelines, 2010
[70] Para 2.14 of the OECD TP Guidelines, 2010
[71] Para 2.39 of the OECD TP Guidelines, 2010
[72] Para 2.47 of the OECD TP Guidelines, 2010

second is the net margin method, which includes the operating expenses as well as direct and indirect costs for production.[73] There is however a problem with drawing a precise line between the three categories of costs since various countries may treat costs differently.[74]

4.3.3.3. The profit mark-up

The profit mark-up is determined through a benchmark which compares the profit mark-up to profit mark-ups of other transactions in an open market. It is important that there are no differences between the transactions being compared or between the entities undertaking those transactions, which could materially affect the profit mark-up (or resale price margin) in the open market. The cost plus method is not as sensitive towards differences in the transactions as the CUP method since service differences are less likely to have an impact on the profit mark-up compared to what it would have on the price. Price differences are not as important since the profit mark-up focuses on gross compensation after the cost of sales for specifically performed functions.

The 2010 OECD TP Guidelines provides an example: A distribution company performs the same functions selling toasters as it would by selling blenders, and hence there should be a comparable level of compensation for both activities. Nevertheless, consumers would not consider toasters and blenders to be specifically close substitutes, and hence there would be no reason to expect their prices to be the same.[75] It may be more appropriate to place credence to other attributes of comparability i.e. functions performed, economic circumstances etc. as the profit margin relates primarily to those other attributes and only secondarily to the actual product being transferred. This does not apply in situations where a relatively unique service is being transferred. In addition, the way an entity carries out its business could have a material effect to the comparability. It could affect the level of costs (e.g. difference in management efficiency) which will provide differences in profitability. Adjustments can be made, but it is important to understand that the extent of adjustments affects the reliability to apply the cost-orientated methods.[76]

4.3.3.4. Determining a remuneration using the resale price method

The resale price method calculates the remuneration by using the resale price, minus a resale price margin. The resale price margin includes all costs for selling, and other operating expenses plus an appropriate profit element. The profit element is based on the functions performed, assets used and risks assumed. What is left from after the extraction of the resale price margin is the remuneration for the intra-group transaction. Similar to the cost plus method, the resale price margin is determined through a benchmark which compares the resale price margin to resale price margins of other transactions in an open market. It is important to ensure that there are no differences between the transactions being compared or between the entities undertaking those transactions which could materially affect the resale price margin in the open market. The resale price method is not as

[73] Para 2.48 of the OECD TP Guidelines, 2010
[74] Para 2.48 of the OECD TP Guidelines, 2010
[75] Para 2.24 of the OECD TP Guidelines, 2010
[76] Para 2.26 of the OECD TP Guidelines, 2010

sensitive towards differences in the transactions as the CUP method since service differences are less likely to have an impact on the resale price margin compared to what it would have on the price. A resale price margin focuses on gross compensation after the cost of sales for specifically performed functions. Instead there are other comparability factors that become more important, i.e. functions performed, assets used and risks assumed. This does not apply in situations where a relatively unique service is being transferred.[77] Also, the way an entity carries out its business could have a material difference to the comparability. It could affect the level of costs (e.g. difference in management efficiency or marketing activities) which will provide differences in profitability.[78] Adjustments can be made, but it is important that the extent of adjustments affects the reliability to apply the cost-orientated methods.[79]

4.3.4. Profit-orientated methods

The profit orientated methods examine the profit arising from the controlled transaction. There are two profit orientated methods: The transactional net margin method ('TNMM') and the profit split method. Since the methods examine the net profit, the remuneration can only be determined the year after the transaction. Therefore, the profit orientated methods are very good 'checking tools' which some experts refer to as the sanity check.[80]

4.3.4.1. Determining a remuneration using the TNMM

The TNMM examines the net profit margin in relation to an appropriate base (e.g. costs, sales, assets), which the entity realizes from a controlled transaction. The TNMM is similar to the cost-oriented methods and should be applied in a consistent manner with these methods. The difference is that the cost-oriented methods examine the gross profit margins which do not include operating profits in the calculations.[81]

Similar to the cost-orientated methods, the TNMM compares its net profit margin to a net profit margin of a comparable uncontrolled transaction. The entity should first determine the least complex entity for purposes of performing a functional analysis (functions performed, assets used, and risks assumed). After that, the entity tries to find a comparable by analysing the result of functions, assets and risks from an uncontrolled transaction. If the transactions are not comparable, the entity may make necessary adjustments to obtain a reliable result.[82]

The TNMM is less dependent on service similarities as is the CUP method, and is less dependent on functional and risk similarities as the cost plus method, since the net margin is not as sensitive toward transactional and functional differences.[83] Due to the fact that operating expenses are included in the

[77] Para 2.28 of the OECD TP Guidelines, 2010
[78] Para 2.31 of the OECD TP Guidelines, 2010
[79] Para 2.31 of the OECD TP Guidelines, 2010
[80] Hamaekers, IBFD database, General information on transfer pricing, Para. 11.2.4
[81] Para 2.58 of the OECD TP Guidelines, 2010
[82] Para 2.58 of the OECD TP Guidelines, 2010
[83] Para 2.62 of the OECD TP Guidelines, 2010

calculations could make the method unreliable, since operating expenses are sometimes influenced by other factors that are difficult to adjust.

The TNMM is also used as a checking tool for other methods. It is called a sanity check, so that the MNE can be sure that its transfer price falls within the arm's length range which is a range of figures which are acceptable for establishing whether the conditions of the controlled transactions are at arm's length.[84]

4.3.4.2. Determining a remuneration using the profit split method

The profit split method works through two steps: First the profit must be identified, and then the profit is split between the affiliated entities on an economically valid basis, which approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The profits are allocated though either a total profit split or a residual profit split. The profit split method is particularly useful when comparables cannot be found since the transactions are very interrelated and a lot of intangible properties are used. The advantage of the profit split method is that all parties receive reasonable remuneration for their functions performed, assets used, and risks assumed, because the method checks and evaluates each party's contribution to the arrangement.[85] Even though the method is useful when there are no comparables, it still has a weakness, since the arm's length principle emphasises comparability with independent entities.[86] The profit split method is not commonly used in practice for services.

4.3.5. In summary

Entities should use the method which is the most appropriate method for a particular case. No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.[87] The commonly used methods for pricing services are the cost plus method and the TNMM.

The CUP method is not easily applied for services, since it is very sensitive towards transactional differences. Services are often unique and it is difficult to find a comparable service in an open market which could provide an appropriate arm's length result.

The cost plus method or the TNMM would probably be the most appropriate methods to determine the remuneration of the service. The cost plus is probably better with services that do not have intangible property included in the transaction since this makes it difficult to find comparables.

The TNMM is not as sensitive towards functional differences and could therefore be easily applied, but might give an unreliable result since it includes some operating expenses in the cost basis.

[84] Glossary – Arm's length range, OECD TP Guidelines, 2010
[85] Para 2.114 of the OECD TP Guidelines, 2010
[86] Para 2.114 of the OECD TP Guidelines, 2010
[87] Para 2.8 of the OECD TP Guidelines, 2010

4.3.6. Should a charge include a profit element?

The question whether a profit element should be included in the charge has been discussed from an OECD perspective which gives room for interpretation.

If the CUP method is applied the question of whether a profit element should be included becomes irrelevant as the open market price already takes into account a profit. The question arises when the cost-orientated and profit-orientated methods are used.

The 1984 OECD Report expresses that normally a charge should include a profit element, as long as it is something that independent entities normally include. Where the provision of the services concerned is a major activity of the entity or the entity is particularly capable of providing valuable services to related recipients, a profit element would be mandatory. Nevertheless, in some situations, under special circumstances a profit element may not be appropriate. The key factors when determining special circumstances is to look at the function of the render and in what type of situation it has been rendered. Where a group service centre renders services to group members only, the function of such a centre may in essence be to reduce the costs of the group rather than making a profit for itself. In such a case, only direct or indirect charging of costs should be included.

There are according to the 1984 OECD Report, three non-exhaustive situations where a profit element should be added to the charge:

1. If a provision of that type of service is one of the main activities of the provider;
2. If a provision of that type of service is not a main part of the business, but the provider is particularly capable of providing such service and the value of the service is greater than the costs for the recipient; and
3. If the cost of the service represents a substantial part of the expenses of the recipients business.[88]

Even if the examples are non-exhaustive the OECD has concluded that it is difficult to provide other general cases when a profit element is appropriate. The first two conditions refer to situations where the service activity is a potential source of profit for the provider. For example, if the only activity of an entity was to provide the service(s), it would not have the profit making capability if a profit element was not included in the remuneration. The third example gives room for interpretation since it does not define the word 'substantial'. For example, some services might only be an ancillary activity for the provider, but since the recipient uses the service extensively for a period of time it becomes a substantial part of the expenses. If the arrangement is analysed in the period which the recipient uses the service, it would show that the services represent a substantial part of the recipient's expenses. If the arrangement is analysed over a longer period of time (e.g. when it was entered into), the services might not represent a substantial part of the recipient's expenses. The 1984 OECD Report gives room for interpretation, but insinuates that the second example could be applied under these circumstances, i.e. a profit element should be included in the charge if the provider is particularly

[88] Para 76 and 77, Chapter III of the OECD TP Report, 1984

capable of providing such service and the value of the service is greater that the costs for the recipient.[89]

The 2010 OECD TP Guidelines is not straightforward on this topic either. In paragraph ('para') 7.33 of the 2010 OECD TP Guidelines, reference is made to independent service providers who generally have the intention of generating a profit rather than merely just recovering costs. There are circumstances outlined in the discussion on business strategies in Chapter 1 of the 2010 OECD TP Guidelines which mentions that independent entities may not realise a profit from the performance of service activities alone, for example where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities.

'Therefore, it need not always be the case that an arm's length price will result in a profit for an associated enterprise that is performing an intra-group service'.[90]

Some countries require a profit element in the charge if the direct charging method has been used to allocate the costs in the arrangement. This should be done, according to the concerned countries, without considerations whether the services are only rendered within the MNE or to independent entities as well. The importance is to take into consideration all special circumstances of all entities within the group. For example, a group service centre's functions and situation might differ considerably from those of independent entities which render the same kind of services. A group service centre might only render its services to affiliated entities and the group service centre's only purpose could be to achieve the economies of scale. If the demand of the group service centre services decreases, it would not be able to increase its marketing expenses for the expectation of new customers as would be the case for an independent entity under the same circumstances. In this situation the group service centre should only try to cover its costs from the affiliated entities, as long as the three non-exhaustive examples are not applicable.[91]

The three non-exhaustive examples do not distinguish between direct charging and indirect charging. However, the 1984 OECD Report, states that some countries' tax authorities approve 'cost only' based contributions to a cost sharing arrangement, as long as the contributions are proportionate to the benefits received or expected.[92] There are however some countries that do not require a profit element in the remuneration of services where costs are allocated throughout indirect charging.[93]

Difference in application of profit elements between countries is concerning since it increases the risk of double taxation and disputes between tax authorities and taxpayers.[94]

[89] Para 79, Issue Three, Chapter III of the OECD TP Report, 1984
[90] Para 7.33 of the OECD TP Guidelines, 2010
[91] Para 81, Issue Three, Chapter III of the OECD TP Report, 1984
[92] Para 83, Issue Three, Chapter III of the OECD TP Report, 1984
[93] Para 84, Issue Three, Chapter III of the OECD TP Report, 1984
[94] Para 85, Issue Three, Chapter III of the OECD TP Report, 1984

5. Countries views on the problems

5.1. Overview of intra-group services in various countries

The purpose of this chapter is to investigate how different countries approach the treatment of intra-group services within a transfer pricing arena. The research explores four issues as they are the most appropriate for purposes of this research. Firstly, this research looks at countries' legislation and practices and the legal compliance of the OECD guidance. Secondly, an analysis of how countries approach the question of whether a service has been rendered. Thirdly, the research evaluates how charging methods are considered and applied in different countries and finally an exploration of how remuneration is determined in different countries.[95] The research will first look at various OECD member countries and thereafter explore various developing countries' views on intra-group services.

5.2. Overview of OECD member countries

Today, 34 OECD member countries span the globe, from North and South America to Europe and the Asia-Pacific region. They include many of the world's most advanced countries but also emerging countries like Mexico, Chile and Turkey. The OCED also works closely with emerging giants like China, India and Brazil and developing economies in Africa, Asia, Latin America and the Caribbean.[96] This section of the research will only focus on selected OCED member countries, such as the United States of America ('US, or, USA'), Canada, United Kingdom ('UK') and Australia.

