Intercompany services and intangibles

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Today's integrated global economy presents both opportunities and challenges

Since intercompany trade is a major and growing part of the global economy, developing an effective transfer pricing system is an important objective for many multinational enterprises (MNEs). In addition to measuring revenues, costs and profits to support management and tax reporting, transfer pricing can support the MNE's ability to measure resource capacity and establish clarity regarding the entities that benefit from services and the magnitude of these benefits. Moreover, it is essential that MNEs examine and define the role of intangible property (IP) in delivering services and developing new intangibles to reflect the increasing importance of IP in MNE value chains and ensure that the IP owners pay for the activities that create the IP these entities own.

Unlike intercompany sales of tangible goods, the nebulous nature of services and IP transactions increases potential areas of disagreement and controversy among interested parties. This article describes practical considerations to develop, refine and implement sustainable intercompany pricing systems involving services and IP. Section l provides background and examples describing the issues and challenges associated with the increasingly global nature of services and IP among various forms of business relationships and transactions. Section II focuses on the implications of global services and IP in the international tax arena. Section III describes approaches to design and document service charge systems that enable MNEs to improve their probability of success in sustaining challenges by tax authorities and managing risks of double taxation. This section includes an overview of typical allocation keys that assist MNEs in evaluating the flow of benefits within the company's value chain and administer service charges.

I. Background

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Services and IP occur in a variety of contexts within the global economy. For example, MNEs frequently use third parties to outsource non-core activities or obtain access to expertise. One or more of the participants of joint ventures (JV) typically provide services or IP to the JV. Within MNEs, the volume of services transactions is increasing along with the technology's role within our increasingly connected global economy. JV partners, minority interests, management (impacted by cost accounting for performance measures across business segments), regulatory and tax authorities are concerned about whether the services and IP are priced appropriately. For instance:

- Services pricing and IP within a JV affect the level of profitability of the partner providing the services as well as level of profits achieved by the JV.
- Minority interests of businesses are concerned about whether their interest is overpaying for the services and IP they receive from related parties.
- Management is concerned about whether the price of related party services and IP aligns with performance measures to ensure that decision makers maximise shareholder value as opposed to the results of their individual business units.
- The pricing of services and related IP among business segments can significantly affect the value of a business in the context of a spin-off transaction.
- Government authorities care about whether the costs associated with services and IP between regulated and unregulated entities within a company are arm's length.
- Tax authorities are concerned about whether intercompany service charges to (or from) foreign affiliates are causing the resident entity to understate taxable income on its tax returns.

While the issues, approaches and analytics this article describes apply broadly to the relationships and transactions described above, the remainder of this article will focus on the international tax arena.

II. Global intercompany services and IP

Transfer pricing associated with services among related entities located in different tax regimes or jurisdictions frequently have a significant impact on an MNE's tax liabilities and exposures. Tax authorities reviewing the pricing of service provider entities in their jurisdictions are concerned about whether the entity is under-pricing services. For instance, these tax authorities are concerned about whether the entities are providing services at no charge or significantly below an amount that would be expected under the arm's length standard. Tax authorities reviewing service recipient payments are concerned about whether the entities in their countries are over-paying for services. For instance, in cases where service charges drive the profits of the service recipient to a loss, a tax authority may question whether the services provide sufficient value to the service recipient to warrant the charge. One global trend in transfer pricing is that tax authorities are increasingly scrutinising intercompany services during their transfer pricing reviews. This trend aligns with the increasing complexity of high value services that often include embedded IP.

For example, India places intercompany services near the top of its list for scrutiny during their tax audits. India can be a challenging jurisdiction to deal with from both the perspective of a service provider and service recipient. As a service provider, India takes an aggressive approach to off-shoring where MNEs are benefiting from savings generated by India's low cost labour. The Indian tax authorities typically assert high mark-ups on low cost local labour as a means for India to tax a portion of the cost advantages its labour market offers MNEs.

In contrast, when reviewing service charges from other countries, the Indian tax authorities are concerned that the India entity is over-paying for services. This scenario is most applicable where service charges from a foreign affiliate drive the Indian entity to a loss. Under such circumstances, the Indian tax authorities are more likely to question whether the services provide sufficient value to the India affiliate.

