

Transfer Pricing Considerations for Intragroup Service Transactions

Compiled by Suleiman Yahaya, Manager and Abisola Agboola, Senior Tax Adviser,
Tax, Regulatory and People Services, KPMG in Nigeria

Introduction

In 2012, the Federal Inland Revenue Service (FIRS) published in the official gazette, the Income Tax (Transfer Pricing) Regulations No 1, 2012 (the Regulations). One of the key requirements in the Regulations is for companies to conduct their related party transactions at arm's length. This means that the conditions made or imposed between two or more Connected Taxable Persons (CTPs) in their commercial or financial relations should be similar with those which would be made between independent enterprises.

Broadly, related party transactions may be grouped into four categories as follows:

- **Tangible goods:** this relates to transactions involving purchase/sale of finished goods, raw materials, fixed assets, spare parts etc.
- **Intangible property:** this involves know how, trademark, trade name etc.
- **Financing arrangement:** this will include transactions such as loans, guarantees, cash pooling arrangements and the likes.
- **Intragroup services:** example of service transactions will involve technical services, management services, back office support services such as human resources support, finance and accounts, information technology etc.

For most of the developing countries, the commonest type of controlled transactions is intra group services. This could be domestic or cross border. It is therefore important that tax payers pay attention to how these transactions are carried out to ensure that they are consistent with the arm's length principle. The importance of this cannot be overemphasized as the FIRS will under audit, scrutinize the charges for services enjoyed by Nigerian related entities. To manage this risk properly, tax payers will need to pay attention to the twin issues of whether intragroup services have been rendered and whether an arm's length charge was made for the services.

Determining whether Intragroup Services have been rendered

This test is a substance test. The FIRS will want to satisfy itself that the service was actually rendered before evaluating whether the charges were appropriate. In the event that the FIRS is unable to establish substance to the transaction, there is the risk that they will disallow the entire cost and subject the amount to tax accordingly.

Action 10 of the Base Erosion and Profit Shifting (BEPS) which replaced the current provision of Chapter VII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) have provided detailed guidance on intragroup services. Some of the key considerations for determining if an intragroup service can be deemed to have been rendered include:

- Benefits test:** As established earlier, intragroup services are of great importance to the tax authorities. A major focus of the tax authorities will be determining that a service has been provided. The tax authorities will question the validity of services received; the service recipient should therefore be able to prove the economic value of services received and that they will be willing to pay an independent party for the provision of such services. This analysis is called a benefit test analysis.
- Shareholder activities:** According to Action 10 of BEPS, a service performed by a parent company or a regional holding company solely because of its ownership interest in one or more group members would not be considered to be an intragroup service, and thus would not justify a charge to other group members. Such cost should be borne by the parent company. Usually, these types of activities are referred to as shareholder activities and the group members do not require the activity (and would not be willing to pay for it were they independent enterprises thereby failing the benefits test). Such activities include:
 - Costs relating to the juridical structure of the parent company itself, such as meetings of

shareholders of the parent, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the supervisory board

- Costs relating to reporting requirements (including financial reporting and audit) of the parent company including the consolidation of reports costs relating to compliance of the parent company with the relevant tax laws
- Costs which are ancillary to the corporate governance of the Multinational Enterprise (MNE) as a whole, etc.

iii. **Duplication:** Duplication of services occurs in instances where the intra-group service provided already exists in the group entity. The entity may be performing such service for itself or may have employed the services of a third party. Duplicated services will not qualify as intragroup services.

An exception may be where the duplication of services is only temporary or where the duplicated service is undertaken to reduce the risk of a wrong business decision such as obtaining second legal opinion on a matter.

iv. **Incidental benefits:** There are cases where an intragroup service performed by a group member relates only to some group members but incidentally provides benefits to other group members. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intragroup service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

Group members will therefore not be considered to have received intragroup services attributable solely due to it being part of an MNE or benefiting from group synergies.

