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

Dear Mr. Hickman,

On November 3rd, 2014, the OECD published a further Discussion Draft: "*Proposed modifications to Chapter VII of the transfer pricing guidelines relating to low value-adding intra-group services*", indicating on its website that written comments on this paper should be submitted by interested parties by January 14th, 2015.

The Discussion Draft deals with the charging for intercompany services. This topic is of particular importance for the daily work of our clients. We greatly appreciate the initiative of the OECD to modify Chapter VII of the Transfer Pricing Guidelines (hereinafter "OECD TPG") and in so doing to factually accommodate and confirm the increasing importance of intra-group services within cross-border business models and the relating need for legal certainty. Whereas even appropriate cost allocation schemes still seem to be considered by many domestic tax authorities as models for mere base eroding payments, it can be deemed as a matter of fact that any intra-group operative business as well as any proper exercise of the arm's length principle itself would not work without there being a reliable and efficient framework for the allocation of costs for intercompany services in place.

In this context, we examined the paper with great interest and trust that we will be able to provide you with constructive suggestions. According to the above, we are most thankful for the opportunity given to us by the OECD to participate in this project and hope that you will find useful remarks in our comments below.

Please do not hesitate to contact us should you require any clarification on those comments that are sent on behalf of the Rödl & Partner Global Transfer Pricing Group which encompasses transfer pricing professionals in 27 countries.

With best regards,

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Preposition

Our comments will be structured as follows: The first part will focus on general issues and remarks of overriding importance. In the second part of our comments starting on page 3, however, the particular aspects of the individual paragraphs shall be highlighted in chronological order. Finally, our memorandum shall conclude by summarizing the most important aspects from our point of view.

Overall general remarks

First of all the Discussion Draft deserves the merit to disprove the preconceived idea that charging for intercompany services is in general an instrument for profit shifting. The effort which the OECD invested in clarification is very appreciated by the taxpayers and will reduce hurdles within the international economy. Regarding this the OECD reconfirms the general principle that charging for intercompany services considering the arm's length principle is an appropriate transaction from the transfer pricing point of view.

Regarding the proposed modifications to Chapter VII of the OECD TPG, the OECD concentrates from our standpoint indeed on a practical topic and thus leaves the field of an exclusively academic discussion. From our perspective, this is a commendable development. According to this the proposed modification will generate more interest especially among the taxpayers. In practice, a guideline regarding the charging of intercompany services is necessary for the taxpayers because the topic is frequently and controversially discussed in tax audits.

In comparison to the previous version of Chapter VII the proposed modifications introduce a clearer structure. According to the well-structured table of content the remarkable points regarding the charging for intra-group services can be followed easier by the taxpayer than before because the proceeding for charging, which must be considered by the taxpayer, is already mentioned in the table of content. Additionally, we absolutely appreciate the introduction of an additional Section D devoted to low-value adding services which mainly attempts to reduce the administrative burden of the MNEs which is an important aim in order to establish an effective guideline-system.

Moreover, the Discussion Draft includes numerous examples regarding the definition of intercompany services in general, stewardship services and low-value adding services. These examples enable a suitable classification and reinforce the practical usage of the OECD TPG. In practice, this may give valuable guidance for particular cases when designing a transfer pricing regime for intra-group services and furthermore, we trust that making reference to a specific example of the OECD TPG may facilitate defending service charges within a tax audit, providing a higher degree of legal certainty for both the taxpayers and the competent tax authorities.

Nevertheless, the examples focus mainly on definitions and only to a minor extent on implementation issues. In other words, there are many examples regarding the question which services are chargeable or not and which services are low-value adding but there are less examples dealing, for e.g., with the concrete implementation of billing. For instance, there are no examples regarding the appropriate cost base or mark-up. This point will be considered in more detail later on.

The OECD has offered a proposal for a charging mechanism which is convenient to meet a high degree of acceptance among the current OECD members. This possible far-reaching consensus at

least among the OECD members could lead to a unified regulation and according to this to legal certainty within a broad area which is very important for the MNE groups because it is burdensome for them to deal with several different domestic law regulations and in the next step complying with their requirements. Although the efforts at OECD level will not per se have any impact outside of the OECD where tax jurisdictions often do not accept for instance the indirect cost allocation at all or at least implement obstacles which may lead to implementation problems for the MNE groups. Consequently, we appreciate that at least the OECD makes further attempts to create among the member states a broad acceptance range. Regarding this, the work of the OECD is an essential contribution to establishing global transfer pricing guidelines, which is a desirable development from the MNEs' perspective.

