

Transfer pricing of intragroup services: recipient's and provider's risks 2/24/23



Senior Manager, Transfer Pricing, PwC
Latvia
Zane Smutova



Director, Transfer Pricing, PwC Latvia
Tatjana Koncevaja

Our experience suggests that intragroup services represent the most common centralised activities in a multinational enterprise (MNE) group and they are also transactions being scrutinised by the tax authority.

When it comes to analysing intragroup services for transfer pricing purposes, there are two questions we want to answer:

- Were those intragroup services indeed provided?
- What is an acceptable arm's length fee?

This article explores the opportunities and risks inherent in determining an arm's length fee for intragroup services.

How to determine the service fee

Almost every MNE group agrees on a wide range of intragroup services that are available to its members, in particular administrative, support, technical, financial and commercial services.

Related parties are required to set a fair fee for a service that supports an identifiable and reasonably expected benefit. The fee should be one that independent entities would be willing to accept. Yet the arm's length nature of a transfer price is determined by the transaction's facts and circumstances.

Using the Cost Plus method to set the service fee

Cost Plus is a commonly used method for setting service fees.

Where the service and related costs can be clearly identified for one MNE company, the direct cost recovery method can be used. Setting a direct fee makes it easier to establish the basis for payment and demonstrate the service fee is arm's length.

However, in many cases where a service is provided to two or more MNE companies in a centralised manner, this method cannot be applied. Such cases involve using a cost allocation method typically known as the indirect fee method. Calculating an appropriate service fee is based on estimates or approximating those in proportion to the actual or reasonably expected benefits for the service recipients. Having to assess service-related costs and process financial information places a heavy administrative burden on the service provider.

The centralised service provider usually calculates the fee once a year, measures the total direct and indirect costs incurred in providing the service during the financial year. Depending on the substance of the service, the provider selects cost allocation criteria to reflect the benefit this type of service gives its recipients, and adds a suitable markup.

Our experience suggests that the Latvian tax authority tends to scrutinise intragroup services and will always ask if the service fee is arm's length. The tax authority focuses on service expenses that are recorded in the service recipients' books and taken to the profit and loss account, asking to provide details of the service costs and explain their allocation, which may be "mission impossible" for many taxpayers – service recipients. In most cases the tax authority states it's impossible to trace the transaction and activities involved in providing the service, so the fee cannot be treated as the value (price) of the documented service. The tax authority ends up finding that the service merely exists on paper and the transaction is not a service for a consideration according to its economic substance.

Using the actual contribution method to set the service fee

If it's the service provider who examines the service fee for compliance with the arm's length principle, then another risk may arise.

First of all, the service provider's service costs must be linked to his business functions. It's also important for the service provider to receive a fee that reflects the added value he has created – the relative value of his contribution in the controlled transaction.

Our experience suggests that the single integrated concept of "using the cost method to set the fee" should be changed for providing certain management and other high added-value services because the cost-based fee the service provider receives for his contribution fails to properly demonstrate that the service is arm's length.

Examining the allocation of functions in the service provider's transaction leads to the following findings about the company:

- Providing the service involves substantial human resources.
- The provider's contribution to the business processes and performance results of the recipients has reached a critical degree of materiality.
- The recipients' profit largely depends on the provider's centralised contribution.
- The provider has launched, maintains and keeps developing a single integrated concept for the recipients.

The provider's centralised functions and responsibility have gradually increased to an extent that his contribution to the recipients' business is no longer considered an activity exposed to a limited risk.

Examples of key risks facing service recipients are market risk, competition risk and economic risk. These risks (i.e. relevant costs and a suitable fee) are more relevant for the provider and not the recipient, because the provider is the one who takes key decisions. Some of these risks, however, are also taken by the recipients, as they are responsible for implementing the provider's single integrated business concept.

This means a different approach should be used for setting the fee, i.e. the actual contribution method.

If the transfer price is set for a full-risk service provider and the cost method is not used, the provider's economic benefits will:

- Help set a suitable fee for the contribution
- Help assess the growth potential – the fee will depend on the recipients' performance results (e.g. revenue or profit)
- Ease the administrative burden of processing financial information significantly

- Cut costs and ease the recipient's burden of proving the allocation criteria

If your company is involved in intragroup services and would like to revise the method used for setting fees, please feel free to reach out to us.

PwC's transfer pricing team will be happy to discuss your relevant transfer pricing issues and recommend transfer pricing solutions.

You are also welcome to learn more about transfer pricing on PwC Academy's transfer pricing webinars.