UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services

Dear Mr. Hickman,

USCIB[1] is pleased to have this opportunity to provide comments on OECD's discussion draft on guidelines relating to low value-adding intra-group services.

General Comments

USCIB supports the OECD's efforts to bring clarity to the area of intra-group services, including especially the new guidance on low-value intra-group services. This is a significant issue for business because so many audit and dispute resolution resources are spent resolving these issues. Companies incur intra-group service expenses in order to run their businesses. In recent years, countries where these costs are incurred are demanding that they be charged out to affiliated entities while the countries of the affiliated entities assert that the costs provide no benefit and cannot be deducted. These conflicting positions mean that companies may be effectively denied a deduction anywhere for legitimate business expenses. Effective global resolution of this issue would not only be good for companies, but would also enable tax administrations to refocus limited audit resources.

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

The purpose of Article 9, its commentary and the OECD Transfer Pricing Guidelines is to allocate taxing jurisdiction over transaction income to countries based on the arm's length principle. This principle is so fundamental that sometimes it may be overlooked. USCIB raises this principle here because we believe that agreement on Chapter VII implies agreement with a number of important underlying premises which are described below.

First, Chapter VII is clearly premised on the principles that the source of services income is the place of performance and taxation should be on a net basis. This is consistent with the paragraphs 42.18 and 42.19 of the commentary on Article 5 of the OECD Model Income Tax Convention. Paragraph 42.18 provides:

> All member states agree that a State should not have source taxation rights on income derived from the provisions of services performed by a non-resident outside that State.

Paragraph 42.19 provides:

> Another fundamental issue on which there is general agreement relates to the determination of the amount on which tax should be levied. In the case of non-employment services (and subject to possible exceptions such as Article 17) only the profits derived from the services should be taxed.

Obviously, the BEPS project includes countries that are not members of the OECD and that may not share this view[2]. However, proposed Chapter VII cannot be sensibly applied unless the OECD view is accepted; so it should be made clear when countries agree to Chapter VII they are agreeing to apply the generally accepted OECD principles on sourcing of services and the net taxation of services that generally underly it.

Second, the implication of the line-drawing on shareholder services, direct-charge services, and indirect-charge services, is that costs that fall into each of these categories ought to be deductible as follows: shareholder services by the parent; direct-charge services by the company benefitting from the service; and indirect charge services by the company with respect to its properly determined allocation. Although the Model Convention does not generally deal with the deductibility of expenses, at least with respect to direct-charge and indirect-charge services, the proposed allocation principle will fail and double taxation will result unless the service recipient is permitted to deduct or otherwise reduce its income by the amount of these expenses. It would be appropriate to say that paragraph 2 of Article 9 requires the elimination of these amounts from the income of the service recipient whether by granting a deduction or otherwise. Granting a deduction would seem to be the most obvious solution to what would otherwise be clear double taxation.

Third, Chapter VII should clearly state that services priced in accordance with this Chapter are not base eroding payments. When the Action Plan was published, business was genuinely surprised that it described "management fees and head office expenses" as base eroding

[2] