For indirect partners participating in underlying partnerships through other partnerships, there are new sections added which will require underlying trades and businesses to be separately reported for each underlying partnership. There are also codified rules on commencement and cessation where trades are carried on through indirect partnerships. Again, these are largely intuitive.

Overseas partners in investment partnerships

To end on a bright note, one very welcome change is the final resolution of a long running saga for funds lawyers. Until these changes, TMA 1970 s 12AA(6) required every partnership return to include a unique tax reference number (UTR) for each partner. This caused a problem for investment partnerships, which may have had a large number of non-UK resident investors who did not have or want a UTR.

Although HMRC has more recently allowed the use of a dummy UTR in these circumstances (see HMRC's *Self-assessment Manual* at SAM100137), the new provision at TMA 1970 s 12AZB now makes it clear that this will no longer be required for partners for whom the partnership is already making a return under the Common Reporting Standard or EU Council Directive on Administrative Cooperation (which will be all of them, in practice).

Conclusions

Subject to some clarification, which will hopefully be forthcoming in guidance, or final tweaks to the legislation on certain of the unintended consequences (in particular with regard to profit share), the legislation is broadly welcome in the limited direct tax changes it makes and the pared back, and so mostly helpful, administrative changes.

To end on a bright note, one very welcome change is the final resolution of a long running saga for funds lawyers

However, as overlooked in the original consultation and hopefully brought out from some of the examples which come to mind here, partnership structures (in part because of their innate flexibility) are often unique; and so the application of these rules should be considered carefully by trading partnerships and managers of funds formed as partnerships to make sure there is no unintended adverse effect.

In relation to the other proposed changes, again the proposals now, compared to what they might have been if the consultation had progressed unchecked, are much improved. Nominee partners will want to ensure that they begin to collect the required information about beneficiaries of bare trusts and investors in tiered partnerships (or to report their partnership statement on all four bases). ■

For related reading visit www.taxjournal.com

▶ The consultation on partnership taxation (James McCredie, 8.9.16)

Practice guide

Intra-group services and transfer pricing

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Speed read

Intra-group services feature in most multinational groups and are a common transaction type in transfer pricing policies. Charging for services is crucial to get right, as tax authorities will often raise questions focused on whether there should be a deduction in a territory. Understanding the benefit created by the services is a key step, together with understanding how best to allocate costs, set a mark up and identify what should not be charged. Good documentation is important and groups may be able to take advantage of the new OECD simplified approach when supporting the charges made.

Intra-group services – often the management and back office support every business needs – are among the most common transaction between connected parties. Most international businesses will have services provided from other parts of the group; and most of these are thought of as comparatively routine, in that they do not carry much business risk and are not a key value driver.

However, it would be a mistake to think that this makes setting and calculating service charges as routine and low risk as the services themselves.

Service charges are easy for tax authorities to spot and understand. A successful challenge can result in a tax deduction being denied, while question marks over what should be a straightforward process can cast doubt on the robustness of the transfer pricing policies applied to other transactions.

There are three key questions to answer to avoid this trap:

- Has a service actually been provided?
- What is the appropriate charge for the service?
- How should the charging be documented and supported?

We'll consider each of these in turn.

Has a service actually been provided?

Services can cover a wide range of activities. When the OECD considers services in Chapter VII of its Transfer Pricing Guidelines (2017) ('the OECD guidelines') it has in mind 'in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group.' This is a broad brush definition that essentially focuses on those activities which are an integral part of what a business needs to function, but which are not themselves directly driving top line revenues.

This can include wholly back office services, such as HR, IT, finance, legal and internal audit. The OECD guidelines distinguish these as 'low value adding services', of which more later. Other services can approach the customer facing side of the business more closely. Marketing, research and development, and broader management support are all frequently found to be provided between group entities, often from a central head office or service hub. What all of these have in common is that their value is based on the people and the time they spend on behalf of the service recipient. It is then the recipient's risk and responsibility to put those services to use to optimise its sales and profits.

Other kinds of services can be found. For example, professional service firms will provide services between offices on client facing projects. While they will make a brief appearance, these activities are not what the OECD has in mind when its guidelines turn to services in Chapter VII.