5.2.1. The US TP legislation

The USA has the oldest and most developed transfer pricing legal system in the world[97] and it was enacted prior to the original OECD Guidelines. Transfer pricing in the US is governed by the Internal Revenue Code ('IRC') § 482 and the US Treasury Regulation Section ('Sec') 1.482-9 promulgated thereunder and monitored by the Internal Revenue Service ('IRS').[98] The USA is a member of the OECD but the US Regulations do not follow the OECD Guidelines on all aspects. The US



[95] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? *International Transfer Pricing Journal,* November/December , pp 435
[96] Accessed the following address: http://www.oecd.org/about/membersandpartners/
[97] Hamaekers, H., March/April 2001. Arm's Length - How Long? *International Transfer Pricing Journal,* Sec. I. Introduction
[98] The Internal Revenue Code ('IRC') § 482 and US Treasury Regulations Sec. 1.482

Regulations are very strict in comparison to other countries transfer pricing legislation and the IRS provides comprehensive regulations on transfer pricing.[99] The IRS has strong powers and is seen as having authoritative interpretations of tax law.[100]

5.2.1.1. Determining whether intra-group services have been rendered

Similar to the OECD, the US Regulations focus on the recipient of the service and not the provider. Before the 2003 Proposed Service Regulations, the benefit test focused on the render of the service. The change was to confirm the US Regulations towards the international standard and more consistency to the OECD TP Guidelines.[101] The US Regulations do not adopt a 'general benefit test' on the MNE as a whole and therefore the test does not take into consideration economies of scale. The IRS and the Department of Treasury argue that a general benefit test is inconsistent with the arm's length standard, i.e. arm's length principle. The IRS intends to restrict charges for some types of 'headquarter' services from a central source, since they only benefit the group as a whole, however it may be accepted if the benefit for the service recipient can be identified.[102]

The four different non-beneficial service activities, in the arm's length test, are somewhat similar except for the definition of shareholder activities.[103] The US definition is narrower than the OECD definition, since the US Regulations focuses on the 'sole effect' of the transaction. The service is not chargeable if the sole effect is to protect the provider's capital investment, or if the activity relates to compliance with reporting, legal or regulatory requirements of the provider.[104] The US Regulations also have a very narrow definition of duplicative services, which could only in clear cases be non-chargeable.[105] The US Regulations include examples when services are non-chargeable, which make the definitions even narrower. The US Regulations and IRS views are very strict and most services are chargeable under US Regulations.[106]

5.2.1.2. Methods used for allocating costs of intra-group services

The appropriate charging method should reflect: sound business principles, total service costs, total costs for the relevant activity, assets used, sales, compensation, space utilized and time spent. Considerations shall also be given to how the taxpayer usually allocates its costs for its general practice[107] however, the US Regulations do not bind the IRS to these considerations and the IRS does not approve of an allocation of costs which is based on generalized or a non-specified benefit.[108]

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[99] Andrus, J., 2009. 'Tax treatment of Transfer Pricing', IBFD Transfer Pricing Database and loose-leaf publications (Andrus, The IBFD TP Database), Country analysis – United States, Para. 2.5
[100] Id
[101] Levey , M. M. & Wrappe, S. C., 2007. *Transfer Pricing: Rules, Compliance and Controversy*. 2 ed. Chicago: CCH, Para. 530.01
[102] Id., Para. 530.02
[103] Hamaekers, H., 2009. 'Tax treatment of Transfer Pricing', IBFD Transfer Pricing Database and loose-leaf publications, General information on transfer pricing, Para. 13.4.1
[104] Temporary Regulations Sec., 1.482-9T(1)(3)(iv)
[105] Levey , M. M. & Wrappe, S. C., 2007. *Transfer Pricing: Rules, Compliance and Controversy*. 2 ed. Chicago: CCH, Para. 530.03
[106] Id
[107] Id., Para. 540.10
[108] Temporary Regulations Sec., 1.482-9T(k)

5.2.1.3. Calculating an arm's length consideration

The US Regulations apply open market valuation, cost oriented methods and profit methods. The US applies the Best Method Rule, which states that the arm's length price will be found under the pricing method, which gives, under the facts and circumstances, the most reliable measure of an arm's length result. This means that there are no preferable methods and there is no need to show inapplicability of another method, unless it is established that another method shows a more reliable result.[109] In the US the burden of proof is very strict and in a US court case, the court referred to it as a 'heavy burden of proof' for the taxpayer.[110]

The US has seven methods for pricing services: comparable uncontrolled service price ('CUSP') method, cost service plus ('CSP') method, gross service margin ('GSM') method, service cost method ('SCM'), comparable profit method ('CPM') and profit split method ('PSM'), and 'unspecified methods'.[111] Not all of these methods are common in practice and the most common methods are the CSP method (same as OECD's cost plus) and the CPM (similar to TNMM).

In 2006, the Treasury issued temporary regulations whereby the simplified cost based method was replaced with the SCM, which permits certain 'non-integral' services to be priced at cost. Sec. 1.482-9T(b)(4) of the temporary regulations specifies the category of covered services that are eligible for the SCM. The first category consists of specified covered services such as payroll services, general administration services, accounts payable and receivable services, meeting co-ordination and travel planning services, and staffing and reporting services. The second category of services consists of low margin covered services that have a median comparable arm's length mark-up on total services of not more than 7%. Services which usually fall into this category do not contribute to the fundamental success of the business.

Whether a profit mark-up should be used depends on whether the SCM is applicable or not. The SCM creates a theoretical discrepancy compared to the OECD cost plus method without a plus.[112] The SCM has very strict requirements compared to the 2010 OECD TP Guidelines, which addresses the circumstances where an independent entity might not expect a benefit, or the administrative burden is not justified to determine an arm's length price.[113] This makes the US SCM's application far more limiting and not to east to apply compared with the application of the OECD's 'cost only'.[114]

5.2.2. The Canadian TP legislation

Canadian transfer pricing rules are contained in Sec. 247 of the Canadian Income Tax Act and described in the Canada Revenue Agency's Information Circular 87-2R ('IC 87-2R') and various

[109] Temporary Regulations Sec., 1.482-1(c)(1)
[110] *Procacci v. Commissioner*, 94 TC 397, 414 (1990)
[111] Temporary Regulations Sec., 1.482-9T(a)(1-5)
[112] Allen, S., Wright, D. & Tomar, R., 2006. United States - Sec. 482 Services Regulations: Implications for Multinationals. *International Transfer Pricing Journal,* November/December, Para 3.3
[113] Para 7.33 and 7.37 of the OECD TP Guidelines, 2010
[114] Allen, S., Wright, D. & Tomar, R., 2006. United States - Sec. 482 Services Regulations: Implications for Multinationals. *International Transfer Pricing Journal,* November/December, Para 3.3

Transfer Pricing Memoranda ('TPM') published by the Canada Revenue Agency ('CRA'). The Canadian rules conform to the 2010 OECD TP Guidelines and the CRA endorsed the 2010 OECD TP Guidelines in the TPM 14, which was issued in October 31, 2012.[115]

5.2.2.1. Methods used for allocating costs of intra-group services

The charge for the intra-group services is determined under either the direct charge method or indirect charge method. The direct charge method is applied where the actual cost for the intra-group services is identifiable. Where the expenses are allocated using common keys, the indirect charge method is applied. The Canadian tax authorities adopt an increasingly proactive and sophisticated approach and prefer the direct charge method in determining the arm' s length price for intra-group services.

Under Canadian law, a taxpayer is first required to determine whether the activity performed by its group member constitutes a service for which a charge is justified and subsequently determine the arm' s length price for such services.

5.2.2.2. Calculating an arm's length consideration

Similar to the practices adopted in other countries, the Canadian tax authorities do not provide for any mark-up to be charged on the cost of intra-group services that are ancillary in nature[116] however, there is no specific support for this position in Canada's transfer pricing legislation.[117] The CRA states that where a charge for an intra-group service is justified the amount charged should be determined in accordance with the arm's length principle.[118] The CRA also indicates that arm's length service suppliers would usually expect to recover their cost, plus an element of profit.[119]

Based on this evidence, one would think that the CRA would allow an arm's length mark-up to be applied to inbound intra-group services irrespective of whether the service was ancillary in nature. According to the CRA, the price the recipient is willing to pay for a service often does not exceed the cost of rendering the service.[120] To illustrate its point, the CRA suggest that *'in many cases, the services provided through intra-group arrangements are administrative or ancillary in nature, and the participants would only have been prepared to centralize the activity if they could share in the cost savings. Cost may represent an arm's length charge in such situations.'*[121]

[115] Sec. 247 of the Canadian Income Tax Act
[116] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? *International Transfer Pricing Journal,* November/December, pp 435
[117] Sec. 247 of the Canadian Income Tax Act and IC 87-2R
[118] Para 163, IC 87-2R
[119] Para 159, IC 87-2R
[120] Para 163, IC 87-2R
[121] Para 163, IC 87-2R

5.2.2.3. Practical difficulties

The CRA believes that the 2010 OECD TP Guidelines support its position regarding mark-ups on intra-group services, however a careful read of para 7.33 and 7.34 of the 2010 OECD TP Guidelines suggest otherwise. In fact, the Guidelines are less definitive in its guidance on this issue.

For intra-group services, the issue may arise whether it is necessary that the charge be such that it results in a profit for the service provider. In an arm's length transaction, an independent entity normally would seek to charge for services in such a way as to generate profit, rather than providing the services merely at cost.[122]

Although situations are cited in which 'it may be' inappropriate to establish a transfer pricing policy related to intra-group services that ensures the service provider earns a profit, nowhere in the 2010 OECD TP Guidelines is it written that in all cases a mark-up on ancillary intra-group services should be disallowed.[123]

Given the inconsistency between the 2010 OECD TP Guidelines, the IC 87-2R, and the CRA's audit position, it is not surprising that foreign multinationals face significant uncertainty when addressing the issue of whether to apply a mark-up on the charges transferred to Canadian subsidiaries for intra-group services. This uncertainty is increasing the time it takes to complete audits and increasing the incidences in which Canadian taxpayers are forced to take their reassessments to appeals or seek relief from double taxation through competent authority. It has become a needless resource drain on both the taxpayer and the tax authorities involved. It is incumbent on the CRA to provide further guidance on this issue to reduce taxpayer uncertainty and reduce the associated administrative burden.[124]

5.2.3. The United Kingdoms' TP legislation

The UK's transfer pricing legislation is found in part 4 of the Taxation (International and other Provisions) Act 2010 ('TIOPA 2010'). The UK has enacted no specific legislation on management services but detailed guidance is provided by Her Majesty's Revenue and Customs ('HMRC') in its International Manual ('INTM440060'), and, consequently, where a business in the UK is paying for management services from a related party, the general rules on the deductibility of expenses applies. In general, the payment is tax deductible where the business receives a benefit for the services provided and where the payment is connected with the business and is at an arm's-length price. The UK follows the OECD Guidelines in relation to services. There is no definition of services for the purposes of UK transfer pricing and in principle anything that is not a transfer of goods could be regarded as a service.

[122] Para 7.33 of the OECD TP Guidelines, 2010
[123] Para 7.34 of the OECD TP Guidelines, 2010
[124] Rolph, B., 2012. To mark-up intra-group services or not, that is the question. *Insights: Transfer Pricing,* Charles River Associates, pp 2

5.2.3.1. Methods used for allocating costs of intra-group services

HMRC are sensitive to the characterization of services and, in particular, whether a simple service, which might qualify for cost plus treatment, also includes a licence or transfer of intangible assets, they would be reluctant to accept such treatment. Whether a service has in fact been provided or received will depend upon the facts of the case, taking into account the stipulations of the OECD Guidelines, for example by applying the benefit test.[125] Furthermore, the definition of shareholder's costs is that of the OECD Guidelines. HMRC also recognizes that there will be 'difficult borderline cases' where an activity is partly management or protection of an investment and partly of benefit to the subsidiary involved. The conclusion is that the test should be whether an independent party in comparable circumstances would pay for the benefit.[126]

5.2.3.2. Calculating an arm's length consideration

A number of services typically centralized within multinational groups may qualify for a simplified approach, under which HMRC will accept that the cost plus method can be applied without detailed evaluation. These are essentially centralized management services that are 'routine low-risk activity'. A number of tests are suggested for this which includes assessing whether the activities would attract 'modest margins of up to around 10%' and checking that they are 'of a routine and administrative nature'.[127] Examples given of services qualifying for a simple cost plus treatment are simple management services, such as payroll administration.

