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ATTENTION

LOW VALUE ADDED SERVICES

FROM OECD PERSPECTIVE

TP201 : WEEK 2

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THE ROADMAP TO

Low Value-Added Services

First, it's crucial to understand ***what services are*** and how they differ from the tangible nature of goods.

Second, understand which **types of services** fall under low-value-added services.

In the last section, we will learn how to determine the **Arms-Length price** for the Low Value Added Services.

NAVIGATING THE RULE BOOK ON LOW-VALUE ADDED SERVICES IN TRANSFER PRICING VIA OECD GUIDELINES.

CHAPTER I

INTRODUCTION: NAVIGATING THE RULE BOOK ON LOW-VALUE ADDED SERVICES IN TRANSFER PRICING

In the world of transfer pricing, a phrase continues to loom large yet remains frustratingly vague: "low-value-added services." This week, we will shed light on the realm of transfer pricing law concerning low-value-added services via OECD guideline.

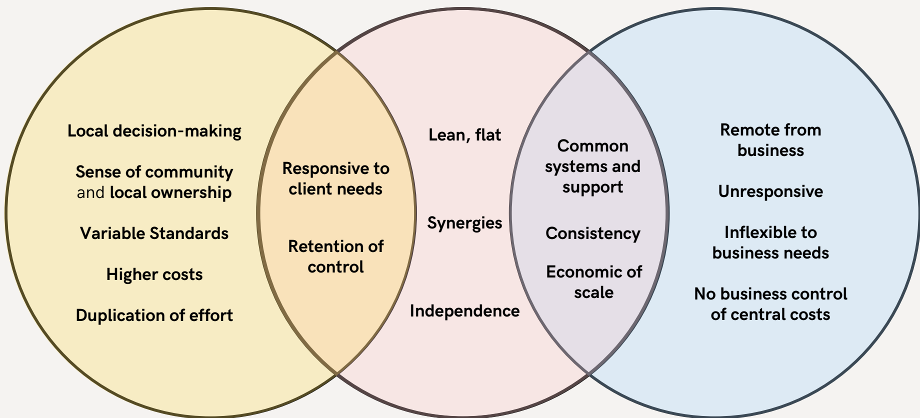
Centralised Services and Decentralised Services : Their Challenges

In the context of a group of companies, some services are inherently centralised and provided by a 'hub' to various entities. For instance, regional branches may devise a company's marketing strategy centrally and then localised. The challenge here lies in ensuring that the cost of these centralised services is apportioned in a manner that not only reflects the true benefit to the subsidiaries but is also compliant with tax and transfer pricing regulations.

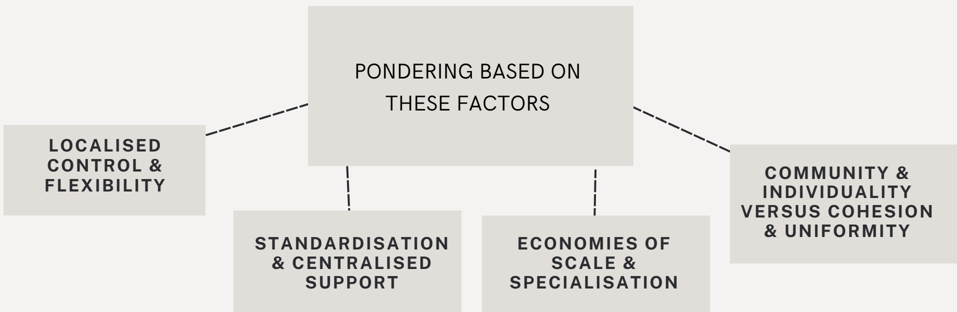
This requires careful analysis, identifying the transfer pricing policy, and documentation of cost allocation methodologies, which should be robust enough to withstand the scrutiny of tax audits and disputes. However, such centralised services can also provide an opportunity for manipulating costs and profits, particularly in cases where the market for these services is ill-defined or non-existent.

Please see the Vann Diagram on the next page for more discussion of the differences and standard features of Traditional, shared, and centralised services. The information provided clues to help in building the right context on why the company decided to select one service model over the other.

VENN DIAGRAM
Service Model



UNIQUENESS AND **INTERSECTIONALITY** OF EACH MODEL



CHAPTER 2: UNPACKING THE ISSUES WITH SERVICE TRANSACTIONS

CHAPTER II

UNPACKING THE ISSUES WITH SERVICE TRANSACTIONS

Services Vs Products

Services involve actions, skill sets, and a more ambiguous '***value proposition***' than a product's essence. When services are exchanged within related companies, they can uphold crucial functions, from administrative tasks to complex financial analyses.

