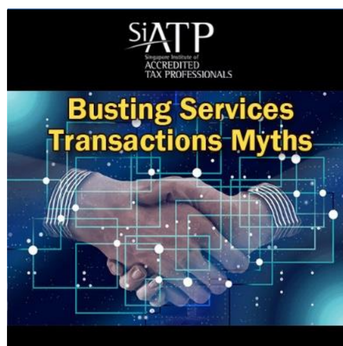


# Busting Services Transactions Myths

*Getting Transfer Pricing Right For Services Transactions*

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In today's global business environment, it is commonplace for multinational enterprise (MNE) groups to provide a wide array of intra-group services for various strategic reasons. These services may range from routine administrative services to other specialised services such as financial, marketing, technical or research and development (R&D) services.

As one of the most common related-party transactions carried out by MNE groups, intra-group service transactions are regularly scrutinised by tax authorities, and increasingly so in the post Base Erosion and Profit Shifting (BEPS) era.

## *"Ideal Steps" to Set Up a Service Transaction*

To mitigate transfer pricing risks associated with intra-group service transactions, Adriana Calderon, Director, Transfer Pricing Solutions Asia, recommended a five-step process that MNEs could adopt at the recent Tax Excellence Decoded (TED) session organised by the Singapore Institute of Accredited Tax Professionals (SIATP). These steps are designed to ensure that the service charges are defensible in the event of a transfer pricing review or audit by the tax authorities.

### STEP 1: ADDRESS THE "BENEFITS TEST"

The "benefits test" is used to determine whether intra-group services have indeed been rendered. If the "benefits test" is not satisfied, tax authorities may challenge that no intra-group service has been provided, and accordingly, disregard the entire transaction and deny the service charge deduction.

In Singapore, the tax authorities consider four key factors when determining whether intra-group services have been provided.

Intra-group services are generally considered to be provided if:

i) the activities are performed for another party which receives (or reasonably expects to receive) benefits from such activities;
ii) there is commercial or practical necessity for the activities to be provided;
iii) the benefits have economic or commercial value (such that an independent party would expect to pay to receive the benefits), and
iv) the benefits are direct and substantial.

The Organisation for Economic Co-operation and Development (OECD)'s guidelines provide further guidance regarding the "benefits test" by categorising intra-group activities into chargeable or non-chargeable activities (to the associated enterprise). Chargeable activities refer to those activities that provide a benefit and therefore constitute the rendering of services for which a charge should be levied, while non-chargeable activities refer to those activities that do not provide a benefit.

### *Specific Benefit Activities*

Services performed to meet the specific needs of another entity in the group would generally satisfy the "benefits test", as they are specifically designed to cater to the operations of the associated enterprise. Such specific benefit activities would therefore be categorised as chargeable under the OECD framework. An example would be a marketing campaign carried out by the group marketing company that is specifically tailored for one of its associated enterprises' product.

Adriana Calderon, Director, Transfer Pricing Solutions Asia, shed light on the key transfer pricing considerations when setting up a service transaction, and what it takes to ensure that intra-group services are appropriately priced.

### *Centralised Activities*

Centralised activities are services which benefit the group as a whole. They are commonly undertaken by one of the group entities, usually the parent company, and made available to the entire group. Such services are typically chargeable on the basis that group entities receive a benefit for which an independent enterprise would be willing to pay.

### *Shareholder Activities*

Shareholder activities are services that a group entity, usually the parent company or a regional holding company, performs solely for its ownership interest and in its capacity as shareholder. Shareholder activities may include activities pertaining to the juridical structure of the parent company, compliance requirements of the parent company and investor relations.

As shareholder activities do not benefit other group entities, they would not satisfy the "benefits test" and are hence non-chargeable under the OECD framework.

### *Duplicate Activities*

Generally, duplication of services occurs when an intra-group service is provided to a group entity which has already performed the same activity. Duplicate activities are generally not chargeable on the basis that associated enterprises do not receive any benefits from them. For example, if Parent Company A charges its subsidiary for accounting services even though the subsidiary has a finance team handling its own accounting needs, such accounting services provided by Parent Company A would likely be duplicative, and hence considered non-chargeable activities under the OECD framework. The key for MNEs is to demonstrate why the service is not duplicative.