If services are tiered, in the sense that one is incorporated within another for the purposes of delivery and charging, then the principal concern in the UK is to ensure that the profit element is not added twice (margin stacking). Where the UK receives a charge calculated in this way, it is important to be able to demonstrate what the underlying costs are, how they are allocated to the UK and what mark-ups were applied to which costs.

5.2.4. The Australian TP legislation

In January 1999, the Australian Tax Office ('ATO') issued its taxation ruling on services: Income tax: international transfer pricing for intra-group services ('TR1999/1'). In it, the ATO outlined its position in relation to charging for services within a multinational group. In general, the ruling follows the international consensus on the arm's length principle and its application, expressed in chapter VII of the 2010 OECD Guidelines.

The ruling generally covers the internal arrangements for the provision of a wide range of services for the constituent parts of a multinational enterprise, for example administrative services such as planning, accounting and auditing a worldwide advertising campaign, etc. There is currently no Australian case law addressing the definition of services for the purposes of applying the transfer

[125] HMRC International Manual (INTM440060)
[126] Id
[127] Id

pricing rules and management fees paid by Australian taxpayers are subject to the general rules of deductibility under Sec. 8-1 of the Income Tax Assessment Act 1997.

To conform to the arm's length principle, the costs of intra-group services can only be charged for where the recipient of the services expected, at the time the relevant activities were undertaken, to derive a benefit from those activities. The expected benefit must be sufficiently direct and substantial so that an independent recipient, in similar circumstances, would be prepared to pay for it. If no benefit has been provided (or was expected to be provided), then it is not possible to charge for the relevant activity.

5.2.4.1. Calculating an arm's length consideration

Where a service has been provided, the ATO expects a profit element will be derived by the provider of the services on the basis that an arm's length price would expect a profit element. To determine the appropriate mark-up to apply when performing the cost plus method, taxpayers need to undertake a benchmarking study. When performing the study it is important to consider the nature of the services provided and consideration of whether the services are routine or non-routine in nature.

In determining an appropriate mark-up, consideration should also be given to whether one of the two administrative concessions (or safe harbours) outlined by the ATO in TR1999/1 apply. These practices represent two separate instances where the ATO will not seek to adjust profit margins attached to services between international related parties, and therefore not strictly enforce the arm's length principle, where an adjustment might otherwise be authorized.

The two instances relate to ***non-core services*** and ***de minimis cases.***

Non-core services

The safe harbours may be used for non-core services supplied or acquired by foreign associated enterprises to Australian group companies only where all of the following conditions are met:

- the amount charged for all non-core services supplied or acquired by/to Australian group companies by their foreign associated entities is not more than 15% of the total accounting expenses/revenue of the Australian group companies in the year;
- the transfer price for these services is not more than the relevant costs incurred plus 7.5% of those costs. A transfer price of up to cost plus 10% (or down to 5%) would be accepted for non-core services where it is established by the taxpayer's group that it is the practice of the other country involved to require that price (or mark-up) in respect of such services for its tax purposes. However, in such cases, the foreign jurisdiction must also accept the same price (or mark-up) in respect of services provided by Australian companies to associated entities resident in that country; and
- adequate documentation is kept.

***De minimis* cases**

The ***de minimis*** case applies where the total direct and indirect costs of supplying services to Australian or foreign associated entities, as appropriate, do not exceed AUD 500,000 in a year. The practice will apply to all intra-group services supplied or acquired where the relevant cost limit is not exceeded and all the following conditions are met:

- the transfer price for these services is not more than the relevant costs incurred by the foreign associated entities plus 7.5% of those costs. A transfer price of up to cost plus 10% (or down to 5%) would be accepted for non-core services where it is established by the taxpayer's group that it is the practice of the other country involved to require that price (or mark-up) in respect of such services for its tax purposes. However, in such cases the foreign jurisdiction must also accept the same price (or mark-up) in respect of services provided by Australian companies to associated entities resident in that country; and

- adequate documentation is kept.

5.2.5. General comments relating to safe harbours

The OECD Transfer Pricing Guidelines define a safe harbour, or safe haven, as a circumstance in which taxpayers could follow a simple set of rules under which transfer prices would be automatically accepted by the national tax administration. Benefits for a safe harbour include the reduction of taxpayer's compliance costs. This is particularly beneficial for routine services as the amounts involved are frequently not significant. Although the requirement to document the intra-group services remains, there is no longer a need for a benchmarking analysis to determine the cost plus mark-up. Other benefits include providing taxpayers certainty on an acceptable mark-up.

As discussed above Australia as well as other countries such as Austria, New Zealand and Singapore have adopted the safe harbour for intra-group services to simplify transfer pricing compliance and reduce the administrative burden. The OECD has warmed to the idea through their Discussion Draft for a low value-adding intra-group services safe harbour as outlined in the BEPS Action item 10 which will be discussed in further detail in Chapter 7.

A broad overview of the services covered, safe harbour margins and the prescribed transfer pricing methodology is presented in Appendix A. Further, countries such as Hungary, Japan the Netherlands and US have simplified their transfer pricing measures for intra-group services, as discussed in Appendix B.

Safe harbours are optional for taxpayers and besides the routine and non-core service type requirements there are also limits to the percentage of the service charge to total expenses. In addition, New Zealand and Australia (as discussed above) allow a minimum dollar threshold for other services that would not be defined as non-core that can also use the safe harbour however, this is only the case if no other transfer pricing policies are applied for other services.

In determining whether the safe harbour rules are applicable it is necessary to note the following points:

- all companies in the group must use the same mark-up on costs for services supplied to or acquired from associated entities in the same country;
- the taxpayer must maintain documentation that establishes the benefits provided, i.e. what services are chargeable, and the cost of providing the services. Further, the classification of the services as core or non-core needs to be documented;
- when classifying services, research and development cannot be included in non-core services; and
- where a transfer pricing method has been applied to the aggregate level of the group, for example the TNMM, then neither of the administrative practices may apply. This still allows for these services to be charged at cost plus 7.5% but the entity as a whole must still satisfy the TNMM profit level indicator.

5.2.5.1. Challenges for safe harbours

Inconsistent rates

As discussed throughout the research, various jurisdictions have different mark-up rates. These safe harbours don't work when dealing with other tax jurisdictions with conflicting rates. Australia and New Zealand do however have a 2.5% tolerance if they are dealing with another country that has an established policy for a mark-up. In this case, a 5% mark-up for services between either Australia or New Zealand and Singapore would qualify.

All-in or All-out

Several safe harbours including the proposed OECD Discussion Draft require global consistency for the policy. Conceptually this is reasonable and provides fairness however this is not an option for taxpayers that experience inconsistent safe harbour mark-up rates in different jurisdictions.

Complexity

Historically, safe harbours have often been viewed as a tool that is of benefit only to the taxpayer and not the tax authority. As mentioned in the IRS's 1988 *A Study of Intercompany Pricing* white paper, safe harbours were described to '*all have one common element that makes them both attractive to the taxpayer and potentially troublesome to the government: they generally would serve only to reduce tax liability*'. Even though the OECD recognized in the 2012 Safe Harbour Discussion Draft that certain safe harbours can provide more optimal use of tax administration's resources, a lot of safe harbour rules contain complex requirements for qualification of these routine services.

The table below is a summary of the US, Canada, the UK and Australia's approach towards intra-group services within a TP context:

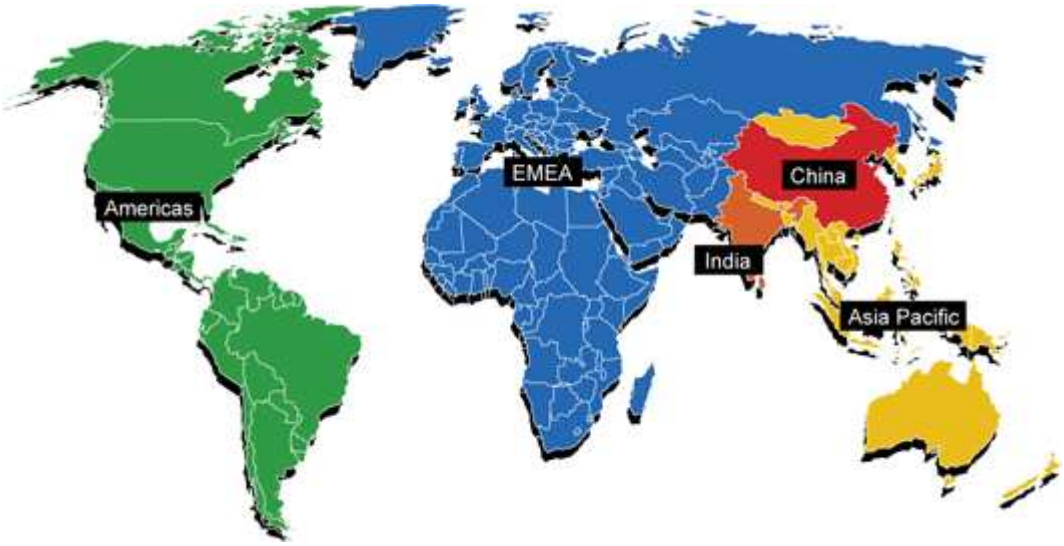
Table 4: Summary of the US, Canada, UK and Australia's approach towards intra-group services

	USA	Canada	UK	Australia
Guidance on Services	(Treas. Reg. § 1.482-9T)	Part 6 of IC 87-2R	International Manual (INTM440060)	Taxation Ruling on Services: TR1999/1
Services Defined in Local Legislation	Yes	No	No	Yes
Following the OECD Approach	Yes	Yes	Yes	Yes
Following the UN Approach	No	No	No	No
Case Law	***Young & Rubicam Inc. v. US. Westreco Inc. v. Commissioner. Etc.***	***General Electric Case. GlaxoSmithKline Case. Etc.***	No	No
Following the Benefit Test	No	Yes	Yes	Yes
Methods Applied	Comparable uncontrolled service price - CUSP method	CUP method	CUP method	CUP method
	Gross service margin method - GSM	Cost plus method	Cost plus method	Cost plus method
	Cost service plus method - CSP			
	Service cost method - SCM			
	Comparable profit method - CPM			
	Profit split method - PSM			
	Unspecified method			
Safe Harbour Rules	Yes	No	Yes	Yes
Non-Core Services	services cost less than or equal to 7%	Admin services are compensated on a cost recovery basis.	Cost plus 10%	Cost plus 5% to 10%
Justification of a Mark-Up	No specific guidance	Services which are based on efficiency, expertise and other similar commercial considerations will include a profit element.	No specific guidance	No specific guidance
Documentation Requirements for Intra-group services	There are no documentation rules unique to services transactions.	There are no unique or special documentation requirements.	Documentation requirements for services follow the general rules for TP documentation.	There is no legal requirement to have TP documentation.
Common Audit Issues	1. Whether the pool of costs to be allocated is large enough (and includes all direct benefits and overheads). 2. Whether the taxpayer's methods for allocating and apportioning costs among subsidiaries are appropriate. 3. Whether any holdbacks for shareholder services/stewardship are appropriate.	1. If services were provided and if they offered incremental value to the taxpayer or if they are more akin to 'stewardship'. 2. Or whether the transfer includes a discrete but embedded transfer of intangibles which non-resident withholding tax would apply.	1. Whether a service was received. 2. The underlying costs. 3. The allocation of those costs if an indirect method is used. 4. The mark-up applied if the cost-plus method is used. 5. Whether all the relevant services have been charged and, if the cost plus method is used, that sufficient cost has been charged out.	1. Proof of benefits for the service recipient. 2. Determination of the cost base. 3. Determination of the level of mark-up applied to the cost base.

5.3. Overview of emerging markets

This research intends to highlight some of the challenging issues faced by emerging countries, and to share China and India's practical experience in dealing with intra-group services.