Like standalone companies, entities within a group need business support services. They will need to make sure that computers are running and HR requirements are met. It may be labelled as 'hygiene' by the business, but it is something money will be spent on. That money could be spent on an in-house department or used to buy in support from outside providers. In most groups, there is the option of buying in this support from one or more group providers; this can offer consistency, as well as the economies of scale that come from consolidating the work in one team.

> The OECD does not require the creation of a cottage industry around services charging, so it is important to find a policy which is both practical and robust

As it is the recipient which must use these services in its business, it will want to see the benefit. 'If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity should not be considered as an intra-group service under the arm's length principle' (OECD guidelines, para 7.6).

This has become a main line of challenge from tax authorities in recent years: is the local recipient of the services paying for something it actually needs, and something it actually receives? The OECD acknowledges that this will be based on the facts and circumstances of the group and its arrangements, and so careful functional analysis will be important. However, it will be critical for groups to be able to answer this question. This can involve demonstrating what that benefit is and how it was delivered.

This can be contentious. Even before a tax authority is involved, a group may need to agree between its head office and local operations exactly what those benefits are. The head office may feel that its days are spent bending over backwards for the rest of the group, whereas the local operations may question what it is that head office has ever done for them.

This is not a topic to be considered for the first time in the throes of a transfer pricing inquiry.

There is little in the way of prescription around the nature of benefit for a group member, beyond that set out above, i.e. there is 'economic or commercial value to maintain its business position' (OECD guidelines, para 7.6). However, there is additional guidance around what should not be charged.

Shareholder activities

Shareholder activities are performed by a group company 'solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder' (OECD guidelines, para 7.9). As this would not be required by those group members on a standalone basis, there is no need for them to incur costs for this kind of management, which can include accounts consolidation and shareholder relations. This cost should be retained by the group's parent company, and you would only see a charge when another group company undertakes the day-to-day activity and then passes the cost to its parent.

Duplicate activities

Activities may duplicate functions already performed at the local level. For example, if a subsidiary has a local HR department, does head office's HR function provide anything of benefit to that subsidiary? If not, no charge should be made.

However, it is important to distinguish 'tiers' of management and how they may complement each other. Many groups will have local, regional and global functions, each charged with a differing responsibility. Such tiered structures may not result in duplicate services and each may provide benefit to local operations, but how they fit together will be important to rationalise.

Incidental benefits

Incidental benefits are where group companies receive a 'knock-on' benefit from a service provided to another group entity; for example, costs incurred to make an acquisition which on integration will enlarge the group and trading opportunities. As acquisition costs are something the other companies would not have paid for at arm's length, then a charge would not be expected under the arm's length principle. The same goes for the kind of benefits which come from wider group membership and passive association – a 'halo effect'. This can often come into sharp focus on questions of financing terms enjoyed by subsidiaries, and whether they are benefiting from passive association or more explicit support.

Stewardship

Broader management activities may involve elements of oversight, as well as the provision of expertise that is specifically relevant to the recipient's local business. In these cases, the functional analysis will be especially important to determine where support stops and oversight starts, as it may be appropriate to charge only a proportion of these costs.

Case study 1: Head office provides a range of services to its operating companies ('the opcos'). These include management time, which shares the expertise of the senior team with the local businesses, while at the same time providing comfort to head office that the opcos are effective. Following functional analysis, it is determined that this support is greater for smaller opcos, whereas larger opcos with more experience benefit less. Of the time spent on the smaller opcos, 70% is charged; and 30% is retained by head office to reflect time spent on oversight. For the larger, more self-sufficient opcos, 40% is charged and 60% is retained.

Specification requirements

Another challenge often seen from tax authorities is whether the local operations need the level of support provided in light of the overall group requirements. A high specification IT system or HR policy designed to meet the needs of the largest subsidiaries, or the business needs of particular territories, may give rise to a cost that is considered excessive for more basic operations. Again, it may be most appropriate for some or all of the difference in cost between a 'basic' system and one with all the bells and whistles to be focused on those territories which specifically require the extra attributes.

What is the appropriate charge for the service?

Having identified the service activities provided to connected parties, the next step is to appropriately identify and allocate costs. A margin on those costs (usually effected through a mark up) must also be considered. Both underlying costs and margin are important, as while the mark up has traditionally been the subject of debate, the underlying costs represent a much larger number at stake in the event of tax authority challenge.