We appreciate the OECD argumentation coming from an economic point of view. This opens a certain degree of flexibility for the MNEs and facilitates the implementation of different approaches depending on individual cases. According to this the transfer pricing system can go along with the operative business model.

However, in addition to the need for flexibility and a case-based approach there are two more characteristics which a well-balanced regulative environment has to fulfill from our point of view: Legal certainty and reduction of administrative burden. In such context it appears that there is a sort of trade-off between flexibility on the one hand and legal certainty on the other hand. Especially, our clients which are mostly SMEs (small and medium-sized enterprises), many of them being family owned, prefer legal certainty to flexibility and discretion. SMEs often have limited resources to administer tax issues themselves, therefore they also have a strong interest in reducing the administrative burden and desire clear framework conditions for charging intercompany services. According to this, it would be helpful especially for SMEs if the OECD could be more concrete in terms of its examples and suggested approaches such as for instance the introduction of safe harbors or regarding the cost base. We are going to explain this point in more detail in the following sections.

It is worth emphasizing that in the Discussion Draft indirect cost allocation receives legitimation by the OECD which is conspicuous especially because of the resulting reduction of the administrative burden. Practice shows that direct cost allocation is often only feasible under the consideration of a disproportional effort. Regarding the direct and the indirect cost allocation the Discussion Draft at hand offers the taxpayer the possibility to harmonize cost allocation with the operative business model.

According to this, the proposed changes to Chapter VII are a successful step further in the right direction to establishing a general guideline for the charging of intercompany services.

B.1 Determining whether intra-group services have been rendered

- **Pr. 7.7, line 7-8** It should be highlighted that the reference to determine whether intra-group charges are deductible or not, should be the behavior of third-parties under comparable circumstances. However, there may be cases in which a particular service may not normally occur between independent parties but which nevertheless constitutes a chargeable service from the transfer pricing point of view. There may be activities which can be characterized as services even if they do not generate a direct benefit to the services provider nor to the recipient but provide commercial value to enhance or maintain the commercial position (e.g.

repair services beyond guarantee periods without charge for key-account clients) or even services that do not provide direct benefit to the services provider nor to the recipient (i.e. the costs exceeding the related incomes) but still enhance or maintain the commercial position of the services provider, of the services recipient or both (**Pr. 7.7**) or provide incidental benefits (**Pr. 7.13-7.14**) to the MNE group. This behavior may be related to business strategies, the market characteristics and competitors behavior (who may as well be members of MNE groups or not) or when the compensation for the services are included in the price for other transactions (**Pr. 7.29**). The costs related to these services should be allocated to and shared between the enterprises involved in the provision of such services according to the expected benefits or the behavior of third-parties under comparable circumstances.

- **Pr. 7.10** We appreciate the detailed definition of shareholder services and the resulting consequences for cost allocation. However, in this paragraph the OECD also mentions the term stewardship services. According to definition, both could be seen as synonyms, but the OECD indicates in the Discussion Draft that there are differences between stewardship services and shareholder activities **(line 7)**. However, from our point of view the differences and their consequences are not defined clearly enough. Therefore the question arises as to whether both expressions may be used as synonyms or whether there are essential differences. According to this it would be helpful if the OECD could make an attempt to explain in more detail the differences, if any, and the resulting consequences for the taxpayer. If both expressions should express the same meaning, from our point of view it would appear preferable to confirm this in the given context.

- **Pr. 7.11** In our judgment, the example which is mentioned in this paragraph is too general so that it would be more meaningful if the OECD could explain under which circumstances the respective scenario could be classified as a shareholder activity. Unfortunately, the OECD only mentions: *"… independent enterprise would have been willing to pay ..."* ***(line 7)***. This expression appears to be too theoretical and general in order to provide significant guidance in practice. It is a definition rather than an example. Accordingly this example would not have the desired effect. Therefore from our point of view the OECD should formulate a more concrete example.

- **Pr. 7.12** The restrictions regarding the duplication of intra-group services are commendable because they show the operative reality of MNEs. According to this every case needs to be considered individually. We appreciate also the reasons mentioned for duplication like restructuring or protection of important decisions. Regarding this the OECD authorizes operative reasons for duplication. This suggestion is very helpful for the taxpayer. We would appreciate even more if the OECD could make an attempt to mention further examples for duplications which go along with the arm's length principle in order to intensify the discussion about these circumstances.