The OECD Transfer Pricing Guidelines have been the 'gold standard' for tax administrations and taxpayers to apply the arm's length principle for the valuation, for tax purposes, of cross-border transactions between related parties for much of the period since the original version of the guidelines were first issued in 1995. As the world economy becomes increasingly globalized, transfer pricing is an issue faced not only by developed countries, but is increasingly a critical matter for developing countries. Such nations face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines. Therefore, while much of the OECD guidelines may still be applicable to developing countries, the UN Transfer Pricing Manual should put a special focus on offering practical solutions to issues faced by developing countries.[128]



China started looking into transfer pricing issues in the late 1990s. While the early focus of transfer pricing investigations was mostly on tangible goods transactions, it has since been expanded into a range of other transactions, and in particular, those involving intangibles and services. As a developing country, China faces a number of difficult challenges, many of which remain unanswered by the OECD Guidelines. These include a lack of appropriate comparables, quantification and allocation of location-specific advantages, and identification and valuation of intangibles. The UN Transfer Pricing Manual must address these common issues for it to be useful to developing countries.[129]

[128] United Nations (UN), 2013. UN Practical Manual on Transfer Pricing for Developing Countries, New York: UN, pp 374
[129] Id, pp 375

5.3.1. The Chinese TP legislation

The Corporate Income Tax Law of the People's Republic of China ('CIT Law')[130] and its Implementation Regulations ('CIT Implementation Regulations')[131] provide the legal framework for transfer pricing enforcement and require that contemporaneous documentation be prepared. The Chinese tax authority is called the State Administration of Taxation or ('SAT'). In order to carry out and implement the CIT Law and its Implementation Regulations and regulate and strengthen the administration of special tax adjustments, on 9 January 2009, the SAT formally issued Circular Guo Shui Fa [2009] No. 2, Implementation Measures of Special Tax Adjustments (Trial Version) ('The Measures'), which contained the long-awaited details of the contemporaneous transfer pricing documentation requirements in China. In addition, China's transfer pricing legislation has drawn upon the 2010 OECD TP Guidelines with specific attention to TP methodologies, comparability analysis, transfer pricing documentation and APA processes.[132]

The SAT is of the view that service fees paid and received by related parties must be in accordance with the arm's length principle. Tax authorities are empowered to make adjustments if an intercompany transaction reduces the taxable income or revenue of the entity and which is determined not to be in compliance with the arm's length principle. Management fees as described in Article 49 of the CIT Implementation Regulations are quite expansive and are explicitly not deductible for income tax purposes. The SAT explains that management fees defined in the law, in general, relate to shareholder activities carried out by a parent company in its capacity as a shareholder and charged on the basis of the relationship between investors and investees. The SAT concedes that entities often take tax deductions for intra-group service fees, including management fees, under the category of service fees.[133]

5.3.1.1. Determining whether intra-group services have been rendered

The tax authorities in China determine the arm' s length price for intra-group services by applying six tests, namely the benefit test, the necessity test, the duplication test, the value creation test, the remuneration test and the authenticity test.[134]

5.3.1.1.1. The benefit test

The service fee should not be charged merely because the subsidiary may benefit from such services. The benefit test should be performed from the perspective of both the service provider and recipient. This helps further explain the SAT's views of the definition of shareholder services in the OECD TP Guidelines, which SAT believe is too narrow.

[130] Articles 41 to 44, article 46 and 48 of CIT Law, Effective 1 January 2008
[131] Articles 109 to 115 and articles 121 to 123 of the CIT Implementation Regulations
[132] PwC., 2015. 'Transfer Pricing Country Guide', PwC TP123 Database, Country analysis-China, [https*://tp123.pwc.de/Guide/Download*
[133] Chong, S. & Yuan, J., 2014. China SAT's views on intra-group services and management fees. *Tax Insights from Transfer Pricing Tax Controversy and Dispute Resolution*, 18 April, pp 1-3
[134] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? *International Transfer Pricing Journal,* November/December, pp 435

5.3.1.1.2. The necessity test

When performing the benefit test, analyses should also be made with regard to whether the services are necessarily needed by the subsidiary.

5.3.1.1.3. The duplication test

Consideration should be made with regard to whether the provision of various services has already been remunerated through the transfer pricing policies of other related party transactions. In SAT's view, mere control (e.g., management decision approval from the parent companies due to authorisation requirements) is likely to be duplicative activities and should not be charged.

5.3.1.1.4. The value creation test

The SAT expects taxpayers to demonstrate value add from the services provided by offshore parent companies. Further, such efforts should also be consistent with the characterization of the local entity's function and risk profile.[135]

5.3.1.2. Practical difficulties

Based on recent public reports, the major controversy surrounding intra-group services in China concerns the cost allocation keys used and the consistency in the cost allocation carried out under the inter-company agreements.

Another practical difficulty faced by tax authorities is that they are not provided with the details regarding the group entities providing such intra-group services, which in turn makes it difficult for tax authorities to validate the authenticity of the services received and the reasonableness of the associated allocation mechanisms.

The SAT and the local tax bureaus have recently been focused on intra-group service transactions. According to recent public reports, the SAT have concluded several transfer pricing audit cases on intra-group service charges and the controversy between the tax administration and taxpayers almost without an exception are related to the definition of cost pools, consistency between business reality and intercompany agreements and the selection of allocation keys.[136]

5.3.2. The Indian TP legislation

The Indian Regulations i.e., Indian Income Tax Act, 1961 contain a separate code on transfer pricing, as per which 'international transactions' or 'specified domestic transactions' between 'associated enterprises' should be undertaken at an 'arm's length price'. Indian transfer pricing rules are described in Sec. 92 to 92F of the Indian Income Tax Act and Rules 10A to 10E of the Income Tax Rules, 1962 ('the Rules'). In addition, the Institute of Chartered Accountants of India ('ICAI') have

[135] Chong, S. & Yuan, J., 2014. China SAT's views on intra-group services and management fees. *Tax Insights from Transfer Pricing Tax Controversy and Dispute Resolution*, 18 April, pp 1-3
[136] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? *International Transfer Pricing Journal,* November/December, pp 435

issued a guidance note on transfer pricing. The scope of transactions covered under the Indian regulations is fairly exhaustive, so as to include any transaction having a bearing on an entity's profits, income, losses, assets, etc.

In order to provide uniformity in application of transfer pricing law there is a specialized Directorate of Transfer Pricing to administer transfer pricing rules under the supervision of the Director General of Income Tax (International Taxation). Transfer Pricing Officers ('TPO') are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. A dispute resolution panel (in short DRP) is available to taxpayers to resolve disputes relating to transfer pricing before disputes over a final written order by an Assessing Officer (which incorporates the written order of the TPO).

Over the past ten years, the Indian transfer pricing administration has witnessed several challenges in the administration of transfer pricing law. One of the most prevalent issues litigated by India tax authorities concerns payments to related entities for intra-group services.

Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support between one or more locations by way of shared services. Since these intra-group services are the main component of 'tax efficient supply chain management' within an MNE group, the Indian transfer pricing authorities attach high priority to this aspect of transfer pricing.[137]

The Indian Income Tax Act has not specifically laid down any provisions regarding the determination of the arm's length price for intra-group services, although there are provisions discussing cost contribution or cost allocation.[138] The absence of specific guidelines has resulted in a significant increase in litigation involving intra-group transactions. The tax authorities and taxpayers reference the OECD Guidelines, UN Practical Manual on Transfer Pricing for Developing Countries and the Guidelines issued by the EU Joint Transfer Pricing Forum in dealing with intra-group services. The discussion below focuses on the main issues faced by taxpayers in India in justifying the arm's length price for intra-group services during the course of an audit by the Indian tax authorities.[139]

Experience in TP audits shows that the TPOs expect a taxpayer to undergo the following tests:

(i) willingness to pay test;

(ii) evidence test;

(iii) benefit test; and

[137] UN, 2013. UN Practical Manual on Transfer Pricing for Developing Countries, New York: UN, pp 402
[138] Income Tax Act 1961, sec. 92, National Legislation, IBFD
[139] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? *International Transfer Pricing Journal,* November/December, pp 433

(iv) arm's length test.

The responses to the above tests enable the Indian TP authorities to determine if the Indian subsidiary has received or provided intra-group services that require arm's length remuneration. It has been observed that most of the TP adjustments arise on account of the inability of the taxpayers to provide appropriate documentation to support the benefits test. Some of the recent rulings with respect to intra-group services are provided below.

Rulings against the taxpayer

Bangalore Tribunal held in *Gemplus India Pvt Ltd*. that since the taxpayer had been unable to prove a commensurate benefit received for the service fee paid to its associated entity, management fees paid by the taxpayer were not deductible.

In another ruling by Delhi Income Tax Appellate Tribunal ('ITAT') in *Knorr-Bremse India Pvt. Ltd.* (TS-700-ITAT-2012(DEL)-TP), the ITAT held that no cost contribution, cost reimbursement or payment for management support services to the associated entity was required as only an incidental and passive association benefit was received by the Indian company. It rejected the use of the TNMM for benchmarking these transactions as all the transactions were not 'closely linked with each other'.

Rulings in favour of the taxpayer

The Delhi Tribunal in *AWB India P. Ltd. v. Addl. CIT* (ITA No. 4454/Del/2011) held that payment of management fees (services included corporate risk advisory, human resources, legal, trading and marketing, etc.) was allowed as a deduction as the taxpayer had demonstrated the benefits test by producing appropriate evidence of availing of such services. ITAT concluded that the revenue authorities are not empowered to question the taxpayer's commercial wisdom and it is entirely for the taxpayer to take such decisions as favour the advancement of its business. Furthermore, the Delhi bench of ITAT had taken a similar view in *McCann Erickson India Pvt. Ltd. v. Addl. CIT* (ITA/No. 5871/Del/2011).

Similarly, in the case of *TNS India Private Limited v. ACIT* (ITA No. 7/Hyd/2012), the Hyderabad Tribunal held that the revenue authorities could not question the business prudence of the taxpayer for making payments in respect of services received.

5.3.2.1. Determining whether intra-group services have been rendered

The tax authorities typically request first that the taxpayer demonstrate the receipt of intra-group services with supporting documentary evidences. If the taxpayer fails to prove the receipt of intra-group services, the tax authorities tend to disallow the entire expense and determine the arm' s length price for the payment of intra-group services at nil.

The taxpayer in *Quintiles Research (India)*[140] had submitted voluminous evidence in the form of invoices to the tax authorities evidencing the receipt of intra-group services. Although the Bangalore bench of the Income Tax Appellate Tribunal ('the Tribunal') agreed to the existence of evidence on record as regards the allocation of cost and the basis of such allocation, the Tribunal observed that invoices per se did not demonstrate the nature of services received, and directed the taxpayer to link the invoices to the emails describing the nature of the intra-group services.

5.3.2.2. Determining benefits from the receipt of intra-group services

During audits, taxpayers are required to satisfy the benefit test as well as the arm's length test. Taxpayers are specifically asked to produce detailed documentary evidence to substantiate the actual delivery of services by their foreign affiliates. Producing the copy of a debit note, invoice, service agreement, etc. is not considered reliable by the tax authorities. Considering the nature of such services, at times it is practically difficult to obtain and maintain evidence in the form of detailed documents.

On the other hand, in relation to the provision of services by Indian entities to their affiliates, the tax authorities during audits inquire as to the functions of employees, their qualification and the nature of their job, in order to assess whether any commercial services have been provided by the taxpayer and whether these have been appropriately compensated.

Further, during recent audits, it has been observed that the tax authorities treat certain non-integral services, viz. administrative services, centralized support services, marketing support services, etc., as intra-group services, requiring cross-charges, and attribute a mark-up on the same. This has resulted in substantial adjustments for taxpayers.

The tax authorities in India also require that the taxpayer determine the quantum of benefit derived from intra-group services received from its related parties. The mere existence of service agreements would not justify the benefits received by the taxpayer for the payment towards intra-group services.

The Mumbai Bench of the Tribunal in *Dresser Rand India*[141] held that it was irrelevant for the tax authorities to determine whether the intra-group service was beneficial to the taxpayer. The Tribunal held that the tax authorities cannot question the commercial necessity of the taxpayer, and that the tax authorities must restrict themselves in determining the arm's length price for intra-group services.

In a few other rulings, the Tribunal held that payments for intra-group services were at arm' s length where the taxpayer had demonstrated the benefits received from the intra-group services and the tax authorities could not examine the commercial necessity of the services to the taxpayer.

