Transfer pricing of intra-group management services

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Has the OECD BEPS project had a significant impact on the transfer pricing of management services, and what changes are likely to emerge from the new transfer pricing guidance? What measures should tax professionals be considering as a result?

Intra-group services are performed for the management and coordination of a group and include the provision of a wide range of services, such as legal, accounting, tax, administrative services and business management services. Some tax administrations have considered the charging of management services to be an example of profit shifting, if they believe that taxpayers have inflated charges to companies in high tax countries in order to move profits to lower taxed companies. On the other hand, services charged at cost or with a low profit margin have also been challenged as understating the arm's length price. In the case of management services that represent a key entrepreneurial business driver, a low cost-plus, or potentially the cost-plus method itself, may be challenged as insufficient.

BEPS has made a distinction between two categories: 'low value-adding intra-group services'; and a residual class of what might be called 'higher value-adding intra-group services'.

Low value-adding services

The OECD has provided guidance on low value-adding intra-group services in *Aligning transfer pricing outcomes with value creation, Actions 8–10, 2015 final reports*. Low value-adding intra-group services are defined as:

- being of a supportive nature;
- not being part of the core business of the group;
- not requiring the use (or leading to the creation) of unique and valuable intangibles; and
- not involving the assumption or control of substantial or significant risk and not giving rise to the creation of significant risk.

For services that meet that definition, the guidance provides what is effectively a safe harbour option that may be selected by the taxpayer. The mark-up would be 5% of the relevant costs and applied to all low value-adding services, irrespective of the category of the service. However, these are limited to support services (such as accounting, legal, human resources, public relations, tax and administrative services) – in contrast with business management activities that drive the business tactically and strategically.

For jurisdictions that adopt the OECD guidance, a safe harbour may be useful for streamlining compliance for support services. However, the focus will switch to transfer pricing their higher value sibling: the 'real' management services. These can no longer be swept into the same class and given a low mark-up. Conversely, it can no longer be presupposed that they can be priced as licensed intangibles. An objective analysis will be essential to validate the degree of benefits actually involved and price them at arm's length.

High value-adding services

Higher value-adding services will be those intra-group services that do not meet the low value definition; and, as real management services will fall into this category, what approach might be used to transfer price them? As ever, a functional analysis will be critical to establish the facts. The economic analysis might consider characteristics that could broadly fit into three classes:

1. Limited risk functions and no creation of unique and valuable intangibles: Services that are part of the core business but involve few key risk functions and do not lead to the creation of unique and valuable intangibles may fall into this category. Cost-plus may well prove to be the most appropriate transfer pricing method.

2. Significant risk functions but no creation of unique and valuable intangibles: These services involve functions that accept, control, manage and dispose of substantial or significant business risks, but do not lead to the creation of unique and valuable intangibles. Selecting the most appropriate transfer pricing method here is likely to be less straightforward. Depending on the circumstances and information available, the comparable uncontrolled price (CUP) method or the profit split method may be suitable. In some cases, the cost-plus method may still be available. A corroborative method should be considered to manage tax risk where the answer is not clear cut.

3. Creation of unique and valuable intangibles: Management functions that lead to the creation of unique and valuable intangibles will need to be considered under the revised Chapter VI of the Transfer Pricing Guidelines. It may be that the management services are so linked to functions creating 'hard to value intangibles' that they cannot be considered separately. Services that lead to the creation of unique and valuable intangibles may well require the use of the profit split method. While the CUP method is permissible, it may be difficult to find sufficiently comparable transactions to implement it successfully. Higher value-adding intra-group services that lead to the creation of unique valuable intangibles may need to be included in an economic analysis applied across wider elements of the value chain. Again, a corroborative analysis may prove useful. It is unlikely that the cost-plus method will be accepted.

The basic transfer pricing themes of BEPS – such as properly delineating the transaction under consideration, and providing evidence that people functions are authentically carried out where the transfer pricing rewards them – will be decisive in establishing a successful analysis. To obtain a deduction, it is essential to establish whether or not services have been delivered and, in most cases, to show a benefit to the recipient's business.

Jurisdictions such as China and India have attacked what they consider to be duplicative charging, where local operations are billed for IP and additionally for a management fee. This can be contrasted with the UK, where HMRC has often questioned UK headquartered groups for undercharging for the provision of UK based management teams. This tension may be heightened with the coming of country by country reporting, where misconceptions may arise about the international footprint of a business compared to reported metrics. It is unlikely that management services will remain the forgotten child of the transfer pricing world. ■