However, their intangible nature presents an inherent challenge for tax authorities, which requires a precise evaluation of what is being 'sold' between inter-company entities to assess and collect tax appropriately.

Unlike goods, whose value can be **relatively more straightforward to appraise**, services can be shrouded in uncertainty, creating **ample room for strategic tax planning that skirts the edge of legality and ethics**.

Inherent Tax Issues

For years, service transactions have been a point of contention for related companies and tax authorities. On the one hand, corporations argue that these services are often inherent to a group's functioning, and the actual 'value add' is collectively generated. On the other hand, tax authorities are sceptical, seeing these intangible flows of value as potential avenues for '**profit-shifting**.'

Intercompany service transactions are further complicated by the difficulty in **objectively measuring the value of services**, establishing whether the services are priced at arm's length, and identifying **tax jurisdictions where the service was 'consumed.**'

These challenges have made services a hotspot for transfer pricing disputes, adding complexity to an already fraught area of international tax.

CHAPTER 3: DEFINING LOW VALUE-ADDING SERVICES

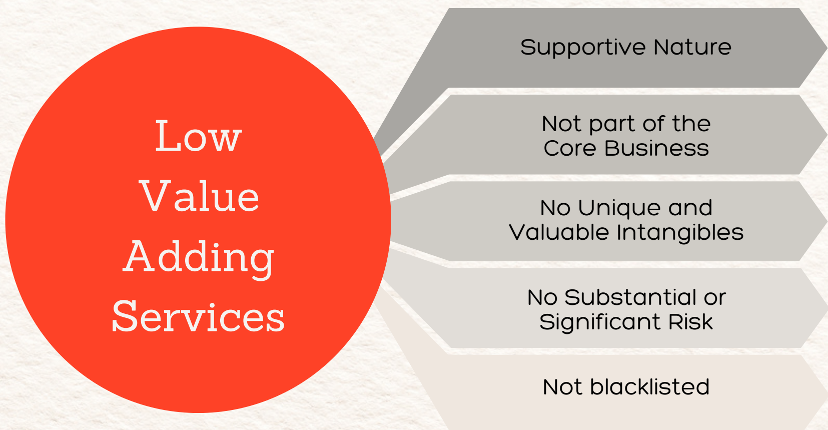
DEFINING

Low Value-Added Services

The concept of services being 'low value-adding' is contentious. **What does it mean for a service to add little value? Does it mean the service is mundane or simply routine? Does it refer to services that are easily replaceable in the open market or those that are integral to the company's operations?**

The challenge is defining and identifying these services within related parties' vast and varied landscape.

The label' low-value-adding' triggers a comprehensive litmus test. **Which type of services can be considered Low-Value-Adding? Here's a List provided by OECD, to provide clarity on which type of transaction can enjoy the benefits of Low Value Adding Services.**



Criteria to qualify as a Low Value-Adding Service, the following requirements should be met at the same time (OECD Guidelines, 7.45):

Intra-Group Supportive Nature, and NOT part of core business

Intra-group services are low-value-adding if they are supportive and not part of the group's core business. But herein lies the key question —**what is a 'supportive' service, and how different is it compared to the core business activities?**

The answer is the service is **not part of the main business activities** of the related company and is of a supportive nature. Such services are **not part of the Company's profit-generating** and **economically significant activities**, but enable the related companies to **perform or improve these activities**.

NOT Unique and Valuable Intangibles

Further, supportive services should **not depend on or contribute to unique and valuable intangibles**. But in today's landscape, where intellectual properties are often queens on the multinational chessboard, this criterion, too, is under scrutiny. It attracts the same limelight in Malaysia.

NO significant Risk

Another facet of low-value-adding services is that they **do not involve substantial risk for the service-providing entity**. Risk is the warp and weft of the business fabric, and any service—whether labelled core or supportive—will inevitably tangle with it.

For clarity, look back at the notes on Function, Asset, and Risk (FAR) analysis provided during the seminar. ***We will also cover FAR in future email.***

NOT Blacklist

The final litmus test in OECD’s elective procedure is the services that are not blacklisted.