[140] *Quintiles Research (India) Private Ltd v. Deputy Commissioner of Income Tax [2014],* Bangalore IT(TP)A No.1605/Bang/2012
[141] *Dresser Rand India Pvt. Ltd. v. DCIT*, ITA 8753/Mum/2010

5.3.2.3. Determining the cost base

Under the Indian cost plus method, the mark-up has to be applied on the total cost which consists of both direct and indirect costs. Thus, determination of the cost base is as important as determination of the margin. The indirect costs have been determined by applying certain allocation keys that when computed are significantly higher than the direct cost itself. Furthermore, the analysis would also require examining whether the costs incurred by the group service provider need some adjustment to make the comparison of the controlled and uncontrolled transactions reliable. During an audit, the pass-through costs incurred by the Indian entity, which was reimbursed on a cost-to-cost basis by the foreign affiliate, was also evaluated by the tax authorities to be included in the cost base for the purpose of computing the arm's length price of the taxpayer.

The Delhi ITAT in *Cheil Communications India Pvt. Ltd. v. DCIT* (ITA 712/Del/2010) has held that the pass-through costs do not warrant a mark-up and should be excluded from the cost base when computing the margin of the company. Similarly, in the case of *HSBC Electronic Data Procesing India Limited v. ACIT* (ITA No. 1624/Hyd/2010), the Hyderabad Tribunal held that reimbursement costs should be excluded from the cost base of the taxpayer while determining the mark-up, as such cost does not involve any functions to be performed so as to consider it for profitability purposes.

5.3.2.4. Documentation requirements

Documenting intra-group services received by the taxpayer is extremely significant in establishing the legitimacy of intra-group service charges before tax authorities. Although Sec. 92D of the Indian ITA and Rule 10D of the Rules prescribe general requirements for transfer pricing documentation, no specific guidance is provided in the context of intra-group services. The taxpayer should provide documentary evidence such as copies of reports, email correspondence and other relevant records as may be required during the course of assessment to the tax authorities.

The Bangalore Bench of the Tribunal in *Festo Controls*[142] observed that the taxpayer had not determined the arm' s length price for intra-group services in its transfer pricing documentation under any of the methods prescribed in Sec. 92C of the Indian ITA. The Tribunal directed the taxpayer to establish various aspects such as the nature of services, the details of the related entity rendering such services, other group entities that are recipients of such services and the costs incurred by the related party in rendering the intra-group services in the transfer pricing documentation maintained by the taxpayer, so as to determine the arm's length price.

The Delhi Bench of Tribunal in *Atotech India*[143] acknowledged the fact that the taxpayer had maintained detailed documentation and other relevant agreements, contracts, arrangements and invoices in substantiating the arm's length nature of the transaction and directed the tax authorities to

[142] *Festo Controls Pvt. Ltd. v. DCIT*, IT(TP) A 969/Bang/2011
[143] *Atotech India Ltd.*, ITA 104/Del/2012

consider the documentation submitted by the taxpayer and to determine the arm' s length price for the intra-group services.

The table below is a summary of China and India's approach towards intra-group services within a TP context:

Table 5: Summary of China and India's approach towards intra-group services

	China	India
Guidance on Services	No	Sec. 92B(1) of the Act
Services Defined in Local Legislation	No	Yes
Following the OECD Approach	Yes	Yes
Following the UN Approach	No	Yes
Case Law	No	Yes, many cases
Following the Benefit Test	Yes	Yes
Methods Applied	CUP method	CUP method
	Cost plus method	Cost plus method
		TNMM
Safe Harbour Rules	No	No
Non-Core Services	No specific guidance	Cost plus 10% to 15%
Justification of a Mark-Up	There is no explicit requirement for a profit element.	Business Process Outsourcing services are classified as high end services.
Documentation Requirements for Intra-group services	There are no special documentation requirements.	No specific guidance has been given.
Common Audit Issues	1. Determination of the amount or cost of services. 2. Management fees are understood to be those related to shareholder activities, which are charged on the basis of an associated relationship between investors and investees, therefore not deductible.	1. Classification of non-chargeable services. 2. Inability of taxpayers to provide the necessary documentation to prove the benefits test. Benchmarking issues – whether transactions should be aggregated or not. 3. Costs to be determined for calculation of the cost base by using appropriate allocation keys. 4. Whether a mark-up on costs is allowed and treatment of pass-through cost. 5. Basis of allocation of certain elements of common cost and the allocation keys used.

5.4. Overview of developing countries

5.4.1. Transfer pricing and developing countries

There is a growing mindfulness on the part of developing countries of the risks presented by transfer pricing. Their goal in addressing these risks is identical to that of developed countries – to protect their tax bases while continuing to attract foreign direct investment and facilitate cross border trade. It is essential to note that for some developing countries the tax base is still relatively small and for a subset it is still less than the aid they receive. Consequently it is predictable that many developing countries are inexperienced in dealing with transfer pricing issues and their top priority is to assess the level of potential transfer pricing risk in their own country and growth capability and increase capacity in their tax administrations to effectively address that risk.[144]

An early objective for developing countries should be to ensure that they have put in place with their main trading partners double taxation agreements with effective exchange of information provisions and domestic laws that enable them to secure necessary information and documentation. Developing countries will also want to make use of the internationally agreed principles of the OECD Transfer Pricing Guidelines to help in the battle to stop the transfer of profits abroad while restraining the double taxation of profits for international groups.

An African Tax Commissioner's experience when obtaining relevant information with regards to management fees is described below:

'Management fees are one of the many ways that multinational entities are using to reduce taxable profits in African countries. Usually these fees have no relationship with the actual cost of providing any management services but are just expressed as a fixed percentage of revenues. When questioned about the justification of the fees, the multinational entities provide a figure of head office expenses that has been apportioned to the entity which eventually bills the African entity. When requested to provide the trial balances of the head office so that the tax administration can apply its mind to the expenses apportioned, a multinational's subsidiary or branch says that it does not have access to that information. The conclusion the taxpayers make is that even if a direct method of charging the African entity was used, the results would have been the same or an even higher charge could have been made to the African entity.'[145]

'Often management fees are charged where the local company has competent and capable management of its own. There is often visible duplication of functions and/or services but multinational entities seek to find ways of explaining away any duplication. Auditors and inspectors are sometimes not sure what criteria to apply to decide whether to accept these explanations as valid. For example, the taxpayer will usually describe a lot of value adding activities that the parent company or related party is performing, and yet these aspects will be outside the scope of the

[144] Organisation for Economic Co-operation and Development (OCECD), 2012, Transfer pricing and developing countries, in *Dealing Effectively with the Challenges of Transfer Pricing*. Paris: OECD, pp 68
[145] Id

contract signed between the related parties, and the contract is the only legal basis of the management fees that are being paid.'[146]

It is apparent how problematic transfer pricing can be and the particular difficulties associated with the issue of management fees and that a lack of good quality commercial information in developing countries is a major challenge for their tax administrations.

5.4.2. African exchange controls

Foreign investors are critical of African exchange controls however there are valid reasons why developing countries still have them. Central banks argue the need to monitor and control the repatriation of foreign currency to and from their countries, to protect the currency by ensuring fair value has been obtained for offshore payments and to prevent abuse. Central banks in Africa have argued that in the global financial crisis they have proved their worth. The arguments against exchange controls are that they hamper business which is bad for the economy. Both arguments are valuable.[147]



Exchange regulations differ from country to country and an offshore investor needs to become familiar with the requirements of each, how it affects inward and outward remittances, and its relevance to foreign personnel working in Africa. Most countries with exchange regulations also have detailed requirements on approvals and supporting documentation, and some countries such as Nigeria will generally not permit retrospective approvals in certain circumstances.

While there may not be country-specific legislation on transfer pricing, most follow the arm's length principle. Authorised dealers may require evidence that specific services were actually rendered in that country. For technical and consultancy services in Nigeria, copies of passports, air tickets and hotel bills, evidence of tax paid on the amount to be remitted and fair and market related service charges with supporting invoices from the service provider must be submitted. There may also be percentage caps in place to prevent excessive outward remittances. The National Office for Technology Acquisition and Promotion ('NOTAP') regulates the provision of management and technical services between a Nigerian company and a non-resident provider regardless of whether the parties are related.

[146] Organisation for Economic Co-operation and Development (OCECD), 2012, Transfer pricing and developing countries, in *Dealing Effectively with the Challenges of Transfer Pricing*. Paris: OECD, pp 72
[147] Harding, C., 2010. 'African exchange controls – almost everywhere you go', how we made it in Africa, Insight into business in Africa

Central or reserve bank approvals are inevitably involved, but this varies, often depending on the extent to which the state has developed exchange control monitoring and compliance to the banks. In some countries, the central bank has held on to this responsibility. In Mozambique, the remittance of funds to offshore jurisdictions requires pre-approval of the relevant agreement by the central bank. Every individual payment requires pre-approval from the central bank and disclosure of the company's financial capacity to proceed with the payment must be given by the company's commercial bank. The central bank also requires proof of any related withholding tax compliance.[148]

5.4.3. The South African TP legislation

Sec. 31 of the South African Income Tax Act No.58 of 1962 ('ITA'), empowers the Commissioner of the South African Revenue Service ('SARS') to adjust the transfer price between connected parties to an international transaction to reflect an arm's-length price for the supply of goods or services. The terms in the above statement can be explained as follows:

An international agreement includes, *inter alia*, a transaction, operation or scheme entered into between a resident and any other person that is not a resident.

A connected person includes, *inter alia*, a holding company of a subsidiary company and vice versa, as well as co-subsidiary companies of the same holding company.[149]

Practice Note 7 has been drafted to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's-length prices. The Practice Note states that the Commissioner intends following the guidelines set out therein when conducting transfer pricing reviews.

Therefore, although the Practice Note is merely a guideline and does not form part of the law as such, it is nevertheless the starting point for a taxpayer in formulating its transfer pricing policies as far as it concerns its cross-border transactions with connected parties.

Whilst there is no statutory requirement in South Africa to prepare or maintain transfer pricing documentation, SARS expects taxpayers to contemporaneously document the process that they follow in determining arm's-length prices.

South Africa is still in its infancy with respect to auditing related party cross-border transactions, even though transfer pricing concepts have been in existence in South Africa for some time. SARS has only in the last few years begun to aggressively audit transfer pricing owing mainly to a lack of resources and skills challenges. At the same time, South African companies belonging to multinational groups are also starting to focus on their transfer pricing compliance.[150]

[148] Harding, C., 2010. 'African exchange controls – almost everywhere you go', how we made it in Africa, Insight into business in Africa
[149] Sec. 31 of the South African Income Tax Act No.58 of 1962
[150] UN, 2013. UN Practical Manual on Transfer Pricing for Developing Countries, New York: UN, pp 410

SARS has also in recent years expanded the transfer pricing questions contained in the company tax returns. In answering these questions the taxpayer is required to make full disclosure of all requested, as well as any relevant, information. If there is non-disclosure of material facts the assessment may be re-opened even if the normal three-year prescription period for the particular assessment concerned has expired.

The taxpayer is required to retain a copy of its transfer pricing policy document and supporting agreements for each relevant year of assessment, in support of the tax return filed. In order to substantiate that cross-border transactions between connected parties have been conducted at arm's length, SARS may request that such information be provided to them. If the taxpayer fails to provide transfer pricing documentation to support the arm's-length nature of its transfer prices there is a risk that SARS will conduct a transfer pricing audit and examine its transfer pricing policies in detail. In the event that SARS, as a result of the examination, adjusts the transfer price adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut the adjustment bearing in mind that the onus of proving the prices set are at arm's length rests with the taxpayer.

5.4.3.1. Relevant information to the taxpayer's business

The Practice Note also provides that due regard should be had to the taxpayer's business strategies and the economic circumstances in which the taxpayer operates when arm's-length prices are determined. This may include strategies pertaining to losses, intentional set-offs, market penetration policies, etc.

5.4.3.2. Status of the OECD Guidelines

It is mentioned in the UN Manual on Transfer Pricing that whilst the OECD Guidelines have been particularly useful in providing a conceptual understanding of *what* is the nature of the arm's length principle, there are instances when the Guidelines fail to address the more practical aspects of *how* to apply the principle.[151] This contribution shares South Africa's experience in applying the arm's length principle and shows how South Africa attempts to work around some of the practical shortcomings.

Due to the international importance of the OECD Guidelines, the Practice Note is based on, *inter alia*, these Guidelines. Although South Africa is not a member country of the OECD, the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard.