Recently, the Indian Income-Tax Appellate Tribunal (the Tribunal) observed that to satisfy the arm's length standard, a management services charge must meet certain conditions. Specifically, the ruling solidified critical principles applicable for service transactions; the Tribunal found that in order to satisfy the arm's length standard, a charge for services or IP must, at minimum, meet the following conditions:

i. the need for services or IP is established;
ii. the services or IP have actually been received and
iii. the benefit from services or IP is commensurate with the charge.

Since the global economy has caused many MNEs to realise low profits and operating losses, MNEs face the need to adjust their transfer pricing to reflect the challenging economic conditions. The role of global services in company value chains, particularly high value services, requires special attention.

Chapter VII of the OECD Transfer Pricing Guidelines (OECD Guidelines) discusses issues that arise in:

i. determining whether services have been provided by one member of a multinational group to other members of that group and
ii. establishing arm's length pricing for intercompany services.[1]

The OECD Guidelines state that the arm's length character of a controlled transaction is ordinarily determined by applying one of the methods specified in the OECD Guidelines.[2]However, the OECD Guidelines do not explicitly indicate specified methods where the controlled transactions under review relate to the provision of services.

The US Internal Revenue Service (IRS) and the Treasury Department issued final regulations dealing with controlled services transactions (or intercompany services) and IP under Section 482 (the US Services Regulations) on July 31, 2009. The US Services Regulations finalise the regulatory guidance on key transfer pricing concepts that apply broadly to most MNEs with operations in the United States. The US Services Regulations include six methods for evaluating whether the transfer pricing results of intercompany service transactions satisfy the arm's length standard:

i. Service Cost Method (SCM),
ii. Comparable Uncontrolled Services Price (CUSP) Method,
iii. Gross Services Margin Method (GSMM),
iv. Cost Services Plus (CSP) Method,
v. Comparable Profits Method (CPM) and
vi. Profit Split Method (PSM).

An unspecified method may also be used to evaluate a controlled service transaction if the method provides the most reliable measure of an arm's length result.

III. Service charge approaches

As MNEs continue to develop and restructure their services and IP to achieve competitive advantages, the transfer pricing objective is to develop a services charge approach that supports the needs of the MNE. Generally, MNEs aim to develop a transfer pricing system that:

i. complies with local country requirements (e.g., the US Services Regulations) and the OECD Guidelines,
ii. supports the MNE's tax planning strategy and
iii. is practical and cost effective to administer.

If a tax authority of the entity in the country receiving the service charge denies the deductibility of the charge from taxable income, this could cause an MNE's effective tax rate (ETR) to increase if the MNE is unable to obtain relief from the resulting double taxation.

A. What type of activity is it?

Once the MNE identifies the costs associated with service provider activities, the next step is to categorise the activity into three groups:

i. stewardship / shareholder activities (Group A),
ii. routine / back office activities (Group B) and
iii. high value services and intangible development activities (Group C).

Group A: These activities occur primarily for the benefit of the shareholders of the MNE, their main objective being to protect shareholder interests. Financial reporting and related activities to support financial reporting (e.g., preparing the 10-K) is a good example of a Group A activity. Group A activities do not provide benefits to the related party affiliates. If an MNE would charge fees for Group A services to affiliates that employ their own financial reporting personnel, these charges would likely be considered nondeductible by the tax authority of the service recipient entity.

Group B: These activities create benefits to affiliates either directly (e.g., a process improvement project performed for the benefit of a specific business unit) or indirectly (e.g., an e-commerce project that benefits multiple affiliates). From a US perspective, the importance and type of activity will dictate whether the MNE can charge out the services at cost under the

SCM or under one of the other methods indicated in the US Services Regulations. For instance, if the activity is closely associated with one of the MNE's critical success factors, the US Services Regulations do not permit the MNE to charge these services out at cost under the SCM.

Group C: High value services often generate and/or include elements of IP. Branding, marketing services, lean manufacturing, supply chain restructuring and strategic sourcing[3] are examples of services that may be bundled with IP. Under normal circumstances, one would expect the profits high value services generate within the value chain would be greater than services that do not create or include IP.