## STEP 2: ESTABLISH THE APPROPRIATE COST BASE

Upon determination that a chargeable intra-group service has been rendered, the next step is to establish an appropriate cost base (constituting only costs associated with the service provided). MNEs may, depending on the scenario, use the direct method or the indirect method when establishing the appropriate cost base, or accept pass-through costs where applicable.

### *Direct Method*

The direct method is best used when several features are clearly identifiable – the actual work done, the beneficiary of the services, the basis of charge and the costs expended in providing the services. This method is commonly used in situations where only two companies are involved in the transaction, or where the service provider is specifically set up to provide the service (for example, an entity specifically set up to provide contract R&D services to all group entities).

While the direct method is generally preferred by tax authorities, direct determination of the cost base is not always possible. It would be impractical, for example, for a group marketing entity to identify the specific benefits that each associated entity receives from its marketing campaign. In such situations, MNEs may consider using the indirect method instead.

***Indirect Method***

The indirect method involves the allocation of costs to the various group entities using appropriate allocation keys for the specific services provided.

Common allocation keys include gross sales, income, headcount, loans and deposits, floor area and asset size. The selection of an appropriate allocation key is dependent on the nature of the service. For example, headcount may be the most suitable allocation key for human resource services, while the actual time spent by the project group (based on timesheet) may be most appropriate for technical services.

***Pass-through Costs***

A group service provider may, at times, arrange and pay for services acquired from other service providers (whether independent or related) on behalf of its associated entities. In such situations, the group service provider may pass on the costs of the acquired services to its associated entities without a markup, provided that such acquired services are for the benefit of the associated entities and have been charged at arm's length; the group service provider is merely the paying agent and does not enhance the value of the acquired services, and the costs of the acquired services are the legal or contractual liabilities of the related parties.

## STEP 3: DETERMINE THE RIGHT MARK-UP

Once the cost base of the intra-group service has been established, the next step is to determine the appropriate mark-up to be applied on those costs. Essentially, the appropriate mark-up depends on the type of service.

"The characterisation of the service, as determined by the functional analysis, is critical," highlighted Ms Calderon. "It is the foundation in supporting that the price of the service is at arm's length."

On one end of the service spectrum are support services, which are generally remunerated on a cost-plus basis. In Singapore, the Inland Revenue Authority of Singapore (IRAS) accepts a 5% cost mark-up to be a reasonable arm's length charge for certain routine support services, subject to certain conditions.

In applying the 5% cost mark-up concession on routine support services, businesses are not required to perform a benchmarking analysis to support the 5% mark-up. Nonetheless, it is good practice for businesses to keep simplified documentation providing an analysis of the "benefits test", cost base and allocation keys, and substantiating that the services are indeed support or routine services (as opposed to being core to their business activities).

On the other end of the service spectrum are core services to the business. These should typically be remunerated at a higher mark-up on the basis that they add value to the main revenue-generating activities. Services such as manufacturing, sales, marketing and distribution, which are normally linked to the core business activities of the company, should accordingly expect a higher mark-up. For such services, separate benchmarking analyses should be performed to determine their arm's length pricing.

Adriana Calderon, Director at Transfer Pricing Solutions Asia, provided insights on key considerations when applying various TP methods.

## Step 4: Ensure Well-Drafted Contracts Are In Place

In a transfer pricing review or audit, one of the first documents that tax authorities would request to substantiate a service transaction is the service contract between the service provider and the service recipient.

Ideally, the service contract should provide a clear description of the activities performed by the service provider and an explanation on how the service charge is arrived at. In addition, it should also reflect the clear appointment of the service provider and service recipient.

## Step 5: Conduct A Transfer Pricing Analysis

Finally, a transfer pricing analysis should be conducted to provide strong support for the company in justifying that its transfer prices set between related parties are at arm's length. It should be noted that the transfer pricing analysis is only useful to the extent that the earlier steps are sustainable.

Tax authorities around the world are getting increasingly sophisticated and savvier in dealing with transfer pricing issues. Instead of focusing on the mark-up, they are questioning the fundamental question of whether a service has been rendered in the first place. Businesses must therefore adapt and stay one step ahead by ensuring their transfer pricing positions are robust and sustainable. It would be wise to start reviewing existing related-party services transactions. If your organisation is making significant service transactions, it may be timely to try out the five-step process to ensure that your service charges are defensible in the event of a transfer pricing review or audit.

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