The OECD Guidelines should be followed in the absence of specific guidance in terms of the Practice Note, the provisions of Sec. 31 or the tax treaties entered into by South Africa.

[151] UN, 2013. UN Practical Manual on Transfer Pricing for Developing Countries, New York: UN, pp 410

5.4.4. Overview of intra-group services in South Africa

The challenge in establishing whether or not payment for a service is at arm's length goes further than the two step approach set out in chapter VII of the OECD Guidelines, which stipulates that the test for establishing the arm's length nature of intra-group services is twofold. Firstly, it must be determined if a service has been rendered and second, it must be determined if the charge for such service is arm's length (para 7.5 of the OECD Guidelines).

As regards the first test, the approach followed is to determine if the services:

- Provide the recipient with economic and commercial benefit;
- Are not services that the recipient is already performing for itself (duplicate service test); and
- Are not shareholder services.

As regards the second part of the test, the audit approach seeks to confirm the following:

- That the cost base is appropriate to the services provided;
- That the mark-up is arm's length;
- That the allocation keys applied are commensurate to the services provided.

In particular, para 7.29 of the OECD Guidelines states that in determining the arm's length prices for intra-group services the matter should be considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient and the costs to the service provider.

Practice Note 7 refers to chapter VII of the OECD Guidelines, which deals specifically with intra-group services and confirms that SARS considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving intra-group services.[152] There are no specific rules dealing with the supply of services nor is there any case law on this matter.

If intra-group services are rendered in the context of an affected transaction, it must be demonstrated that the South African taxpayer benefited from the particular service before an arm's length fee can be determined. The allocation of central administration/management expenses to South African subsidiaries on a basis such as turnover or profit is generally not acceptable by SARS or by the Financial Surveillance Department ('FinSurv') of the Reserve Bank.

To the extent that services are rendered for the benefit of the shareholders, costs related to such services cannot be charged to the subsidiaries. Such expenses will generally be non-deductible expenses since they are incurred to either earn exempt dividend income or capital gains (taxable at differential rates).

According to the Practice Note, the cost plus method is best suited where connected persons have concluded a long-term buy-and-supply arrangement and service agreements. The cost plus method

[152] SARS Practice Note 7

begins with identifying the costs that the service provider incurs when it renders services to a related party. An appropriate mark-up is then added to these costs, which should provide for an appropriate profit to the supplier in the light of the functions performed, assets used and risks assumed.

The mark-up employed in the cost plus method should, according to the Practice Note, be determined:

- With reference to the mark-up earned by the same supplier of goods or services in uncontrolled transactions, or if this is not possible;
- With reference to the mark-up earned in a comparable transaction by an independent supplier performing comparable functions, bearing similar risks, and employing similar assets to those of the taxpayer.

Practice Note 7 acknowledges that the application of the cost plus method presents some difficulties, especially in cases where a company is simply more efficient than a comparable supplier or where there is no discernible link between the costs incurred and a market price.

5.4.4.1. Documentation requirements

SARS would expect to see a services agreement between the respective parties and an explanation of the method applied to determine the fees charged under the agreement (the explanation of which should be included in the company's transfer pricing report of the taxpayer). SARS would focus on the South African party to the transaction.

5.4.4.2. Common audit issues

A SARS audit would typically query the basis for any service fees paid by a South African entity to a connected person offshore. SARS would ask the taxpayer to justify the benefit derived from such services and if SARS is of the view that the services were rendered by the non-resident entity for its own benefit, the expense would not be deductible or the fee would be adjusted under the provisions of Sec. 31 of the ITA to the extent that a benefit could be justified.

It is thus in the interest of the taxpayer to keep clear records of the nature and scope of the services rendered which can assist to justify the benefit derived from the services rendered.

5.4.4.3. Tiered services

Where a South African entity is required to share expenses incurred by one of the offshore entities in a multinational group, e.g. R&D expenditure or international advertising, it is difficult to justify the allocation of a portion of the costs to the South African entity.

In the first place, exchange control rules do not allow an allocation of such costs based on the turnover or profits of the local entity, unless specific approval is obtained. To obtain such approval, the applicant must clearly illustrate the benefit of the services for the South African entity.

The SARS would also generally disallow such indirect expense allocation, unless the taxpayer can clearly illustrate the benefit from such services.

5.4.5. South African exchange control implications

South Africa has exchange control restrictions which apply mainly to residents but also to non-residents. The name of the Exchange Control Department of the SARB changed to the Financial Surveillance Department ('FinSurv') with effect from 2 August 2010.[153]

5.4.5.1. Management and administration fees

The SARB Exchange Control Manual ('Manual'), in Sec. 2.3.7, states that:

'Authorised Dealers may approve, against the production of documentary evidence confirming the amount involved, applications by South African residents to effect payments for services rendered by non-residents, provided that the fees payable are not calculated on the basis of a percentage of turnover, income, sales or purchases.'[154]

Authorised dealers may approve, against the production of documentary evidence confirming the amount involved, payment of a management or administration fee by a resident company to a non-resident. The amount paid must be reasonable in relation to the services provided. Fees calculated on the basis of a percentage of turnover, income, sales or purchases, will generally not be approved.155

In order to obtain exchange control approval for the remittance of fees, the following must be considered:

1. Confirmation is required that the fees are 'fair and market related'. This means that confirmation is required that the pricing method is in accordance with South African (and global) transfer pricing rules and regulations;
2. The applicable South African legal principles are contained in Sec. 31 of the SA ITA, read together with Practice Note 7; and
3. The ground rules for determining an arm's length price for services in a TP context in South Africa stem from the OECD Guidelines – on which Practice Note 7 was based.

An independent auditor's letter must be submitted to the authorised dealer confirming that the methodology followed to calculate management fees for services rendered by the foreign affiliate are in line with the OECD Guidelines, which is an indication of compliance with the arm's length principle in Sec. 31 of the ITA.

In drafting this opinion, the following shall be expressed:

- Confirmation of the allocation key used to allocate the costs to the relevant group companies who received services from offshore group companies;

[153] Olivier,L. & Honiball, M., 2011. *International Tax A South African Perspective*. 5th ed. Cape Town: Siber Ink, pp 713
[154] Exchange Control Manual, Sec. I, 2.3.7, issued by the Financial Surveillance Department
[155] Id

- Comparing invoices (together with its supporting calculations and documents) to the calculated charges per the group methodology;
- Obtaining a representation letter from the company officials of the South African entity confirming that the services were actually received from the offshore group companies and a description of the benefits obtained from these services; and
- If applicable, comparing a mark-up charged with any current existing benchmarking for services.

5.5. A comparison of countries

All countries generally follow the OECD's recommendations, irrespective of whether they are OECD member countries or not. Nevertheless, the US which is a member of the OECD has produced its very own detailed provision in the Treasury Regulation 1.482.

All countries believe that the benefit test should be focused on whether the recipient has received a benefit or not. The US did not follow this approach before, but changed it in the temporary service regulation from 2006 (Treasury Regulation 1.482-9T). The US regulations do not approve a general benefit test and China appears to apply six tests when determining whether intra-group services have been rendered. India applies additional tests when faced with the benefits test as it enables Indian TP authorities to determine whether a service has been provided.

The arm's length test is somewhat different between the countries. The US Regulations have a very narrow definition on shareholder activities. Chinese tax authorities are of the view that the definition of shareholder services in the 2010 OECD TP Guidelines is too narrow and are of the view that management fees should not be deductible for tax purposes as they relate to shareholder activities.

Canadian tax authorities do not provide for any mark-up to be charged on the cost of intra-group services that are ancillary in nature and are of the view that the 2010 OECD TP Guidelines are less definitive in its guidance on this matter. Indian tax authorities require that sufficient supporting documentary evidence be provided when determining the receipt of intra-group services.

The US has very detailed requirements on the use of charging methods, whereas Canada, Australia, UK, China, India and South Africa follow the OECD guidance in general. The US, UK and Australia have adopted the safe harbour for intra-group services to simplify transfer pricing compliance and reduce the administrative burden and South Africa requires exchange control approval for the remittance of service fees.

6. Relevant case law

This chapter encapsulates and examines relevant parts of two tax cases which have caused some upheaval when looking at intra-group services from a transfer pricing standpoint. The purpose of this research is to illustrate the problems taxpayers are faced with when pricing services. The focus is to demonstrate the fact that tax authorities have different methodologies and viewpoints towards intra-group services and the OECD TP Guidelines.

6.1. Danish Oil Case

The following discussion is based on an article which discusses the case.

Danish Oil was a Danish subsidiary in the British Petroleum ('BP') enterprise group, which had been rejected deductions for contributions to a cost sharing arrangement.[156]

6.1.1. Summary of the facts behind the case

In 2001 the subsidiary paid DKK 21 million[157] for services rendered from a related party in the UK, of which DKK 5 million was related to a sponsorship for a Formula 1 team, DKK 2 million was related to a franchising agreement, and the remaining DKK 14 million was to a cost sharing arrangement. According to the arrangement, the subsidiary paid for 'product and application development' and 'technical advice'. The costs had been allocated amongst the group companies using turnover as the allocation key. The Danish tax authorities had interviewed employees of the subsidiary, who had not been able to account for the benefits received by the services. At the request of the tax authorities, the subsidiary had explained and supported the content of 29 specific projects.[158]

6.1.2. The tax authorities decision

The tax authorities based their decision on employee interviews and claimed that Danish Oil did not provide sufficient evidence that the services and relating benefits had actually been received by the subsidiary. According to the tax authorities, the services referred to in the agreement were extremely vague making it difficult to determine the actual nature and scope of the services provided. Furthermore, according to the tax authorities, the payment of DKK 14 million represented a considerable amount and the tax authorities decided to make an adjustment on an estimated basis of 50% of the cost contributions, equal to DKK 7 million.

[156] Wittendorff, J., 2009. International Transfer Pricing Journal IBFD *Oil Company Loses Transfer Pricing Case,* 16(3), para.1
[157] Danish Krone ('DKK') is the Danish currency
[158] Wittendorff, J., 2009. International Transfer Pricing Journal IBFD *Oil Company Loses Transfer Pricing Case,* 16(3), para.4.1

6.1.3. The taxpayer's grounds

Danish Oil contested the tax authorities' decision and argued that it had been engaged in sharing costs and risks relating to R&D, and the utilization of intangible property, for more than 50 years. Significant economies of scale were achieved, compared to a situation whereby each group company would have rendered the services themselves. Accordingly, the benefits for the subsidiary consisted of access to the group's intangible assets and significant cost savings. The taxpayer had claimed that it had conformed to the arm's length principle in Sec. 2 of the Tax Assessment Act[159] and requested the decision go to the National Tax Tribunal.[160]

6.1.4. The National Tax Tribunal's grounds

Consequently, the National Tax Tribunal deemed it impossible to determine whether the subsidiary's contributions matched the expected or received benefits and thus whether the arm's length principle had been complied with. Given these conclusions, the National Tax Tribunal upheld the position of the tax authorities.

The National Tax Tribunal based its decision on the grounds that the UK affiliate decided which companies could benefit from participating in a specific project. According to the National Tax Tribunal, Danish Oil had not revealed how it valued the benefits accrued from the arrangement and the specific results from the arrangement had not been accounted for. The National Tax Tribunal did not question the tax authorities' claim that the amount was significant even though Danish Oil's total turnover was over DKK 7.6 billion.

6.1.5. Comments on the decision

According to the OCED Guidelines, cost contribution arrangements must meet some prerequisites, namely (1) participants must have the expectation of benefits, (2) the participants' contributions to the scheme must be calculated and (3) costs must be allocated in relation to the expected benefits. In the case being considered, neither the tax authorities nor the National Tax Tribunal criticized the allocation key used by the taxpayer.

The dispute solely addressed the benefit test, under which an activity must result in an economic/commercial value to enhance the recipient's commercial position. According to Wittendorf, as the activities of the Danish subsidiary involved the operation of an oil refinery, it should be beyond doubt that the R&D activities were suited to provide benefit to the subsidiary. Moreover, the facts of the case do not suggest that the subsidiary performed its own R&D or that it paid for the right to use intangible assets belonging to other taxpayers. Wittendorf suggested that when the tax authorities considered an amount of DKK 14 million to be 'significant', it must have been without regard to the subsidiary's turnover of DKK 7.6 billion and R&D costs thus constituted 0.19% of turnover.

