Dr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
By email

SUBJECT: DISCUSSION DRAFT ON LOW VALUE-ADDING SERVICES

13 January 2015

Dear Dr. Hickman,

By means of this letter, we would like to take the opportunity to provide comments on the discussion draft regarding BEPS Action 10: "Proposed modifications to Chapter VII of the transfer pricing guidelines relating to low value-adding intra-group services" (the Discussion Draft) as released by the OECD on 3 November 2014. This letter presents the collective view of EY's global transfer pricing network. We agree to have our comments posted on the OECD website.

General remarks

While there is a great variety of transactional models applied by multinational enterprises (MNEs) across the world, virtually all of them to some degree will be engaged in the provision of intra-group services. Therefore the availability of specific guidance with respect to intra-group services is very valuable for MNEs, tax administrations and other transfer pricing professionals. In many cases, the lack of guidance with respect to low value-adding services may have created a disproportional administrative burden for taxpayers to comply with relevant transfer pricing rules and regulations. Against this background, we are very pleased with the OECD's proposed modifications to Chapter VII of the transfer pricing guidelines and in particular the introduction of specific sections regarding low value-adding services.

The Discussion Draft explains that the proposed modifications seek to "achieve the necessary balance between appropriate charges for low value added services and head office expenses and the need to protect the tax base of payor countries." We believe it is equally important to make sure that the proposed modifications also provide taxpayers with certainty and reduce the administrative burden with respect to intra-group services. As you will see in the detailed comments below, the issue of clarity and administrative burden is one of the main themes of our comments.

This proposed guidance is introduced as part of the work in connection with BEPS Action 10 ("Other high-risk transactions") and the aforementioned goal of protecting the tax base of payor countries seems to imply that low value-adding services are high-risk transactions from a BEPS perspective. The qualification of low value-adding services as high risk transactions from a base erosion perspective seems debatable based on the very nature of the services. The introduction of this guidance in connection with Action 10 – without providing an explanation or context – may

even encourage tax administrations to put disproportionate emphasis on the analysis of charges made in connection with low value-adding services. This would not be aligned with the goal of reducing the administrative burden for taxpayers. Therefore we recommend adding an explicit statement that low value-adding services are typically not high risk transactions.

Key comments

Most of the newly proposed elements of the Discussion Draft relate to low value services. Given the importance of the topic, we also provide comments on sections and paragraphs that are not proposed to be changed as compared to the guidance currently available.

Our key comments with respect to the Discussion Draft, as further elaborated upon in the "detailed comments" section of this letter, can be summarized as follows:

- We believe the introduction of the proposed guidance with respect to low value-adding services is not intended to imply that an approach for other services may not have elements similar to the simplified approach. More specifically, it should not be concluded that the mark-up for other services should be higher than 5% per se.
- The benefit test is an important element of the analysis of intra-group services. In many cases it is possible to identify which benefits are provided but difficult or impossible to measure these benefits. We recommend emphasizing that the benefit test should be focused on the quality of the benefit and not so much on the quantum of the benefit.
- Intra-group services very often are unique in nature. Often independent parties are not able to provide services of the same nature and/or quality a related party does. Because of this unique nature, a comparison between the charges for intra-group services with the price level in a service recipient's market in general will not be appropriate.
- According to the Discussion Draft, an MNE group electing to adopt the simplified charge mechanism should apply it on a consistent, group wide basis in all countries in which it operates. This "all-in" or "all-out" approach likely will create problems, for example because some countries may allow a charge-out of costs without a mark-up for certain activities or when countries in which the MNE is doing business do not allow the application of the simplified approach for low value-adding services (e.g., non-OECD member states).
- The need to pool the costs incurred by various members – the initial step in the simplified approach - seems to increase the complexity and the administrative burden of the charge mechanism.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

John Hobster/Ronald van den Brekel

Detailed comments

The Discussion Draft mentions it is preferred that comments be provided with references to paragraph numbers. In light hereof, we have structured our comments in accordance with the structure of the Discussion Draft itself and included references to specific paragraphs where considered helpful. While our focus is on the wording proposed to be added as compared to the current Chapter VII of the guidelines, we also provide comments on sections and paragraphs that are not proposed to be changed as compared to the guidance currently available.