Identifying and allocating costs

It is important to be able to identify the cost of service provision clearly and accurately. Relevant teams will have cost centres which can be tracked. The costs to be recharged will typically be the 'fully loaded costs' of the relevant personnel, including the costs associated with the performance of their services, such as a share of office space and utilities. Services that are bought in as part of the provision, such as advisors, should also be identified.

These costs will then need to be allocated to recipient entities in the group. Again, this can be a focus of tax authorities, which want to be sure the local company receives its appropriate share and is not being overcharged. It is also a key policy question for businesses; while it is possible to go into granular detail, anything past a certain point can prove undesirable. The OECD does not require the creation of a cottage industry around services charging, so it is important to find a policy which is both practical and robust.

Costs can be attributed and charged directly to the recipient of each service. This direct charging 'is of great practical convenience to tax administrations because it allows the service performed and the basis for the payment to be clearly identified' (OECD guidelines, para 7.21). This is usually the most robust approach to support a local deduction for the costs, as it is clear and precise. However, in practice this requires the teams providing the services to keep track both of their costs and to which parties they relate. This needs more rigorous internal infrastructure, together with the acceptance of some form of time recording by staff and management, which may be challenging to implement.

Direct charging often works best for specific projects; for example, an office move or product launch. It can provide comfort that projects are being tracked – and that other locations are not picking up costs that would provide incidental benefit at best – without the need for universal timesheet reporting.

Those costs which cannot be directly attributed should be shared indirectly, using an allocation key. This key should use an indicator that gives a sensible result based on the service and benefit provided. For example, IT or HR might be based on headcount, while marketing and management support might be based on percentage share of turnover. As the size (and service need) of the local business is often consistent with its sales, turnover is a key that is used frequently.

'Any indirect-charge method should be sensitive to the commercial features of the individual case…, contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocation of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service' (OECD guidelines, para 7.24).

The key proviso here is that the costs allocated are commensurate with (reasonably expected) benefits.

> For those support services which are not customer facing and do not involve unique and valuable intangibles or the assumption of substantial or significant risk, businesses may elect to apply a simplified approach

Case study 2: In the same group, the larger opcos have sizeable HR departments and so draw on less support from the central head office HR team. Based on the benefit received, it was decided that an allocation based purely on turnover was inappropriate, as this could overcharge the larger opcos compared to their smaller counterparts, and an additional departmental headcount weighting was required.

Shareholder costs, costs resulting in direct charges and indirectly allocated costs will together typically make up the cost base of the service provider. However, can costs be left which could be recharged from the perspective of the service provider, but which are challenging from the perspective of the service recipient? Sometimes, issues can arise around whether it is appropriate to charge costs incurred at high cost country rates to lower cost locations (where a potentially lower cost equivalent service could be sourced). Such instances can be difficult to resolve, but once again the resolution will lie in the strong articulation of the benefit, and whether it is really possible to source an equivalent service from the low cost location.

Mark-ups and margins

At arm's length, service providers typically expect to make a profit on the services they provide. Therefore, when applying the arm's length principle, the default assumption is that there should be a profit margin (via the mark up) for the service provider.

It is important to note that a mark up will only apply to internal fully loaded costs. Where the provider is acting as an 'intermediary' in a service and incurs bought in costs, such as advisors' time, these third party costs are considered to contain a profit element already and so no further mark up is appropriate.

A comparable uncontrolled price (CUP) for intra-group services is rare. It is unusual for internal business support functions to perform those same services for third parties and so generate a robust CUP which may be applied to the internal transactions.

Another method is typically required. As management support services are 'routine' and delivered to requirements with a managed cost base, a mark up on cost will often be most appropriate. This will be supported using a cost plus method, if data is available; or otherwise by the transactional net margin method, using the net cost plus profit level indicator. The latter support is most common.

The acceptance of this as standard practice has led the OECD to include specific guidance on low value adding services in Part D of Chapter VII of the OECD guidelines.

For those support services which are not customer facing and do not involve unique and valuable intangibles or the assumption of substantial or significant risk (para 7.45), businesses may elect to apply a simplified approach. This follows the familiar steps to determine benefit, identify the cost involved, make a direct allocation where necessary, and then allocate the balance using a reasonable key. A mark up of 5% may then be applied to the amounts charged without the need for a benchmarking study.