[159] Sec. 2 of the Danish Tax Assessment Act
[160] Wittendorff, J., 2009. International Transfer Pricing Journal IBFD *Oil Company Loses Transfer Pricing Case,* 16(3), para. 4.3

In line with the taxpayer's reasoning, it must be assumed that the subsidiary's costs would have been significantly higher had it been required to perform these R&D activities at its own cost and risk, rather than sharing the costs with perhaps 30 or 40 other group companies. Neither the tax authorities nor the National Tax Tribunal seemed to attach importance to this significant matter.

Wittendorf further mentioned that the taxpayer had clearly established the amount and nature of the costs, and that the general requirements for claiming a tax deduction were met. It is therefore surprising that the tax authorities were not required to meet the burden of proof that the benefit test had not been met.

It seems as if the National Tax Tribunal wanted Danish Oil to provide documentation for every benefit it had expected, or received, from the cost sharing arrangement. This was impossible since the cost sharing arrangement used an indirect charging method to allocate its cost sharing contributions, which were interesting since the matter concerned the benefit test and the arm's length test and not the choice of charging method. The benefit test and the arm's length test only prove whether a service is chargeable, not the amount of costs or the calculations of the remuneration.

On the basis of the documentation requirement in Sec. 3 B (5) of the Tax Control Act[161], the National Tax Tribunal essentially tightened the burden of proof for taxpayers in Denmark. Wittendorf submitted that the decision does not change the fact that the burden of proof regarding non-compliance with the arm's length principle continues to lie with the tax authorities. Consequently, no rule exists on a reverse burden of proof under Sec. 2 of the Tax Assessment Act, provided that the documentation requirement has been met.

The National Tax Tribunal's decision may be condemned for not clearly stating whether or not the documentation requirement actually had been met. The Tribunal should have also considered Danish and international case law. Wittendorf's view is that based on the facts of the case, it is doubtful whether the case regarding services had a correct outcome.

6.2. Dow Svergie AB vs. Swedish Tax Agency[162]

6.2.1. Summary of the facts behind the case

Dow Sverige AB ('DSWE') was a Swedish subsidiary in the Dow Chemical Company ('TDCC') enterprise group. The enterprise group manufactured and traded latex for the paper industry and Styrofoam, used for insulation in the construction industry.

The matter concerned deductions made, in 1997 of SEK[163] 5,960,663, for services provided from a Swiss related party, Dow Europe SA ('DESA'). DESA was a group service centre, which managed and supervised the marketing, production, administration and human resources side of the business, for

[161] Sec. 3 B (5) of the Tax Control Act
[162] *Regeringsrättens årsbok*, 2006, ref.37 (*Dow Svergie*)
[163] Swedish Krona ('SEK') is the Swedish currency

all the European subsidiaries of the TDCC enterprise group. DESA had four different service agreements with DSWE, one for each mentioned service area. The Swedish Tax Agency ('STA') had questioned the allocation keys used on agreement one (marketing, net turnover) and two (production, production results), and the deducted costs, in agreement three (administration) and four (human resources), because the STA thought the arrangement included costs that were not deductible according to Swedish tax legislation. The STA had also questioned the DESA's inclusion of a profit mark-up (10%) in the remuneration.

6.2.2. The STA's grounds

The STA claimed that some of the costs included operating expenses which were not used in DSWE's business. The STA also claimed that the allocation keys did not reflect all circumstances for DSWE's situation, since only 10 % (200 of 2000) of the products were sold on the Swedish market when, for example, the net turnover was based on total turnover for all products sold in the enterprise group. The STA made it clear that they still believed that some marketing costs could be of a common interest for all recipients, which also DSWE could benefit from. The STA only approved 75% of the deductions.

On the issue of the profit mark-up, the STA claimed that there was no reason behind DESA's profit mark-up of 10%. The STA referred to the OECD TP Guidelines and said that profit mark-ups shall not be used on services where the recipient cannot affect the choice of allocation method as an independent party.

6.2.3. The taxpayer's grounds

The taxpayer claimed it was entitled to deductions, since the entity does not perform these services itself and needs. This is because DSWE's only business activity was sales of the material, and all other management decisions were made by DESA (e.g. such as pricing, commercials, marketing, external information and sales campaigns).

DSWE argued that the grounds for deduction are achieved when there is a need for the service, or at least have the possibility of using the service (a presumption of need). The taxpayer claimed that only a presumption is necessary, and otherwise the burden of proof would be unreasonable. Taking into account the characteristics of these services, the taxpayer claimed that it could be presumed that there was a need for the services. The taxpayer also said that all services had a connection to their business activity and for their future development, and should therefore be deductible. The taxpayer also claimed that the burden of proof lies on the STA, to show in what way the received services did not benefit DSWE.

The taxpayer also questioned whether the STA had understood the OECD TP Guidelines, since the STA had claimed that the agreement did not take into account the situation of DSWE since they did not sell all the products. The taxpayer claimed that the choice of charging method should be based on reasonableness, and it would be unreasonable for DSWE to allocate the costs for every specific transaction. Reasonable allocation is used on indirect charging and should be based on an analysis of

these services, used over a longer period of time, to get the most reliable result. A long term analysis, according to the taxpayer, shows that the charging is at arm's length. This is since some services might not be used under one year and the usage can differ between the years. It is therefore important that the allocation key reflects the facts and circumstances of each specific case, and should, therefore, be used properly and consistently, and reflects why the service was useful. The taxpayer stated that their choice of allocation keys reflected these aspects, since the allocation key had been the same for all service pool-participants and all data had also been consistent over time. The taxpayer claimed that the OECD's requirements for evidence for indirect charging should be not as strict in comparison as to direct charging and that it would be impossible, and unreasonable, for the taxpayer to provide documentation for every single transaction. If this would have been possible the taxpayer claimed that they would not have used indirect charging.

The taxpayer also questioned the ruling on the profit mark-up. The fact that the arrangement decreases the spending of the whole group does not justify why DESA should not include a profit mark-up. DESA explained that some of their services are highly unique for each recipient since these services were a substantial part of enterprise group's knowledge, which was something the recipients could not have brought in externally or produced themselves in-house. The taxpayer claimed that DESA's main purpose was to provide high quality services and not to reduce the enterprise group's costs, which should justify a profit mark-up in the charge.

6.2.4. The first two instances of the Swedish court system

The country administrative court ruled in favour of STA on both matters. In the first matter, the court did not find that the taxpayer had shown reasonableness behind the allocation, because it could not show why these costs were necessary to DSWE. On the second matter, the court based the decision on the fact that DESA did not bear any risks, since it was DESA who decided when the recipient was going to receive a service, which therefore guaranteed DESA to cover its costs. DESA had therefore no reason for including a profit mark-up in the remuneration. The administrative court of appeal ruled in accordance with the country administrative court.

6.2.5. The Supreme administrative court's grounds and decision

The Supreme Administrative Court ('SAC') clarified that the STA had not questioned whether DSWE had received a large number of services from DESA, or the use of an indirect method of allocation. Neither had the STA questioned the total amount of the charge, or claimed that the services were priced incorrectly, other than that the usage of a profit mark-up.

The SAC stated that, for a price to be wrongly priced, according to the Swedish adjustment provision (chapter 14, para 19 of the SITA213), it has to be different to what independent entities would have agreed on under similar facts and circumstances. Therefore the price difference must have resulted in a less profitable result for the DSWE's business income. According to the SAC, all circumstances of the agreements have to be accounted for.

The purpose of DESA was to provide high quality services and to reduce the MNE's costs. DSWE had not, or in minor extent, used some of the services. DSWE's need for the different services seemed to vary over time. Under these circumstances, and because of the large quantity of services, the SAC decided that the indirect charging method was appropriate. The SAC also approved the use of a profit mark-up since the STA could not give a justified reason for not approving it. SAC allowed DSWE a full deduction for the payments, notwithstanding that the benefits provided by the various services varied and that certain weaknesses in the arrangements had been proved. The SAC attached importance to the fact that the purpose of the arrangement was to reduce the group's costs.

6.2.6. Comments on the decision

The SAC correctly included all relevant aspects and did not base its decision on merely one fact. It may be suggested that the first two instances were based on narrow argumentation since STA may have wanted DESA to allocate its costs through direct charging. The courts stated that all services did not provide a benefit to DSWE, and the allocation should include all DSWE's circumstances, which is only possible if the transactions were charged with direct charging. What is strange is that STA did not contest the use of the indirect charging method, since they obviously did not want DESA to use it. The arrangement included 'on-call' services, and it is not uncommon that the usage for these types of services varies over time. It is common in practice to centralize 'on-call' services, since it would have been very costly for each recipient to have the services on 'standby' when these were not needed. The important factor was *the need*.[164] The SAC found that the services were needed for DSWE's business activities, and since the entity did not provide the services themselves they should have the right to deduct the whole amount.

SAC could have made a far more detailed analysis with regards to the profit mark-up as the services contributed commercial value therefore the mark-up should have been included.

If the purpose of the arrangement is only to reduce costs, it would have been necessary to look at the enterprise's business purposes.

6.3. How to defend

In light of the issues raised by the tax authorities, taxpayers should focus on the following items:

Benefit test. Adequately demonstrating the actual benefits derived from the services will help the taxpayer in defending itself before the tax authorities. Thus, to justify the arm' s length nature of a transaction, the recipient will need to establish through appropriate documentation the actual receipt of services and that it has derived a benefit from such services. In other words, the economic value received from the services must be demonstrated, along with the fact that the taxpayer would have either sourced such services from a third party service provider or developed such capabilities internally, had such services not been received from the group entity. The taxpayer bears the complete

[164] Inkomskattelagen (1999:1227)

burden of substantiating the payment so as to be able to take advantage of the tax deduction, and thus this issue should be dealt with carefully.

Documentation to justify actual receipt of services. Appropriate documents justifying the actual receipt of services should be maintained.

Service agreement. A service agreement, along with the charge-out methodology will be analysed by the tax authorities with great care. Thus, a clear agreement setting forth a complete list of services and the charge out methodology is necessary.

Charge-out methodology. The entire charge out methodology from the total expense incurred, to the allocation mechanism adopted (along with the reason for such choice) must be appropriately prepared and maintained. Reasonable documents must be maintained also to justify the computation to the tax authorities.

Cost base. The cost base considered for the computation of the charge will be analysed by the tax authorities for any gaps. Thus, a clear breakdown of expenses into direct and interest expenses must be maintained, along with the supporting documentation.

Third-party quotes. It may be questioned why similar services were not received from third parties, when available. In such a scenario, a defence should be in place regarding, for example, the nature of the service being different or of superior quality.

7. BEPS Discussion Draft on low-value adding intra-group services

7.1. Background

The OECD, as part of its work on the Action Plan to address BEPS, on the 3rd November 2014 released a Discussion Draft in relation to Action 10[165] proposing a simplified transfer pricing approach for low-value adding intra-group services that will ultimately lead to revisions in chapter VII of the OECD's Transfer Pricing Guidelines.

The proposed modifications do not yet represent a consensus view and are intended to provide stakeholders with substantive proposals for analysis and comment. The goal is to reduce base erosion through excessive management fees and head office expenses, particularly in developing countries. The proposed modifications to chapter VII of the OECD Guidelines seek to achieve a necessary balance between appropriate charges for low value-adding services and the need to protect the tax base of countries in which entities are established that pay the service fees.[166]

The proposed simplified approach to low-value adding services will be helpful for some groups. In many instances it has proved difficult or too costly to provide sufficient evidence to support what may be small individual charges across a wide number of jurisdictions, leading to double taxation. In addition, the simplified approach will benefit tax authorities with limited resources in considering the appropriate mark-up.

The simplified approach for a group that chooses to apply it will need to be applied on a globally consistent basis, which will entail (i) a greater co-ordination of cost pooling and allocation of services, particularly when this is currently done on a regional basis, and (ii) additional compliance in the year of adoption to establish the appropriate cost pools, allocation keys and documentation.

For countries with OECD-based double tax treaties, amendment to the transfer pricing guidelines will likely be sufficient to implement the proposals for simplification, but it remains to be seen whether other countries (particularly outside the OECD) choose to adopt the proposals, and this may affect its practical application on a global basis.