The US Services Regulations specify that a controlled services transaction may include other elements, including loan, rental or transfer of tangible or intangible property.[4] Bundled transactions are sometimes also referred to as integrated, aggregated or combined transactions. Whether an integrated transaction should be evaluated as a service transaction or as one or more elements to be evaluated separately depends on which approach will provide the most reliable measure of an arm's length result.[5] In determining the arm's length pricing, an integrated transaction may be evaluated as a whole provided that each element of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables.[6] The OECD Guidelines recognise that there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated transaction-by-transaction.[7] The right to use IP may include technical services for which it may be more reasonable to assess the arm's length terms of the two items together rather than individually.[8] Thus, both transactions would be evaluated together using the appropriate transfer pricing method.

B. What service charge approach should be used?

Once the activities are categorised, the next step is to develop an approach to determine, administer and document the service charges. A key factor for designing a sustainable charge system is the flow of benefits the services and IP generate within the company. Any entity within the MNE's value chain may benefit from a service provider's activities, including the parent entity, manufacturing entities, distribution entities, other service provider entities and entities that own IP. It is important to identify the benefits the services and IP generate and understand how the service recipients realise these benefits. MNEs often overlook the many forms benefits can take, such as lowering costs, providing access to know-how and processes, increasing efficiency, providing IT infrastructure and increasing quality.

It is essential that the entity that owns the IP pay for the services associated with developing the IP it owns (referred to as intangible development activities (IDAs) in the US Services Regulations). The largest tax dispute in IRS history involved the interaction between services and IP. In 2006, the IRS announced the resolution of a long-standing transfer pricing dispute with GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries (GSK US), a wholly-owned subsidiary of GlaxoSmithKline, Plc, a UK company (GSK).[9] With trial looming, GSK agreed to pay the IRS approximately \$3.4 billion to settle the dispute. The settlement addressed transfer pricing adjustments in relation to Glaxo Heritage Products that arose from an IRS audit in 1992. The IRS argued that the marketing services performed by GSK US were high-value. Since GSK US incurred the costs of the IDAs that increased the value of marketing IP, trademarks and trade names, the IRS determined that GSK US became the "economic owner" of this valuable IP. In establishing its position, the IRS emphasised the contribution of the marketing efforts and other activities performed by GSK US in enhancing the value of the IP. The IRS asserted that GSK US was not properly compensated for the high value services and resulting IP it generated. Accordingly, the IRS significantly increased GSK US's share of profits through transfer pricing adjustments.

The OECD Guidelines offer two main approaches to allocating costs:

i. direct charges for services performed for the direct benefit of a recipient and

ii. indirect charges for services that create benefits for a group of entities.

1. Direct charge

The direct charge approach is applicable where the arrangement for the charge in exchange for the services is readily identifiable. In such cases, the service provider can demonstrate a separate basis for the charge, documenting both the work expended and the costs incurred.[10] For example, where the service provider renders the same services to both controlled and uncontrolled parties, the direct charge method is sufficient.[11] Generally, tax authorities favour direct charges because the relationship between the service performed and the basis of the payment is clearly apparent under this approach. However, in practice, many MNEs have found the direct charge approach difficult to apply as the required data is often unavailable. As such, MNEs often resort to the indirect charge approach.

2. Indirect charge

The indirect charge approach utilises cost allocation and apportionment. The allocation method should reflect the commercial features of the transaction, contain safeguards against manipulation, follow sound accounting principles and be capable of producing charges or cost allocations commensurate with the actual or reasonable expected benefits to the recipient.[12] Further, the indirect cost approach may be appropriate where the value of the services rendered cannot be quantified except on an approximate or estimated basis or where the administrative burden of tracking the services on a separate basis is disproportionately burdensome in relation to the activities.[13]

Under the US Services Regulations, an appropriate method of allocation and apportionment is determined under the reasonable method standard. In other words, MNEs may use any reasonable method to allocate and apportion costs under the indirect charge approach. In establishing an appropriate method, MNEs should consider allocation keys such as costs, assets, sales, compensation, space utilised and time spent.[14] Similarly, the OECD Guidelines provide that an allocation method is appropriate depending on the nature and usage of the service and the allocation key may be based on turnover, staff employed or some other basis. Although the OECD Guidelines support the use of allocation methods, certain tax jurisdictions do not allow an allocation method using an indirect charge approach.

