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Grant Thornton discussion draft response

BEPS Action 10: Proposed modifications to Chapter VII of the transfer pricing guidelines relating to low value-adding intra-group services

Grant Thornton International Ltd, with input from certain of its member firms, welcomes the opportunity to comment on the on the revised draft Chapter VII of the OECD Guidelines issued on 3 November 2014.

We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on the proposed modifications to chapter VII.

Unfortunately we do not agree that the guidance as drafted is balanced between allowing 'appropriate charges' and 'the need to protect the tax base of payor countries' (emphasis added). In our experience, most head office locations struggle to charge out enough of the costs necessarily incurred by them for the benefit of their groups and often suffer tax losses as a result. The reasons for this range from: some very large payee countries refusing a deduction for anything described as 'management services', many countries repeatedly challenging the nexus between each cost and the specific benefit to them (eg asking for evidence of specific local visits), to others applying onerous withholding taxes which can be far in excess of the markups being charged in.

A very helpful clarification at the outset of the new chapter VII would be to specify that this guidance is to be applied to all cases equally, inbound and outbound. We would also very much welcome additional clarification that:

i. recharged costs, using a reasonable allocation key and following the principles in the chapter, should prima facie be deductible locally

ii. where costs are not allowed as intragroup services because they are shareholder costs, they should be deductible at head office level.

Revisions to existing chapter

We note that there have been some minor changes to the existing chapter including the addition of new headings. This additional readability is welcomed. VII.

The commentary on 'incidental benefits' in 7.13 and 7.14 adds much-needed clarity. Furthermore, the clarification that services are not necessarily duplicative just because similar types of costs may be incurred locally (7.12) is also useful.

We note that there is a proposed change to para. 7.43 (which updates para 7.41 of the 2010 Guidelines) referring to contract research carried out by service providers. We welcome the retention in the services chapter of the acknowledgement that 'research is … an example of an activity that may involve intra-group services'. However, the proposed change to this paragraph removes the sentence: 'In such a case a cost plus method may be appropriate'. We disagree with the removal of this sentence given that third party contract research organisations can, and often do, build up their pricing from costs or day rates.

The paragraph also now includes revised wording regarding the selection of method. We consider that the new wording in the last two sentences of this paragraph does not correctly direct the functional analysis. Where contract R&D is carried out, in our experience, 'the precise nature of the research' is less important than where and how the strategic direction of the research is carried out. As detailed in the revised chapter VI, it will be important to consider where the significant people functions in relation to development, enhancement, exploitation and protection of the intellectual property are based. We suggest that this point is clarified within this paragraph.

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Section D Low value-adding intra-group services

It is interesting to note that in the OECD report 'Multi-Country Analysis of Existing Transfer Pricing Simplification Measures' (published in June 2012) that a number of territories indicated that they have simplification methods directed at low value adding intra-group services. The commentary in this report suggested that such transactions were deemed simple with limited differential tax at stake.[1] As such, in this earlier paper prepared by the OECD, such payments were not considered as base eroding, but merely requiring some administrative guidance in order to limit the resources used in documenting and auditing such charges.

A similar view was taken by the EU Joint Transfer Pricing forum in its 2011 paper 'Guidelines on low value adding intra-group services'. This paper was aimed at allowing more efficiency in dealing with the transfer pricing aspects, as the problem was seen to be that excessive resources were being devoted to documenting and auditing these low-value services. We concur with this view, and we are concerned that the mounting pressure asserting that all deductions for group charges are 'base eroding' is being accepted by default every time it goes unchallenged.

It appears that the discussion draft as it stands will have most effect in limiting the ability to charge an arm's length price for genuine services, instead of being a genuine simplification process that is easy for businesses and tax authorities to operate and understand, and which would truly be helpful to all parties.

Definition of low value-adding intra-group services

A standard definition of low value adding intra-group services is to be welcomed. We consider that examples of services at para 7.48 are helpful. However there is a risk that some tax authorities may try to view this as an exhaustive list. We would like to see the text make it clear that this is an illustrative and not an exhaustive list of examples, and that depending on the facts and circumstances of the Group there may be additional activities that could be included on this list.

We consider that the list of non-low-value-adding services provided at para 7.47 is less helpful, especially given the categorical wording (eg 'would not'). In addition, given the limited nature of services that apparently could qualify for the safe harbour 'simplified approach' we would also welcome guidance on pricing for higher value services.

1. paragraph 3, p10 of the Discussion Draft

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

We welcome an approach to dealing with low value-adding services without the need for exhaustive benchmarking. We suggest the mark-up on full costs range given of 2-5% is low and in our experience a range of 3-10% would be more suitable (and could also perhaps encompass some of the currently excluded services in 7.47. It is unclear why in Para. 7.57, if the rates provided are considered benchmarks for arm's length pricing of such services (and if they are not, one has to ask why they have been proposed) that the revised chapter expressly states they cannot be used as such in the case of 'similar' services.

The reference in 7.51 to Cost Contribution Arrangements as a 'possible alternative' to the simplified method seems odd and there is no explanation of why it has been included. It does not seem likely to us that most low value added services would qualify as the sort of costs that third parties might cost-share.

Documentation and reporting

We note that if an MNE Group is to elect to apply the simplified methodology they will need to document specific information set out in the discussion draft and make it available at a tax administration’s request. It is unclear how this would interact with the recommended documentation approach in revised chapter V and we would request that guidance is included here. A 'light touch' is key if the methodology is going to be useful in practice.

Closing comments

The other key determinant as to whether this methodology is going to be useful will be consistency of adoption. If some important countries are prepared to 'buy in' only when they are the payor of these charges, yet when they are the recipient of service fees they continue to insist on very substantial mark ups far in excess of the safe harbours mooted here, the guidance will not be helpful.

We should be pleased to expand on any of the points raised here. Please contact your usual Grant Thornton contact, Wendy Nicholls (wendy.nicholls@uk.gt.com) or Lorna Smith (lorna.smith@uk.gt.com) for further details.

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