Here's the list of service activities which **the OECD regards as not allowed to enjoy the simplified approach attached with the label of "Low Value-Added Services"**:

- Services constituting the ***core business*** of the related company;
- ***Research and development*** services, including software development;
- ***Manufacturing and production services***;
- ***Purchasing activities*** relating to raw materials or other materials that are used in the manufacturing or production process;
- ***Sales, marketing, and distribution*** activities;
- ***Financial*** transactions;
- Extraction, exploration, or processing of ***natural resources***;
- ***Insurance and reinsurance***;
- Corporate ***senior* management services**

But a blacklist, by its very nature, inhibits the organism of business growth and innovation. **Should the OECD wield such subjective power over the innumerable permutations and combinations of necessary transactions within companies?**

Personally, I am of the opinion that the move by OECD is welcoming in the sense that at least there is clarity regarding transactions which ***clearly falls outside the ambit of low-value-added services***.

CHAPTER 4: THE ELECTIVE PROCEDURE TO IDENTIFY THE VALUE OF LOW VALUE ADDED SERVICES

HERE'S THE

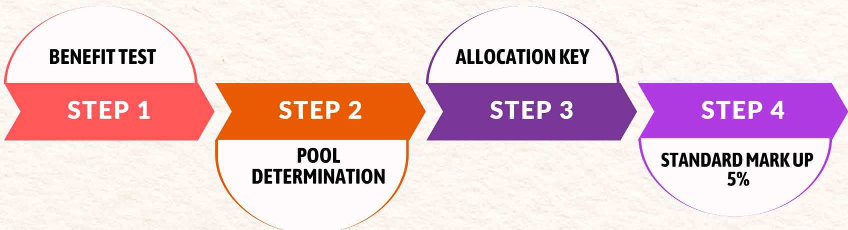
Elective Procedures

TO IDENTIFY THE VALUE OF LOW VALUE ADDED SERVICES

The transfer pricing landscape is permeated with complexities and meticulous determination of value where services rendered within a group of companies need to be justified to be of arm's length.

In the final report on BEPS Actions 8 – 10, the OECD provides revised guidance on low value-adding intra-group services (**Chapter VII of the OECD Transfer Pricing Guidelines)**

Section D of the report delineates an elective and simplified procedure for applying and documenting intra-group charges for low-value-adding services.



Provided by the OECD to simplify the determination of arm's length prices for this category of services by implementing a standardised approach.

(i) a simplified **benefit testing** procedure,

(ii) a two-step cost **pool determination** process,

(iii) the applicability of general **allocation keys** and

(iv) a **standard profit markup of 5%.**

STEP 1 :
THE BENEFITS TEST AND CHARGEABLE SERVICES

THE BENEFITS TEST

Identifying the value of low value added services is the most important part of this e-book. I was so eager to dive into cost allocation calculation when I first started doing transfer pricing documentation. Dr Choong will pulled me back and ask me to explain what is the actual benefits the sister company is getting.

That's what we are going to do now. Hold our horses step back and relook at the nature of transactions and actual benefits transmitted between the related parties. OECD gave it the name of Benefits Test.

What we need to do?

Evaluate whether **a service recipient has derived a benefit** and whether this benefit could have also been obtained at a comparable price on the open market.

While conceptually sound right, Benefit Test principle often stumbles when it meets the raw ambiguity of assessing benefit in intangible services. For example, how can a company quantify the value of an intercompany legal consultation or strategic advice from one subsidiary to another, especially when these services are part of a cohesive corporate strategy?

TWO WAYS TO LOOK AT BENEFIT TEST

1. Demonstration that the recipient <u>RECEIVED</u> the service.

For example, imagine the manufacturing company **inviting the sales company within the group to join them in training**. The demonstration (or proof point) may include presentations, recordings, meeting notes, learning materials, and even calendar invites for the training session conducted by a service provider. However, note that it is not the case that every time such proof points are needed, the taxpayer should be ready to collect and demonstrate them to tax authorities.

2. Demonstration that the recipient <u>NEEDED</u> the service, or, in other words, an independent third party would be ready to pay for such services.

Imagine that the group headquarters insist on **training all subsidiary companies on new regulations enacted in the European Union**. This service is also rendered to the Malaysian subsidiary, even though this company does not interact with EU clients or vendors. Despite the service being provided (the first part of the benefits test has been satisfied), the Malaysian company did not receive any actual commercial benefit from this service. Therefore, the Malaysian tax authorities may disregard the total cost of this service (treating it as non-deductible for income tax purposes).

Understanding these steps is crucial for the corporate tax team; it lays the groundwork for transparent evaluations that can withstand the scrutiny of tax authorities.