The US Services Regulations and OECD Guidelines do not provide a specific method or formula for designing cost allocation systems. Neither the OECD nor tax authorities have published a comprehensive list of

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allocation keys. Table 1 presents a list of allocation keys I have seen in my experience. MNEs can use this list as a starting point to identify appropriate allocation keys for applying their indirect service charges.

Table 1: typical allocation keys

P&L-based keys	Sales (gross or net) COGS Total expenses Gross profit Operating profit
Asset-based keys	Inventory Fixed assets Total assets Capital
Productivity-based keys	Output (units produced or sold) Income producing unit Time spent Capacity
Headcount-based keys	Total full-time equivalents ("FTEs") Exempt FTEs Non-exempt FTEs Number of users
Other types of keys	Square footage Number of trips Number of entities

Although some MNEs use net revenue as their sole cost allocation key, many tax authorities have expressed concerns about whether this allocation key appropriately reflects the benefits of certain services. Examples of such services are information technology and human resources, where tax authorities may consider number of users and headcount more suitable allocation keys than revenue. Tax authorities expect taxpayers to use allocation keys that have a reasonable relationship to the services. The allocation key selection process should consider the nature and use of the service and IP underlying the transaction such that it properly reflects the time and effort spent by the provider and the benefits derived by the recipient. The functions performed, assets employed and risks assumed by the related parties, and the industry in which a MNE operates are factors to consider when selecting allocation keys.

C. Additional approaches

MNEs may consider additional approaches to document and administer their intercompany services. For instance, some MNEs utilise costing approaches developed for management purposes such as activity-based costing (ABC). ABC is a costing model for identifying activities and assigning the costs of each activity resource in accordance with actual consumption. A traditional ABC approach uses a survey process to obtain data used to allocate costs within the organisation. There are potential weaknesses associated with using ABC. For example, the reliability of the model and costing assumptions will reduce over time unless the MNE regularly updates the data and analysis. Cost effectiveness and administration resources and constraints are among the considerations MNEs evaluate when selecting their approach. Given the strengths and weaknesses of the approaches available, MNEs may choose to combine several approaches to evaluate whether the transactions satisfy the arm's length standard if intercompany services and IP transactions present significant transfer pricing risks or planning opportunities.

IV. Conclusion

Today's integrated global economy and climate presents both opportunities and challenges for companies. Through the internet and the increasingly global nature of the world economy, MNEs are accessing low cost labour and new consumer markets and outsourcing non-core functions to third parties. Technology has enabled companies to centralise activities in low cost labour markets as well as locate activities close to end customers and consumer markets. MNEs are developing technology and software tools, leading practices, technology infrastructures and databases that they exploit in markets and transactions that span the globe. At the same time, the role of IP in MNE value chains is becoming more important in the global competitive arena.

This article described several approaches to tackling the transfer pricing issues and challenges associated with service charges and IP. MNEs must weigh the transfer pricing risks and opportunities associated with their intercompany services and IP transactions and the availability of data when determining the approach or combination of approaches they use to design and administer their services and IP transfer pricing.

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NOTES

[1] OECD Guidelines Chapter 7.1.
[2] The OECD Guidelines specify the following methods: Comparable Uncontrolled Price Method (CUP), Resale Price Method, Cost Plus Method, Profit Split Method and Transactional Net Margin Method (TNMM).
[3] The compensation in the form of a non-dutiable buying agent commission for strategic sourcing services is a good illustration of the natural intersection between direct tax and customs valuation transfer pricing considerations.
[4] Treas. Reg. Sec. 1.482-9(m)(1).
[5] *Ibid.*
[6] *Ibid.*
[7] OECD Guidelines para. 3.9
[8] *Ibid.*
[9] See: http://www.irs.gov/newsroom/article/0,,id=162359,00.html
[10] OECD Guidelines para. 7.20.
[11] OECD Guidelines para. 7.21.
[12] OECD Guidelines para. 7.23
[13] OECD Guidelines para. 7.24.
[14] Treas. Reg. Sec. 1.482-9(k)(2)(i).