Once an intragroup service transaction has been scrutinized and is considered to have passed the substance test i.e. a conclusion have been reached that a service has actually been provided, the next step will then be to determine if the amount charged is in accordance with the arm's length principle.

Determination of an arm's length charge

The basic principle for intra group charges is to determine whether independent parties under similar arrangements will be willing to accept such charges. Where there is a strong evidence that the service provider renders similar services to both independent and related parties, the direct charge method (i.e. where the associated enterprises are charged for specific services) would be the most preferred method. According to the OECD Guidelines, the direct charge method facilitates the determination of whether the charge is consistent with the arm's length principle

because it allows the service performed and the basis for the payment to be clearly identified.

It is however practically difficult to apply the direct charge method. This has led to the use of the indirect method which relies on estimation and allocation of cost. Care should be taken to ensure that the cost allocations reflect actual or expected benefits to the service recipient.

A typical example where cost will be allocated is with respect to shared service centres. Under this arrangement, certain back office support services such as legal, treasury, accounting, human resources etc. services are centralized to achieve improved efficiency. In this circumstance, the cost allocated to recipients should be based on an appropriate measure of usage such that each service beneficiary bears its fair share of the total cost incurred by the service provider.

The use of indirect method raises the question as to whether a profit element should be added to the cost of providing this service. While there are certain conditions under which the tax authorities may not insist on the inclusion of a profit element, most of the time, the tax authority will request that the service provider earns a return (typically in the form of a mark-up) on the cost of providing the service. To determine what the appropriate return should be, reference is usually made to what independent parties charge for similar transaction. This means that the service provider must conduct a benchmarking study to identify the independent companies providing comparable services as well as the return that they earn.

Action 10 of BEPS has distinguished between Low Value Adding Intragroup Services (LVAS) and other types of services and has provided a simplified approach to the determination of arm's length charges. It defined LVAS as services performed by one member or more than one member of a group on behalf of one or more other group members which:

- are of a supportive nature
- are not part of the core business of the group
- do not require the use/creation of unique and valuable intangibles
- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risks for the service provider

Examples include but are not limited to accounting and auditing, HR services such as staffing, recruitment, training, remuneration services, etc., IT services, legal and tax activities and general services of an administrative or clerical nature.

The simplified approach to the determination of arm's length charges provides that the service provider shall apply

a mark-up equal to 5% of the relevant cost. The mark-up under the simplified approach does not need to be justified by a benchmarking study and will have to be applied consistently across all jurisdiction.

In applying the simplified approach, the taxpayer will be required to prepare the following information and documentation and make it available upon request to the tax authorities:

- A description of the categories of low value value-adding intragroup services provided including the reasons justifying that each category of services constitute low value-adding intragroup services; the definition of low value-adding intragroup services; the rationale for the provision of services within the MNE; a description of the (expected) benefits of each category of services; a description of the selected allocation keys and the reasons justifying that such allocation keys produce outcomes that reasonably reflect the benefits received, and confirmation of the mark-up applied
- Contracts or agreements for the provision of services and any amendments/addendum to those contracts and agreements reflecting the agreement of the various members of the group.

- Calculations showing the determination of the cost pool and the mark-up applied thereon. This means that tax payers will need to track the service cost (which will include both direct and indirect cost).
- Calculations showing the application of the specified allocation keys. In allocating cost to service recipients, tax payers will need to explain why the allocation keys selected are the most appropriate given the fact and circumstances and also demonstrate how the allocation keys have been used to share the cost incurred by the service provider.

It is however pertinent to note that the simplified mark-up cannot be used to justify the arm's length nature of transactions that do not qualify as LVAS without further analysis.

Conclusion

MNEs operating in Nigeria are net recipients of service transactions from their foreign affiliates. Similarly, Nigerian headquartered companies also conduct significant service transactions amongst themselves. It is therefore very likely that FIRS will review intercompany service transactions in great detail to ensure that the transactions are consistent with the arm's length principle. It is therefore important for companies to ensure that intragroup service transactions comply with the arm's length principle.