There are 6 areas in which the OECD is proposing additional guidance:

1. Providing a standard definition of low value-adding intra-group services;

[165] OECD, 2014/2015, Discussion Draft of the Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services, 3 November 2014 – 14 January 2015, Paris: OECD
[166] Id. pp 3

2. Clarifying the meaning of shareholder activities and duplicative costs, specifically in the context of low value-adding intra-group services;

3. Guidance on appropriate mark-ups for low value-adding intra-group services. The proposed mark-up range of between 2% to 5% is narrower and lower than the EU Joint Transfer Pricing Forum's for similar low-value adding services (endorsed by the European Commission), which suggests that a mark-up range of 3% to 10%, depending on the circumstances is commonly found.

4. Guidance on appropriate cost allocation methodologies to be applied in the context of low value-adding intra-group services;

5. Guidance on the satisfaction of a simplified benefit test with regard to low value-adding intra-group services; and

6. Guidance on documentation that taxpayers should prepare and submit in order to qualify for the simplified approach.[167]

7.2. In summary

By including a specific section on low value-adding services that lowers the burden on MNE groups to demonstrate the beneficial nature of those low value-adding activities for other MNE group members and also imposes a limit on the profit mark-up that can be applied on those low value-adding services, the OECD has taken a step in the right direction to achieve that balance.

The current Discussion Draft, however, fails to substantially address how the additional guidance on low value-adding services will be impacted by the other work the OECD is performing in view of the BEPS Action Plan.

With respect to the determination of the appropriate profit mark-up, a literal reading of the Discussion Draft supports the position that a taxpayer may select any point within the safe harbour range. It may serve to eliminate any doubt, and thus the potential for controversy, if the OECD could make that point explicitly in the next version of the document. Further consideration should also be given to the appropriate bounds of the range, including whether the lower bound should be zero; i.e., allowing for pricing at cost. If pricing at cost is not allowed as a general matter, the OECD should also consider how the apparent conflict with para 7.36 (which allows for the treatment of certain costs as pass-through costs on which no profit mark-up needs to be applied) can be resolved.

Finally, although the Discussion Draft sets forth useful proposals to bring clarity and needed uniformity to an area that often creates controversy as to the deductibility of low value-adding intra-group services, its usefulness in practice will obviously depend upon how many countries agree with and adopt the proposed measures. Although the OECD is only a standard-setting organization and is

[167] Id. pp 3

not involved in implementation and enforcement of its recommendations, it is hoped that OECD and G20 countries participating in the process of drafting the proposed measures recognize the mutual benefits that would inure to both taxpayers and tax administrations from widespread adoption of a uniform approach to this issue.

To the extent that such uniform adoption and implementation is not achieved in this area (and other areas of the BEPS Action Plan), more pressure is placed on Action Point 14 of the BEPS Action Plan, dealing with making dispute resolution mechanisms more effective.

8. Conclusion

Around the world, many tax authorities have adopted an increasingly proactive and more sophisticated approach to examining transfer pricing policies in respect of intra-group services.

As demonstrated in previous chapters in this report, countries around the world treat intra-group services in their own unique way. When formulating an intra-group transfer pricing strategy, many multinationals fail to work out the overall business strategy in tandem with various other pertinent international tax planning considerations. Formulating a comprehensive transfer pricing strategy for intra-group service transactions also requires a solid understanding of various international tax planning principles, detailed knowledge of applicable tax treaties and a thorough understanding of the laws and practices in the home and host countries.

There is currently no widespread legal compliance for the OECD's recommendations. Nevertheless, the OECD's recommendations have some legal value in the countries examined for purposes of this research, i.e. USA, Canada, UK, Australia, China, India and South Africa since the countries have recognized the OECD's recommendations through preparatory work and case law where possible.

The USA has its own transfer pricing legislation and has therefore not recognized the OECD recommendations as a legal source for its taxpayers. The US Regulations have generally taken a more direct approach towards transfer pricing issues, while the OECD recommendations are more ambiguous. Consequently, countries have interpreted the recommendations differently. Also, other factors that could have caused the problems, namely: subjective opinions from governments, tax authorities and courts; protectionism; language barriers; accounting standards; the differences in the legal value of the OECD recommendations; and probably other factors which have not been considered. Consequently, it is difficult to know if the OECD's recommendations are observed 'in practice'.

It is easier to know when a service is chargeable rather than when it is not. The OECD's recommendations are generally good guidance but, there are some areas creating disagreements between taxpayers and tax authorities. As referred to in the analysis they could or have already caused disagreements in practice. Services rendered from a group service centre are especially discussed, since these services are often carried out to all members and are sometimes difficult to relate to the benefit of one member. Some of the countries seem to have a negative approach towards centralized service arrangements and often deny deductions for these types of service expenses.

The OECD's recommendations should apply a similar approach to the US Regulations. This does not mean that the OECD should recommend the same thing as the US Regulations, merely be clearer and narrower in their guidance. Consequently, it should decrease the risk of double taxation since the OECD's recommendations and US Regulations would become more alike.

The choice of charging method depends on which countries render the services. All countries except the USA prefer the direct charging method and some countries seem to have different approaches towards the use of indirect charging. It seems as though the OECD should be more consistent and give a clearer definition when direct charging is unreasonable to use, since this has caused disagreements between taxpayers and tax authorities in practice.

The OECD recommendations should be clarified by including examples and by being more precise when the charging methods should be applied. This approach is generally used more in US Regulations, which may provide more certainty.

Countries have different approaches towards which methods should be used to determine remuneration. The USA has the best method rule which means that they do not have preference over one single method.

Whether a profit element should be added to the charge, the OECD recommendations do not give an adequate answer, and consequently, it becomes necessary for practitioners, in each country, to decide. Nevertheless, the USA's SCM method is a very interesting solution, since it gives predictability to when a service should be charged at cost. Therefore, the OECD's recommendations should apply a similar approach, which should decrease the opportunities for different approaches between countries. Even though, countries have to comply with the SCM it could lead to more consistency between the OECD's recommendations and the US Regulations, which would decrease the risk of double taxation.

There is arguably a need for safe harbours and there is certainly a benefit when using a safe harbour. Although a safe harbour rule may look simple it potentially may lead to double taxation because the mirroring country may not agree with the fact that (1) a (routine) service is performed, (2) does not agree with the cost base used as a safe harbour and (3) does not agree with the cost plus margin listed as a safe harbour. As an alternative to avoid double taxation, countries may start a mutual agreement procedure in case one of them uses a safe harbour, although this is far more labour intensive.

Therefore, perhaps modifications to chapter VII of the OECD Guidelines are exactly what we need as it may bring a sense of clarity and widespread adoption of a uniform approach to intra-group services. There is, questionably, a need for a low value-adding intra-group service safe harbour. With the increase of compliance for transactions at high risk of base erosion and profit shifting, it would be helpful to have a compensating reduction of compliance for transactions at low risk of base erosion and profit shifting. It would be helpful if the OECD Discussion Draft on the safe harbour rate receives a consensus soon as this shall provide global consistency in these mark-up rates for future safe harbours.

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Appendix A: Safe harbour for intra-group services. A global overview

Countries such as Australia, Austria, New Zealand and Singapore have adopted the safe harbour for intra-group services to simplify transfer pricing compliance and reduce the administrative burden. A broad overview of the services covered, safe harbour margins and the prescribed transfer pricing methodology is presented below.

Table 6: Safe harbour for intra-group services[168]

	Year of incorporation	Nature of amendment	Transactions covered	TP methodology prescribed	Safe harbour margins prescribed
Australia	1999	Introduced by way of administrative guidance: Taxation Ruling TR 1999/1	Non-core services such as administrative services, personal services, management of remuneration schemes and other overhead activities.	Cost-plus method	Receipt of intra-group services: cost-plus 7.5% to 10%. Provision of intra-group services: cost-plus 5% to 7.5%.
Austria	2010	Introduced by way of administrative guidance (para. 77-80 of Austrian Transfer Pricing Guidelines)	Routine functions where assets are involved only on a small scale and where risk involved is only small. The intra-group ancillary services should not form part of the ordinary business of the entity.	Cost-plus method	Profit mark-up for routine services should be approximately 5% to 15%. Intra-group ancillary services may be charged without any mark-up. Where only direct costs of the intra-group routine service are available, a mark-up of 5% should be charged without further evidence in considering indirect costs, as well.
New Zealand	2000	Introduced by way of administrative guidance: (para. 557 to 567 of the Inland Revenue Transfer Pricing Guidelines)	Non-core services which are not integral to the profit-earning or economically significant activities of the group. The threshold for the cost of intra-group services is determined at NZD 600,000.	Cost-plus method	Receipt of intra-group services: cost-plus 7.5% to 10%. Provision of intra-group services: cost-plus 5% to 7.5%.
Singapore	2009	Introduced by way of administrative guidance: transfer pricing guidelines for related party loans and services	Routine services as listed in *Annex A of Transfer Pricing Guidelines for Related Party Loans and Related Party Services.[169] These routine support activities that the service provider offers to its related party should not be provided to an unrelated party.	Cost-plus method	Cost of providing services plus 5% for routine services listed in *Annex A of Transfer Pricing Guidelines for Related Party Loans and Related Party Services.

**Annexure A: Services covered under Annex A of Transfer Pricing Guidelines for Related Party Loans and Related Party Services include accounting and auditing; accounts receivable and payable; budgeting; computer support; database administration; employee benefits; general administrative and legal services.*

[168] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? International Transfer Pricing Journal, November/December, pp 436

[169] Inland Revenue Authority of Singapore (IRAS), 2009. *IRAS Supplementary e-Tax Guide. Transfer Pricing Guidelines for Related Party Loans and Related Party Services*. Singapore: IRAS

Appendix B: Other simplification measures for intra-group services

Countries such as Hungary, Japan, the Netherlands and US have simplified their transfer pricing measures for intra-group services, as discussed below.

Table 7: Other simplification measures for intra-group services[170]

	Year of incorporation	Nature of amendment	Transactions covered	TP methodology prescribed	Simplification measure
Hungary	2012	Introduced by way of Regulation: Article 6 of Decree of Minister of Finance 22/2009 X.16	Low-value adding intra-group services and routine services the value of which does not exceed HUF 150 million at arm's length (excluding VAT), 5% of the service provider's net income and 10% of the recipient's operating costs during a given tax year.	Cost-plus method	Simplified documentation and no benchmarking required. Simplification measure may be used if a taxpayer accepts application of the cost-plus method; if the application of the cost-plus method leads to a result other than the arm's length price, this simplification measure may not be used.
Japan	2001	Introduced by way of administrative guidance: articles 2-7 and 2-10 of the Commissioner's Directive on the operation of transfer pricing	Low-value adding services accompanying the original business activities of the enterprises, for which no comparable transactions (neither internal nor external) can be found.	Cost-plus method	Simplified transfer pricing method. Actual cost of providing the services is deemed to be the arm's length price.
Netherlands	2004	Introduced by way of administrative guidance: para 2 of the Decision of 21 August 2004, IFZ2004/680M	Support services with respect to book keeping, legal affairs, tax matters and personnel.	Cost-plus method	Simplified transfer pricing method. At the taxpayer's advance request, all relevant actual costs (instead of arm's length consideration) may be charged for support services.
US	Established in 1968; revised materially in 2006	Introduced by way of regulation: Treasury Regulation Sec. 1.482-9	Provision of low-value adding intra-group services that: Have a median comparable mark-up of 7% or less or are listed in Rev. Proc. 2007-13; are not listed as excluded activities; do not contribute significantly to key comparative advantages or core capabilities, or fundamental risks of success or failure; and services for which certain documentation requirements are met.	Services cost method and associated shared services arrangements for services cost method transactions	Simplified transfer pricing method. *Services cost method:* Taxpayer may choose to price the services at cost rather than the actual arm's length price. Cost reimbursement is deemed to be the arm's length price if the taxpayer properly chooses to apply this method. *Shared services agreement:* If a taxpayer elects to use the services cost method, it may further elect to use a shared services agreement. Such an agreement permits cost allocation on the basis of reasonably anticipated benefits under a relaxed standard. Specifically, the Commissioner must respect the allocation basis if the taxpayer only 'reasonably concluded' that its chosen cost allocation basis most reliably reflects the respective shares of reasonably anticipated benefits. In contrast, absent the rule for shared services agreements, the Commissioner must respect an allocation basis only if it most reliably reflects the respective shares of reasonably anticipated benefits.

[170] Jain, A. K., 2014. Is It Time to Anchor Intra-Group Services in the Safe Harbour? International Transfer Pricing Journal, November/December, pp 437