SHAREHOLDER ACTIVITIES AND DUPLICATE SERVICES

The OECD provides a solid framework for the application of the benefit test in transfer pricing. It also offers instances where the benefit test might NOT BE SATISFIED, highlighting the need for caution and prudence in claiming benefits:

SHAREHOLDER ACTIVITIES: A RED FLAG

Activities that primarily benefit the ultimate shareholder company — filing reports for the parent company, director appointments, or capital raising — do not qualify as intra-group services. As such, costs associated with these activities should not be charged to other group entities. Recognising and steering clear of such activities in transfer pricing agreements is imperative to avoid adverse tax implications.

Shareholder activities can **often be disguised under the veil of necessary group services**. To effectively discern them, consider the **practical examples** offered by the OECD Manual:

- the preparation and filing of reports required to meet the ***juridical structure of the parent company***;
- the appointment and remuneration of ***parent company directors***;
- the meetings of the parent company's ***board of directors*** and the parent company's shareholders;
- the parent company's preparation and filing of ***consolidated financial statements***;
- the activities of the parent company for ***raising funds*** used to acquire share capital in subsidiary companies; and
- the activities of the parent company to ***protect its capital investment*** in subsidiary companies.

Drawing a clear line between these activities and **genuine intra-group services is essential**. Failure to do so can lead to challenges from tax authorities and potential adjustments to transfer pricing arrangements.

SHAREHOLDER ACTIVITIES AND DUPLICATE SERVICES

THE CASE ON DUPLICATE SERVICES

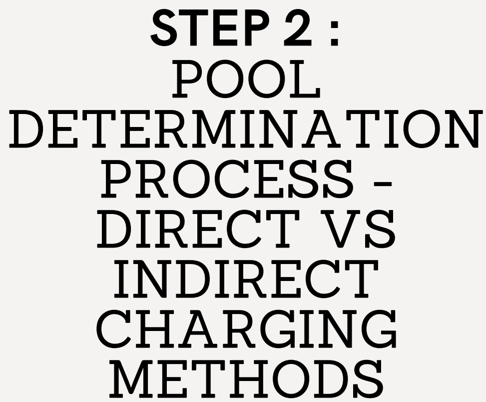
Another area of contention is the presence of duplicate services. This arises when a company is charged for services from an associated entity that it might **already be performing or receiving from an independent third party or internally within the entity itself**. The OECD guidelines highlight the non-recognition of these charges as legitimate service costs, emphasising the need for **clean separation and genuine service provision under transfer prices**.

Identifying and preventing duplicate services can save organisations from unnecessary financial burdens. It requires a meticulous **review** of **inter-company service agreements, ongoing transactions, and the roles and responsibilities of each related party**. Centralised entities providing services that local subsidiaries may already perform are an illustrative example.

In such scenarios, a low-value-added service provision can conceivably be a duplicate activity, inflating costs without corresponding benefits—a **red flag for tax authorities and a significant tax risk for corporations.**

It is not rare for a group of company which uses a **centralised services model to have a similar function executed by multiple divisions or subsidiaries at the same time**. For example, local subsidiaries may have **small IT departments** that ensure the hardware is operational and provided to the personnel. **The central IT department within the separate entity** (i.e., in India or any other country) may provide **centralised services, including software support**. However, this case is not an example of duplicate activity. Even though both activities can be broadly characterised as “IT”, **these are different activities, so no duplication exists**. Duplication, in contrast, is when the same activity is executed twice.

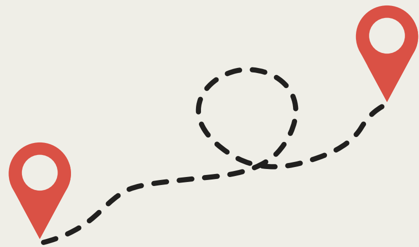
The OECD Guidelines (7.11) do provide an **exception**: An exception may be where the duplication of services is **only temporary**, such as when a group of companies is **reorganising to centralise its management functions**. Accordingly, the costs of the temporary duplicative activities **can still be accepted**.



STEP 2 :
POOL DETERMINATION PROCESS - DIRECT VS INDIRECT CHARGING METHODS

POOL DETERMINATION PROCESS

In chargeable services, two categories of charging methods are commonly used: direct and indirect.