- **Pr. 7.13** It is mentioned that incidental effects are not considered as intercompany services. This is commendable in order to reduce the administrative burden of the taxpayers because external effects like incidental effects are hard to quantify for taxpayers. Additionally, it is almost impossible to distinguish whether the external effects result from the group structure

or from other circumstances. Moreover, charging external effects would discriminate MNEs in comparison to third persons because the latter are ordinarily not charged for external effects. In general incidental effects appear to be comparable with shareholder activities.

- **Pr. 7.14** We agree with the OECD that an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable to its being part of a group. However, we would like to expand the example and its explanation. In our judgment, in general every entity should be rated under the assumption of a stand alone basis and to the extent possible like in the case of a guarantee. Whereas in some cases due to an affiliation to a group it is not possible or it is only possible under an inappropriate burden to identify the single rating, no transaction should be deemed to exist. In such cases a group rating is acceptable. However, in cases in which identification of a single rating is feasible with reasonable effort such approach should prevail. We would appreciate it if the OECD could initiate a discussion regarding this.

- **Pr. 7.15** In the context with centralized services further guidance could be added as to how to allocate cost advantages resulting from the centralization which can be characterized as synergy effects. A centralized service center results in most cases in price advantages. The OECD should give a recommendation regarding how to allocate these advantages. Insofar the OECD should make reference to the OECD/G20 Base Erosion and Profit Shifting Project, ACTION 8: 2014 Deliverable[1], Chapter I-II, "D.8 MNE group synergies" considering MNE group synergies and also distinguishing between advantages which depend on special deliberate structures and external effects.

  In our understanding it would be helpful if the following passage were to be added to the last sentence of the paragraph : "*… for themselves under comparable circumstances, even though the fact that there are services that do not normally occur between independent parties*"**.** According to the extension of this statement the acceptance of intra-group services based on the behavior of the parties and the related benefits rather than on the nature or the name of the services could be increased. We would appreciate it if the OECD would accept this passage hence all intercompany services are included which have a commercial value for the MNEs.

- **Pr. 7.17** The costs for offering low value-adding "on call" services should be included in the cost pool of the low value-adding intra-group services. This would reduce the administrative burden as well (**Pr. 7.52-7.54**). From our point of view "on call services" can refer to both, low-adding services and common services. We would appreciate it if the wording could put this distinction straight.

  From our point of view it is a general principle that the services provider receives for its activities, regardless of whether they refer to an actual provision of services or mere 'on call' offering, an arm's length remuneration.

[1] OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.
http://dx.doi.org/10.1787/9789264219212-en

Other issues arise with respect to services provided "on budget". Independent enterprises offer and obtain services according to budget (lump-sum). As a result the service recipient is usually aware of the estimated fees before receiving the services, and they accept the estimated fees after comparing them, or not, with the offers of other services providers or with the costs of performing the services themselves. Nonetheless and under specific circumstances it may turn out that the actual fee is higher or lower than the estimated fee, but always with a justification by the services provider of this modification.

In this regard, it should be more important whether the services provider obtains an arm's length remuneration during a given period of time (e.g. fiscal year), even if specific services or specific service recipients would not be profitable to the services provider when analyzed separately.

- **Pr. 7.18-7.19** From our point of view it would be helpful if the OECD could provide more guidance concerning the information which should be kept to show that intercompany services have been rendered.

B.2 Determining an arm's length charge

- **Pr. 7.25** "*sound accounting principles*" As the accounting principles may vary country by country and also enterprise by enterprise, more guidance should be provided relating to which costs are to be included/excluded in/from the cost basis in order to apply the cost plus method. Additionally, we would also appreciate more guidance regarding the possibility of applying the transactional net margin method when the cost plus method is not available (due to the lack of appropriate financial information or when the costs of obtaining such information are disproportionate).