Benefit test

The general rule as described in paragraph 7.7 is conceptually clear: an intra-group service is provided if the activity performed provides the service recipient with economic or commercial value to enhance or maintain its commercial position and this can be determined by considering whether an independent enterprise would have been willing to pay for the activity or would have performed the activity in-house for itself. In many cases it is possible to identify (or qualify) which benefits are provided but difficult or impossible to measure (or quantify) these benefits. To avoid intra-group charges being challenged merely because of the difficulties with respect to the measurability of the benefit, we recommend emphasising that the benefit test should be focused on the quality of the benefit and not so much on the quantum of the benefit. Moreover, for completeness it would be helpful to add a statement acknowledging that some activities will never actually produce the benefits that were reasonably expected when they were performed (reference is made to the wording used in paragraph 7.34).

Another point of attention with respect to the benefit test is the often unique nature of intra-group services. Sometimes services provided by a related party may appear to be available in the local market or could be performed in-house at a lower price, but in practice they are often so specific and tailored to the business of the MNE that no other company than the related party would be able to provide the exact same service or with the exact same quality. This should be recognised when applying the benefit test to intra-group services. It would be helpful to explicitly mention this in the section with respect to the benefit test.

Shareholder activities

Paragraph 7.10 defines a shareholder activity as "one that a group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members." This means that activities partly performed because of ownership in one or more other group members do not qualify as shareholder activities and therefore not all costs related to these activities should be disqualified for purposes of being charged out to the respective group members. It would be helpful to provide further clarifications in this regard.

The introduction of specific examples of shareholder activities (paragraph 7.11) is very helpful and will likely reduce the divergence between the interpretation by taxpayers and the interpretation by tax administrations. A minor comment in this regard is that the first sentence of paragraph 7.11 speaks of shareholder activities, whereas the examples concern shareholder costs.

Duplication

The wording added to paragraph 7.12 addresses the main point of discussion with respect to the issue of (possible) duplication, i.e., the fact that if similar functions are performed at different levels

within an MNE, this does not necessarily mean they are duplicative in nature. The proposed wording clearly addresses this issue by stating there are many levels of activity. In practice, we often see that the main levels of activities are the strategic level (e.g., long term decisions made at the head office level), the tactical level (e.g., translation of the strategy into an action plan by a regional head office) and the operational level (e.g., the actual implementation and execution by operating companies at the local level). As many MNEs are organised like this, it may be helpful to add some additional wording to the example of marketing services in paragraph 7.12.

Paragraph 7.14 assumes the so-called "halo effect." We assume this will be further discussed in the context of BEPS Action 4 ("Limit base erosion via interest deductions and other financial payments") or the related financial services transfer pricing project. We believe it would be very helpful if the OECD would provide concrete guidance and examples with regard to this topic. We would be happy to provide you with more detailed comments in this respect.

Determining an arm's length range

The wording in paragraph 7.23 that MNEs should often be able to adopt a direct charge arrangement seems to contradict the statement made in paragraph 7.24 that a direct charge arrangement is difficult to apply in practice. Based on our experience, adopting a direct charge arrangement in many cases is only feasible (taking the administrative burden into account) with respect to certain expenses such as travel expenses and insurance premiums, fees incurred with third parties on behalf of member(s) of the group, or costs in relation to projects undertaken for a specific entity. It also requires that such costs are captured by the MNE's financial systems in such a manner that they can be easily allocated. While this is recognised in paragraph 7.24, we believe it would be helpful if the wording in paragraph 7.23 is amended in such a way that it does not suggest a direct charge arrangement is often feasible.

The acceptability of an indirect charge method is invaluable for many MNEs, among other reasons because of practical challenges and the disproportionately heavy administrative burden of direct charge arrangements. Because of the great practical value and importance of indirect charge methods, some modifications to paragraph 7.25 could be considered to make sure taxpayers are not confronted with unreasonable requirements. For example, paragraph 7.25 indicates that indirect charge methods should be allowable provided sufficient regard has been given to the value of the services to recipients. It may be more appropriate to require taxpayers to give sufficient regard to the "expected" benefit of the services. Also the statement that "every attempt should be made to charge fairly for the service provided" may impose a disproportionate (administrative) burden on taxpayers. In light of the context, it seems more appropriate to require taxpayers to make a "reasonable effort" instead.