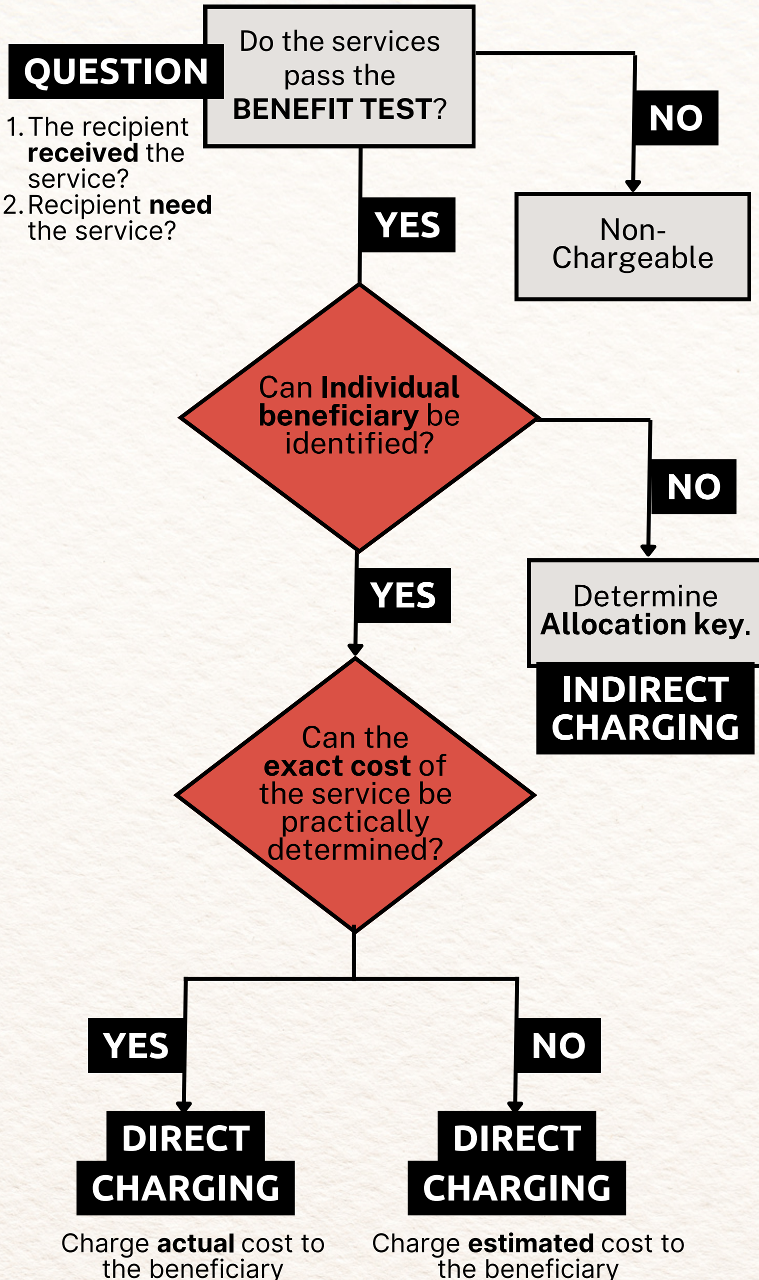
- **DIRECT CHARGING** assigns specific costs to specific services, enabling a clear line of sight between the benefit and the charge.

- **INDIRECT CHARGING**, by contrast, allocates costs by a particular **Allocation Key** (such as headcount or hours worked). Service is complex and the benefits are distributed unevenly that's why Dr Choong provided an in-depth explanation and also sample of the calculation during the Minimum Transfer Pricing seminar.

Unfortunately, the **direct charge** method may be associated with a significant administrative burden. Usually, the head office employs teams of employees to provide intra-group services, and many specialists and teams support multiple entities within the group at the same time. The **identification of the beneficiaries and costs related to such support becomes a very difficult (or even impossible) task**. This is especially true for services provided by centralised headquarters offices.

When it is **difficult or impossible to identify the exact beneficiary** of the service, the **indirect charging method is used**. Indirect charging involves identifying the ***allocation key***, as illustrated in the subsequent flow chart on next page.

The FLOW CHART below summarises the decisions to be made, to establish value of intra-group services.



STEP 3 :
ALLOCATION
KEYS AND THEIR
APPLICATION

ALLOCATION KEYS AND THEIR APPLICATION

If the individual beneficiary cannot be identified clearly, selecting the appropriate allocation key is crucial in assessing charges for services provided within a group of companies fairly.