- **Pr. 7.26, line 11-12** "*The allocation method chosen must lead to a result that is consistent with what comparable enterprises would have been prepared to accept*". There are circumstances in which the enterprises would prefer to estimate the services fee according to direct or indirect-calculation methods depending on variables other than the costs assumed for providing the services (e.g. the mark-up over the costs charged by a third-party). These methodologies should be accepted as well. In these cases, the margins obtained are cost-sensitive (however without calculating the actual costs incurred by the services provider for providing the services, in particular when it is disproportionate to calculate these costs). Third-parties may apply the same methodology under comparable circumstances and/or third-parties may be willing to accept the services fees resulting from these methodologies, depending on the facts and circumstances of the case. Therefore, in our opinion such methods should be accepted as well.

- **Pr. 7.32** The Discussion Draft addresses the following issue: the required price by the service provider is higher than the willingness to pay of an independent entity. Practice shows that this is a common issue. However, no general solution seems to be available for this mismatch. Thus, we agree with the OECD not to provide such a general solution. However, some kind of guidance could be provided nonetheless. We suggest that in this situation bargaining power should be decisive, e.g., the price may be based on an entrepreneurial decision.

- **Pr. 7.33** The Discussion Draft mentions that if the CUP method and the cost plus method are not applicable the usage of more than one method may be helpful. From our experience, in most cases the cost plus method should be applicable but if the administrative burden implementing one of these methods would be too high or another method would be more appropriate, any other method which is appropriate in this case should be accepted as well.
- **Pr.7.35** According to the cost plus method, there is no concrete advice regarding which cost basis should be used. For instance, the OECD does not give advice regarding whether the taxpayer should use the budgeted or actual costs (as already mentioned in the general remarks), nor does it explicitly state that such decision should be made at the taxpayer's discretion. Furthermore, the OECD gives no recommendation on how to deal with costs caused by third parties. In this case the mark-up should not be added on to the full costs but only on to the value contribution of the service provider.
- **Pr. 7.36, line 7-9** Taking into account the guidelines of this paragraph but in the context of low value-adding services, the cost base respectively, the cost pool and the mark-up are not defined in sufficient detail. Under the circumstances of Pr. 7.36 and when the activities are part of low value-adding intra-group services according to the new Section D, the corresponding costs for providing the services should be included in the costs pool (**Pr. 7.52**) and the external costs should be recharged without mark-up to the end-beneficiaries of the costs.

  The administrative activities related to the recharge of external costs that are high value-adding (e.g. insurance premiums) could be classified as low value-adding intra-group services (e.g. intra-group administrative services).
- **Pr. 7.37, line 4** The Discussion Draft includes the following wording: *"… rather than providing the services merely at cost"*. From our point of view the following wording should be added to the sentence mentioned above: *"…even assuming all the costs without charging the services recipient".* There may be circumstances in which independent enterprises would assume the costs of the services if this behavior were to enhance or maintain their commercial position.
- **Pr. 7.37-7.38** The Discussion Draft also discusses cost allocation without a mark-up. This suggestion is acceptable from an economic point of view. We have already addressed this point in 7.35. However, it is worth mentioning that some tax authorities would not accept a cost allocation without mark-up. This may lead to a clash with domestic tax laws. However, in general the suggestion should be accepted in case this behavior corresponds to the behavior of third-parties under comparable circumstances. Nevertheless, it would appear helpful to maintain a flexible approach insofar.

D.1 Definition of low value-adding intra-group services

- **Pr. 7.46** We appreciate the detailed definition of low value-adding services. The definition makes a clear classification possible and regarding this the certainty for taxpayers is encouraged. In particular, the mentioned examples are helpful.

- **Pr. 7.47** We agree with the definition of these activities not being low value-adding, but there may be activities of a supportive nature related to these activities that should be considered as low value-adding intra group services (e.g. invoicing related to insurance activities, financial transactions, etc.) when such do not form part of the core business of the MNE group (**Pr. 7.50**).

D.2 Simplified determination of arm's length charges for low value-adding intra-group services

- **Pr. 7.51 et seq.** In our judgment more guidance regarding how to create a proper cost pool (e.g. salaries (fixed or variable, both, perks, among others), overhead, depreciation, etc.) should be provided by the OECD. It is also not clearly defined which costs can be combined in one cost pool. The total costs of all low value-adding services or only the costs of the services which are similar? We would support the idea of allocating the costs of all low value-adding services into one cost pool.

- **Pr. 7.52** The Discussion Draft often mentions the expression cost pool. However, there is no definition of the composition of the cost pool. Regarding the cost pool the OECD is unfortunately very reluctant. The OECD mentions no recommendations about the implementation of an appropriate cost base.