Furthermore, the guidance with respect to the use of an indirect charge mechanism and allocation keys suggest that any charging "must lead to a result that is consistent with what comparable independent enterprises would have been prepared to accept" (paragraph 7.26). In practice it is often impossible to establish what independent parties would have been willing to accept, for reasons as simple as the lack of sufficiently detailed comparability data. Also in this respect we believe the focus should be on the reasonable efforts made by taxpayers.

From practical experience, we believe paragraph 7.27 rightly raises the point that there is an increased risk of double taxation for various reasons when indirect charge methods are applied. In this context, we would recommend encouraging tax administrations to apply a pragmatic approach and, for example, to focus on the quality of the link of the allocation key with the expected benefit,

the unique nature (and therefore lack of alternatives) of the intra-group services and whether the charge mechanism is applied consistently throughout the group.

Form of the compensation

Paragraph 7.28 elaborates on various allocation keys and when they might be appropriate. This paragraph might therefore be better placed under section B.2.2.2 on indirect-charge methods.

Calculating the arm's length compensation

The emphasis on the value of the service and on how much an independent enterprise would be prepared to pay for that service (paragraph 7.31) may create issues for a number of reasons addressed in some of our comments above. For example, it is often not possible to accurately quantify the expected benefit of the service for the service recipient. In such cases, a mathematical comparison between the value of the service and the cost of the service is not feasible. Furthermore, it is often not possible to accurately assess how much an independent enterprise would be prepared to pay, e.g., because of the unique nature of the intra-group service and due to a lack a reliable comparability data.

Paragraph 7.32 mentions that "from the perspective of an independent enterprise seeking a service, the service providers in that market may or may not be willing or able to supply the service at a price that the independent enterprise is prepared to pay." This section may cause tax administrations to compare the charge for the intra-group service provided with the cost of "similar" services in the local market or, more generally, to compare the price level in the service recipient's market with the price level in the service provider's market. Such a comparison is often flawed when it concerns services for which no substitute is available in the local market, e.g., because the service is tailored to the MNE's business (in terms of IT systems used, knowledge of the company, etc.) to a degree that cannot be offered by independent service providers. Also paragraph 7.35 may be interpreted as suggesting that a comparison of the price level in the service recipient's market and the price level in the service provider's market is needed. We believe that in general this would not be appropriate. It would be helpful to add explicit wording to clarify the above.

With respect to the need for comparability adjustments to account for differences in the level of costs incurred by the group service provider and the costs that would hypothetically be incurred by the recipient were it to perform the service itself, we refer to our comments on the section on low value-adding services further below.

In cases where the transfer pricing policy adopted entails the (direct or indirect) charge-out of costs incurred by the service provider, tax administrations should not be allowed to 'sit in management's chair' and determine whether the cost base is appropriate; the presumption should be that the cost base is appropriate as management has decided to bear these costs. The only question should be whether the allocation of costs (directly or indirectly) and the mark-up can be considered appropriate. We recommend emphasising the importance of acknowledging the business considerations underlying the decision to have a service provided by a group member in a certain jurisdiction and the company-specific nature of the services involved.

Some of the issues mentioned above (e.g., the difference in price levels and lack of sufficient comparability data) may be particularly true for developing countries. Further clarifications as suggested above would therefore be helpful for taxpayers and tax administrations in developing countries.

Paragraph 7.36 effectively concerns the issue of pass-through costs, as introduced in paragraph 2.93 of the guidelines. Paragraph 2.93 states that the answer to the question whether costs can be treated as pass-through costs "depends on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up on part of the costs it incurs." As mentioned in paragraph 2.94, comparability issues may arise in practice where limited information is available on the breakdown of the costs of the comparables. In practice, this is very often the case and alternative approaches have to be adopted. Paragraph 7.36 is helpful where it mentions that "for example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function." It would be helpful if more general guidance would be provided along these lines; for example, by explaining that a relevant question is whether an independent party would have been able to incur certain costs directly. In the absence of reliable comparability data, this question could be answered by applying existing guidance and transfer pricing principles, e.g., by applying economic principles governing relationships between independent enterprises, as mentioned in paragraph 1.52 (in the context of the absence of written agreements).

