Hang-ups over Mark-ups?

The OECD Issues a Discussion Draft on Intra-Group Services

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News: As part of its *Action Plan on Base Erosion and Profit Shifting*, the Organization for Economic Co-operation and Development ("OECD") identified charges for intra-group services as contributing to the erosion of the tax base of payor countries. In November 2014, the OECD issued a public discussion draft on *Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services*. Seeking to provide taxpayers with the ability to make appropriate service charges while helping tax administrations avoid base erosion, the draft offers a method for charging an array of administrative support services based on the costs of providing such services. The method also requires a uniform profit mark-up of between 2 and 5 percent. A number of the comments received by the OECD called for the option of applying no mark-up at all.

Views: Do not let its humdrum title fool you: the OECD discussion draft on intra-group services is an important development in transfer pricing. While the original *Action Plan* viewed service charges with suspicion, referring to management fees and head office expenses as "common types of base eroding payments" and including them with "other high-risk transactions," the current discussion draft strikes a more balanced tone. The draft acknowledges the importance of centralized services for multinational enterprises and provides a useful framework for allocating the costs of common administrative services among the benefiting members of the group and for providing documentary support for the service charges. Instead of contributing to base erosion, centralized services can actually reduce the costs of the recipients, which would otherwise have to provide the services themselves or engage a third party to do so.

With respect to mark-ups, taxpayers want a system that is administratively practical and tax administrations appear to want at least some amount of profit element, even for low value-adding services. Neither side should be too concerned. Mark-ups are the least important part of administrative service charges. The key considerations are, in order of importance:

1. Was a benefit provided?

2. If so, which allocation key should be used?

3. Finally, what mark-up, if any, should be applied?

The first question evaluates whether any charge should be made at all. The most important matter in a transfer-pricing audit of intra-group services is whether the services provide a benefit to the recipient so that the recipient may take a deduction for the charge. Once a decision has been made to charge the costs of a particular service, the choice of allocation key can have considerable bearing on how those costs are distributed among the benefiting members of the group. An activity-based costing analysis will seek to identify an allocation key that is closely aligned with how the resources within a service function support the different recipients. The actual markup applied to the resulting cost base is only a small percentage of the total charge.

In sum, even though differences on mark-ups may remain, they are not especially consequential and they should not detract from the benefits of the proposed new guidelines on intra-group services. The simplified charge mechanism for low value-adding intra-group services can help taxpayers adopt a practical, cost-based approach for charging affiliates for shared administrative services. At the same time, tax administrations will require certain documentation, specified in the draft, to support the application of the simplified method. But greater transparency by taxpayers on the underlying services costs and how those costs are apportioned among the members of the group can go a long way in getting tax administrations comfortable with service charges. Anything that can help taxpayers avoid headaches over service charges is a benefit indeed.

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