- **Pr. 7.52 et seq.** The taxpayer is not bound to make use of the simplified approach for low value-adding services. According to this the taxpayer has flexibility which is commendable. However, we suggest that the OECD should also consider extending the simplified pool approach to include common intercompany services, for example with regards to a development community. If every member of such community benefits from the joint activities but also contributes to such, it would be more practical to implement a cost pool and to allocate the costs as well, as it is suggested for low value-adding services. In this case, no mark-up should be applied.

  In our understanding it should be possible to exclude from the cost pool those costs relating to low value-adding intra-group services which are external costs and where the end-beneficiary is clearly identified. Therefore, it would be better to recharge such costs to the beneficiary of these external costs by using another methodology (i.e. recharge of costs without adding a further mark-up as proposed in Pr. 7.36 of the Discussion Draft).

  There is a difference between charging on the basis of the budgeted costs or of the actual costs. However, the OECD does not mention how to deal with differences in the results according to the usage of variable cost bases. In this case the question arises as to whether the taxpayer has to make year-end adjustments. We would appreciate it if the OECD could take a position under which premises an adjustment shall be necessary. We suggest defining a certain benchmark determining the extent to which the actual costs may differ from the estimated costs. In general the deviation should not exceed the mark-up, in order to limit potential losses (in case a deviation exists).

- **Pr. 7.57** The Discussion Draft suggests for low value-adding services a mark-up between 2% and 5%. In order to further increase the legal certainty, it may appear advisable to define the mark-ups as safe harbors as in some tax jurisdictions a mark-up of 2% may be difficult to

defend. For SMEs which have limited resources to administer tax issues themselves and thus are dependent on an adequate degree of legal certainty, safe harbors would constitute an essential reduction of the administrative burden.

Furthermore the OECD suggests using the same mark-up for all services. We support the suggestion of using a uniform mark-up for all included services. However, we would also appreciate it if the taxpayer could have the discretion to implement different mark-ups for different services within the cost pool.

D.3 Documentation and reporting

- **Pr. 7.61** There is no clarification by the OECD regarding the contemplated three-tier documentation approach if the documentation of the intercompany services should become part of the Master File or of the Local File. A suggestion could be distinguishing between services assigned at headquarter level (documentation in the Master File) and central services, for example to be provided by shared service centers (documentation in the respective local file).

  We appreciate the clear recommendations concerning the documentation of low value-adding services. In this context, the wording should also indicate how to update an existing documentation report in the following years if the underlying services have not changed. In this case no update of the documentation should be necessary, except an update of the relating figures (calculation of the cost pool and invoicing). This would provide for legal certainty.

  However, the differences of the documentation requirements between common intercompany services and low value-adding services are not well-defined. There are no simplifications. We would appreciate it if the OECD could expand this paragraph.

Conclusion

Concluding we would like to refer positively to the serious attempt of the OECD to reduce the administrative burden. The simplified benefit test regarding the fact that all low value-adding services can be summarized in one pool which is mentioned in the Discussion Draft and the pooling approach considering low value-adding services should facilitate the provision of intra-group services especially. The OECD-draft makes an attempt to establish guidelines which provide a further step in the right direction to introduce a joint understanding of charging intercompany services inside the OECD. A common procedure is of particular importance for the MNEs in order to implement an efficient transfer pricing system.

In general we appreciate the flexibility regarding the applicable charging approach. According to this we prefer informal guidelines to strict instructions. However, as already mentioned above in some cases the taxpayers, especially SMEs, need engaging information.

From an economical perspective, guidance on the cost base used is more essential than on the mark-up used. Unfortunately, the OECD gives no guidance for the implementation of an appropriate cost base. According to this we would like to request that the OECD be more specific on this point. This also includes the cost base of the cost pool for low value-adding services. Regarding such and in our

opinion also costs of "on call services" which are low value-adding should be accepted in the cost pool. SMEs particularly need support in this case.

The suggested mark-up for low value-adding services by the OECD has not been formulated as a safe harbor regulation. We advocate that the range between 2 - 5% mark-up should be treated as a safe harbor with the consequence that within this range any mark-up should be accepted.

Regarding intra-group services and its charging, we would like to highlight that the activity of the service provider and its commercial value to enhance or maintain the commercial position of the service recipient should generally prevail over the name or the nature of the respective intra-group service.

Munich, January 14th, 2015

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