Low value-adding services

In many cases, the lack of guidance with respect to low value-adding services may have created a disproportional administrative burden for taxpayers to comply with relevant transfer pricing rules and regulations. Against this background, we are very pleased with the proposed introduction of specific sections regarding low value-adding services. Our comments with respect to the proposed sections regarding low value-adding services are presented below.

Definition of low value-adding intra-group services

The definition of low value-adding intra-group services seems to strike a proper balance between being specific on the one hand and flexibility on the other hand. We are pleased that the OECD did not choose to provide an exclusive list of services and that it explicitly mentions that the supportive nature of the services should be determined by comparison with the activities of the MNE, and not on a legal entity basis. With respect to the criteria mentioned in paragraph 7.46, issues may arise about the definition of "supportive" and the definition of "core business." The OECD should consider adding some further clarifications in this regard, e.g., in paragraph 7.50.

The examples of activities that would not qualify as low value-adding services (paragraph 7.47) and the examples of services that would likely qualify as low value-adding services (paragraph 7.48) are helpful. We can imagine that in some industries the activities mentioned in paragraph 7.48 are not low value-adding in nature, even in cases where they are not core business activities. For instance, monitoring and compilation of data relating to health, safety, environmental and other regulatory standards may be more important in some industries than in others. We recommend that the OECD clarify this, e.g., in the first sentence of this paragraph and emphasize that the lists in paragraph 7.47 and 7.48 are indicative. More generally, we believe the introduction of the proposed guidance with respect to low value-adding services is not intended to imply that an approach for other services may not have elements similar to the simplified approach. More specifically, it should not be concluded that the mark-up for other services should be per se higher than 5%.

Some of the activities that would likely meet the definition of low value-adding service might entail activities that can be qualified as shareholder activities (as defined in section B.1.2) for which no charge would be justified. For clarity's sake, it would be helpful to add a statement in this respect to section D.1 or D.2.

As an aside, we note that based on the wording in paragraph 7.46 it is not clear whether all services that meet the criteria would automatically qualify as "low value-adding services" in the terms of section D. This may be a relevant question in light of the elective or mandatory nature of the suggested mechanism for low value-adding services.

Simplified determination of arm's length charges for low value-adding intra-group services

As per paragraph 7.51, an MNE group electing to adopt the simplified charge mechanism should apply it on a consistent, group wide basis in all countries in which it operates. This seems to imply an "all-in" or "all-out" approach with respect to services involved and countries / group members involved.

The all-in / all out nature across countries may create problems, for example because some countries may allow a charge-out of costs without a mark-up for certain activities (e.g., the Netherlands or the United States). While such an approach is not detrimental from the service recipient's perspective, the all-in / all-out approach would force MNEs to adopt this approach globally. Similarly it would create a problem if one (e.g., non-OECD) country in which the MNE is doing business does not allow for the simplified approach for low value-adding services.

Determination of cost pools

Paragraph 7.52 mentions that the initial step in applying the simplified approach to low value-adding intra-group services is for the MNE group to calculate, on an annual basis, a pool of all costs incurred by all members of the group in performing low value-adding intra-group services. This implies that the simplified approach cannot be applied by one legal entity just for the low value-adding services it provides to other group members. The need to pool the costs incurred by various members seems to increase the complexity and the administrative burden in of the charge mechanism, e.g., in terms of collecting data, reconciling data, and calculating and implementing the various charges. In light of the purpose of simplification we recommend allowing the application on a legal entity basis whereby the respective legal entity charges out the relevant costs to the service recipients in accordance with the simplified approach.

In addition, we recommend that the OECD further specify or provide further guidance with respect to the costs included in the cost pool (or cost base). For example, it could be helpful to clarify whether overhead and extraordinary expenses should be included in the cost base. Specifically, guidance should be provided as to the definition of cost that is included and could be applied consistently.

Paragraph 7.53 mentions that, as a second step, the taxpayer should identify and remove from the pool those costs that are attributable to services performed by one group member solely on behalf of one other group member. This rule, as well as the example provided, imply that if one group member provides low value-adding services to more than one other group member, a direct allocation mechanism (as a first step) cannot be applied. While there may be difficulties with respect to direct charge mechanisms, we struggle to understand why a direct charge of some costs (as a first step) would not be allowed.