It should be noted this is a (non-binding) OECD view and benchmarking studies supporting a mark up will remain a key part of the analysis for tax authorities in many territories.

Examples of activities which qualify as low value adding services are provided in the OECD guidelines (para 7.49):

- accounting and auditing;
- processing and management;
- HR;
- monitoring of health, safety and environmental data;
- IT;
- internal and external communications and public relations support (excluding advertising or marketing activities or strategies);
- legal services;
- tax services; and
- general administrative and clerical services.

Having agreements for the provision and charging of services in place from their inception is highly recommended

Core business activities are specifically excluded, along with others such as R&D and the services of corporate senior management.

Management activity, together with marketing support, is often found in services collectively provided by groups to their operating companies. The mark up on these will need to be considered, together with requirements for supporting comparables benchmarking, which reduces the usefulness of the low value added services guidance as a 'one-stop shop' to deal with the charging of services.

The OECD guidelines are quick to point out that: 'The fact that an activity does not qualify for the simplified approach … should not be interpreted to mean that that activity generates high returns. The activity could still add low value' (OECD guidelines, para 7.48). Therefore, any profit margin should be determined in the usual way.

That is assuming that a separate charge is appropriate at all. Where service activities are bound up in a wider transaction, it may be appropriate to bundle them with the other charge. For example:

- ancillary services may be included in a wider charge for the use of technology assets (para 7.3);
- financial services, such as loans, foreign exchange and hedging, may be built into the spread (para 7.15); and
- procurement services may be built into the product price (para 7.15).

Care should be taken to ensure that there is no 'double charging' for costs or margins relating to these services.

How should the charges be documented and supported?

Service charging must be clearly explained and supported through transfer pricing documentation.

The OECD master file standard contains a section to disclose important intra-group service arrangements. While the consistency of service charging around a group may lend itself to explanation once in the master file, it is important to demonstrate the local benefit specific to each territory in each local file. This should include providing evidence of both the costs incurred and the benefits received. This evidence can include deliverables such as policies or presentations, records of time on site, or chains of email correspondence.

Where a group has elected to follow the simplified methodology for low value adding services, the following documentation is required:

- a description of the services, beneficiaries, reasons why the service are low value adding, rationale for the service provision, description of the benefits and allocation keys (including support for their selection), and confirmation of the mark up;
- written contracts or agreements; and
- documentation and calculations showing the determination of the cost pool and mark up applied, as well as the application of allocation keys.

Based on this list from para 7.64, it remains to be seen how much simplification this offers in practice.

In addition, having agreements for the provision and charging of services in place from their inception is highly recommended. These will clearly specify the transaction and set out the intent of the parties to provide and pay for the services. Many territories challenge the arm's length nature of service charges made without a signed service agreement already being in place. It may also help with other tax considerations, e.g. supporting a deduction being appropriate for corporation tax under local rules, and the character of payment for the purposes of withholding tax.

Next steps

To ensure that the charging policy for management and support services is at arm's length:

- Understand the nature of the services themselves and the benefits they provide through a detailed functional analysis which includes the views of local offices. A clear view of the activities is a critical first step.
- Quantify the fully loaded costs of those activities, together with related bought in costs.
- Determine activities which should not be charged and carve these out.
- Identify costs which can be directly charged to a territory or company.
- For those costs that remain, set an appropriate allocation key. Be comfortable that this is a good fit with the functional analysis in practice.
- Determine and apply a mark up to internal costs, supported by benchmarking as required.
- Make the charges at appropriate intervals. (These can be based on budget with periodic true up.)
- Put in place intercompany agreements at the earliest opportunity.
- Consider electing to apply the simplified approach for low value adding services.
- Prepare transfer pricing documentation setting out the policy and rationale, and showing its application.

A robust policy and support for service charges is essential. While service charging is common, that also means that it is visible to tax authorities and so under scrutiny. That charges can be made to large numbers of subsidiaries means that challenges can multiply, with the resulting drain on management time. Service charges can often be reviewed as a proxy risk assessment by a tax authority, with any weakness in this apparently simple area creating a lack of confidence in other aspects of the transfer pricing policy. The opposite can also be true, that an effective charging policy for services can set the group's transfer pricing policy off on the right track. ■