The following allocation keys are often used in practice:

- **Headcount/FTE** count – to allocate the HR support costs;
- **PC count** – to allocate IT costs;
- **Operational expenses** and/or capital expenditures – to allocate finance support costs (OPEX/CAPEX are generally linked to the size of the relevant organisation);
- **Sales revenue** – to allocate marketing support costs, etc.

Common Allocation Keys include ***metrics related to service consumption***, such as revenues or sales volumes, and those tied to service usage, such as the aforementioned headcount, office space square footage, or the hybrid model used by Dr Choong in the Minimum Transfer Pricing Template.

The key is to **select a metric that is a good proxy for the benefit derived from the service.** Yet, the more abstract the service, the more abstract the concept of benefit becomes, leading to the potential overstatement or understatement of charges. The application of allocation keys, therefore, contributes significantly to the accurate assessment of transfer pricing in services.

The primary considerations for determining an allocation key for a particular service are as follows:

1. The allocation key must be ***relevant*** to the type of services and be a fair proxy for the relative estimated benefit.
2. It must contain ***safeguards against manipulation*** and be applied consistently within the group.
3. It is required to ***reflect the changing levels of business activity*** or industry cycles.
4. If there are ***comparable services*** that have already been provided, it is reasonable to use a similar allocation key.
5. It should be adequately documented and **auditable**.

It is crucial to be reminded that the **allocation of costs should be made only to the participants who are expected to receive the benefits of the service.** The allocation should be based on the share of the anticipated benefits – in other words, the more benefits the participant expects to receive, the greater the share of the costs that should be allocated to them.

STEP 4 :
STANDARD
PROFIT MARK-UP
OF 5%

STANDARD PROFIT MARK-UP OF 5%

Last week, we discussed the safe harbour rule. It is a consensus amongst taxpayers and tax authorities that low-value services enjoy the privilege of pricing at a standard profit mark-up of 5%.

Some would question: isn't this a one-size-fits-all that may, in fact, be akin to trying to squeeze every shoe size into a seven? The OECD's intent is noble—facilitating an uncomplicated yet effective mechanism. We must still consider the factors discussed in TP201 Week 1 Safe Harbour Rules.

CONCLUSION

SUPPORTING WITHOUT SLANDERING

Transfer pricing safeguards fair play in the arms race between profit and regulation. However, the path to fairness is rarely broad and straight but paved with the pebbles of uncertainty and the barricades of differing interpretations.

It is essential to understand if the services qualify as low-value-adding. The OECD Guidelines and the Malaysia tax authority allow minimum transfer pricing documentation for value-adding services.

In particular, low-value-adding services enjoy exclusive treatment if prepared as minimum transfer pricing documentation:

- Tax authorities **usually do not review** and **challenge the benefits test** for low-value-adding services.
- Simplified cost determination and charging mechanism – a **higher degree of aggregation** and **allocation are allowed**.
- Standard markup of 5% on relevant service costs – **no requirement to perform a benchmarking study on the transfer pricing methodology**.

In the complex world of transfer pricing, the less meticulous approach to examining low-value-added services can translate to **significant savings in compliance costs**.

The approach to invoice-related party transactions is a key concern, especially with e-invoicing. This is more so for companies that usually pass through the transaction as balance sheet items. With the built-in analytic system of e-invoicing, we expect the Malaysian tax authority to conduct more Transfer Pricing audits. The upcoming E-invoicing seminar with Dr Choong will provide more clarity on this.

REFERENCE

Final report on **BEPS Actions 8 – 10**, the OECD provides revised guidance on low-value-adding intra-group services (Chapter VII of the OECD Transfer Pricing Guidelines).

US 26 CFR § 1.482-9 - Methods to determine taxable income in connection with a controlled services transaction A Visual Guide on the Fundamentals of Typography

Hendrik Fuegemann “When is a service low value adding? Understanding OECD guidance on intra-group services”

OECD (2017) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 7.1-7.65 (pages 319-343)

United Nations (2017) Practical Manual on Transfer Pricing for Developing Countries, B.4.1.1-B.4.5.13 (pages 229-271)

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ABOUT US

The e-book you are currently reading, is part of the Minimum Transfer Pricing program conducted with Dr Choong Kwai Fatt. These e-book is published to addressed specific key topics covered in the program.

It acts as Recap or provide further contextual understanding of important topics, so that you can remember them deeper and longer. Also to consolidate what you have learnt and deepen the know-how.

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Transfer Pricing Documentation vs Pricing Policy

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