In the context of assessing the appropriateness of the cost pool / cost base, we recommend adding further clarifications to make clear that for low value-adding services, it will not be required to examine whether comparability adjustments are needed with respect to the costs incurred by the group service provider and that a reference to the costs that would hypothetically be incurred by the recipient were it to perform the service for itself is not required either. It should be presumed that business reasons are underlying the MNE's decision to provide intra-group services in a certain (e.g., centralized) manner and from a specific location.

Allocation of low value-adding service costs

The comment in paragraph 7.55 that "as a general rule, the allocation key should reflect the underlying need for the particular services" seems superfluous, given the relative nature of the benefit test for low value-adding services. In addition, it can be expected to be interpreted by tax administrations to require a more detailed benefit test than what appears to be intended in the simplified approach. More generally, by definition a simplified approach will result in a less thorough application of the arm's length principle and will therefore not always align with the more rigorous application of the general guidance on intra-group services (i.e., sections A through C).

Paragraph 7.56 mentions that "there may be no need to use multiple allocation keys if the taxpayer can explain the reasons for concluding that a single key provides a reasonable reflection of the respective benefits." If the taxpayer is able to provide such an explanation, we would say there "is" or "will be" no need to use multiple allocation keys.

Profit mark-up

The introduction of a clear rule with respect to the application of a profit mark-up, as in paragraph 7.57, will create certainty for taxpayers, which is generally helpful. However, the proposed range (2% to 5%) may be perceived as being rather narrow and it may force a large number of MNEs to change their existing transfer pricing policies which may include mark-ups ranging somewhere between 3% and 10% (e.g., based on the guidance provided by the EU Joint Transfer Pricing Forum or based on US regulations with respect to intra-group services). Moreover, for some taxpayers it may not be possible to adopt a transfer pricing policy that complies with the OECD guidance on low value-adding services and with domestic regulations. In this regard, the OECD should consider applying a wider range of mark-ups.

Charge for low value-adding services

With reference to our comment with respect to the definition of the cost pool, we note that the implementation of the proposed charge mechanism may be complex if it requires a multitude of cross-charges to be made. It seems that an application of the simplified approach on a legal entity basis would result in a simpler mechanism and to a similar extent would meet the objectives of achieving the necessary balance between appropriate charges for low value-adding services and head office expenses and the need to protect the tax base of payer countries.

It might be helpful to elaborate on how to apply the simplified approach when a central charge entity is used (i.e., one group member collecting / aggregating the costs and on-charging these costs to the relevant group members). To avoid duplication of mark-ups, it would be helpful to explain that no mark-up should be applied by the central charge entity on costs that were already subject to a mark-up by the group member performing the activity. It seems appropriate for the

central charge entity to only apply a mark-up on the costs it incurs in performing its (pooling) function.

Application of the benefit test to low value-adding services

The wording in paragraph 7.60 implies that the benefit test under the simplified approach does not apply to the quantum of the benefit. As this is an important factor for the practical value of the simplified approach, it would be helpful if this was explicitly mentioned.

Paragraph 7.60 indicates that a single annual invoice can be used if the information as mentioned in paragraph 7.61 is made available to tax administrations. For the sake of consistency with the requirements as mentioned in paragraph 7.61, it seems more appropriate to require taxpayers to prepare such information and to require them to make it available upon request. The statement that correspondence or other evidence of individual acts should not be required may be of great practical value for taxpayers and could reduce the administrative burden compared to the current situation. It may be helpful to add examples of such "other evidence" to make clear that asking for flight tickets, hotel bookings, meeting notes, etc. in many cases creates a disproportional administrative burden for taxpayers.

In light of the aim to have a simplified benefit test for low value-adding services, we recommend that the OECD reconsider the wording used in paragraph 7.61, first bullet. In particular the request for a description of the benefits or expected benefits, as well as the request for a description of the reasons justifying that the allocation keys used produce outcomes that reasonably reflect the benefits received, could be used by tax administrations to effectively require a benefit test that is not materially different from the benefit test for other intra-group services. We believe the benefit test for low value-adding services should be applied on an MNE basis (i.e., describing the benefit for the group) rather than on a legal entity / service recipient basis.