

Preparing An Effective Defense For Your Intra Group Service Charges Before Tax Authorities

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Summary

In the operations of Multi-National Companies (MNCs), intra-group service charges play a crucial role. These services are vital and arise from the necessity for centrally coordinated services among MNC entities. They are essential for maintaining global standards, and ensuring quality and confidentiality, all while striving to reduce costs.

However, tax authorities globally often view these charges as red flag or soft transactions and commonly disallow them by setting the arm's length price to zero. This article aims to aid taxpayers in building a strong case to defend such charges before tax authorities.

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I. Article

Intra-group service charges are an integral aspect of operations for multinational companies (MNCs). These services are essential and driven by the need for centrally coordinated services by MNC Entities. These services are crucial for maintaining global standards and ensuring quality, and confidentiality, all while striving to reduce costs.

These charges are however considered red flag transactions by tax authorities and are often disallowed by setting the arm's length price to nil. Such grounds include assertions that no services were rendered by the affiliate, no tangible benefit was derived by the taxpayer, duplicate services were rendered, or shareholder services were rendered by the affiliate. The tax authorities argue that no independent party would be willing to pay for similar intra-group services, leading to the determination of the arm's length price as nil.

II. International Jurisprudence

The OECD and G20 have continuously strived to streamline transfer pricing rules for intra-group services as these services were susceptible to base erosion in the recipient country.

MNEs would have to meet the benefits test, maintain documentary evidence, and maintain details of the cost structure and margin of services received for all intra-group services.

To simplify the transfer pricing compliance of intra-group services, the OCED categorized certain services as low-value-adding services that act as non-core support activities within MNE groups. These categories are detailed in Chapter VII of the Transfer Pricing Guidelines under OECD BEPS Action 10. According to BEPS Action 10, examples of activities falling under low value-adding intra-group services include - accounting and auditing, legal and corporate secretarial services, tasks related to tax obligations, litigations, representations, and compliances, processing of accounts payable and receivable, HR activities and payroll processing, information technology services, communications and public relations, as well as data monitoring and compilation.

The OECD further provides that a mark-up of 5% for such services may be used. Such services however still need to meet the benefits test and documentation to provide receipt of services are to be maintained.¹

The Guidelines further provide that for application of this simplified methodology MNE Groups shall prepare the following information and documentation and provide it to the tax officer to support the intra-group services received:

- A description of the services;
- Benefits received;
- Confirmation of the mark-up applied;
- Written contracts or agreements; and

¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration 2022

- Documentation and calculations showing the determination of the cost pool and allocation of costs.

Analysis

Accordingly, Taxpayers need to prepare a robust case before the Tax Authorities in support of payment of intra-group services to foreign affiliates. Documentation that should be maintained to support the service fee payments include:

- **Agreements-** The inter-company agreements may include specific clauses covering aspects such as the capabilities of the Foreign-Related Party, the necessity for availing management services, detailed service descriptions, and the basis for fees.
- **Records of Services received:** Contemporaneous records of the services received, research reports received, copies of presentations, and emails by the affiliate companies reflecting such services were rendered may be collated by the taxpayer.
- **Evidence of the related party's capabilities:** The financial statements of the affiliate company can be included along with auditor or management certificates certifying the workings of the intragroup service charges.
- **Proof of Services rendered by the related party:** Documentation of personnel, costs, and infrastructure deployed by the affiliate along with the mode of service delivery can be presented.
- **Proof of services received by the taxpayer entity:** Invoices, ledgers, benefits accrued, and absence of corresponding expenses in the P&L may be used to substantiate the case.
- **Transfer Pricing Report:** Presentation of a detailed chart describing the services, mode of receipt, and proof of receipt should be documented. The report should include relevant details to cover service description, benefits, and rationale for availing services from the related party.

How to benchmark the payment of Intragroup services

The arm's length price of intra-group services can be determined by aggregating all transactions under the Transactional Net Margin Method ('TNMM'). This involves applying TNMM collectively to all international transactions of the taxpayer, including the intra-group services, and benchmarking it, by a comparison of the Taxpayer's Profit Level Indicator ('PLI') at the entity level, with the PLI's of comparable companies. The OECD Transfer Pricing Guidelines (2022) recognize aggregation of closely related transactions. The benchmarking under TNMM can further be corroborated by using quotations from third-party suppliers providing the same or similar kinds of services.

The Management Services can also be benchmarked by taking the affiliate company as the Tested Party and benchmarking the margin earned by the affiliate company from the intra-group services. This exercise would still have to be undertaken to meet local country requirements even if the margin adopted is within the safe harbour prescribed by the OECD.

Choice of Mark-up

Another common difficulty involves justifying the arm's length quality of the markup applied to intra-group services. The markup should be derived from a comparable profit margin that an independent service provider would achieve in a similar arm's length transaction. However, locating such comparables can be challenging, particularly for unique or intricate services that lack external benchmarks. Additionally, the markup must consider the risks, functions, and assets of the internal supplier. Hence, a comprehensive analysis of comparability should be thoroughly documented in the transfer pricing report to validate the margin adopted.

III. Conclusion

Intra-group service charges are commonplace but an often-overlooked area of transfer pricing by taxpayers. Most cross-border charges are for relatively routine activities and calculations simply rolled forward from one year to the next. However, as digital, and "borderless" business models and remote working become more commonplace, the scope of employee roles may change, expand, or cover wider geographies. It is therefore important to review transfer pricing policies regularly and ensure that all intra-group services are appropriately documented, and evidence is collated to defend and support the transactions in case of a tax audit.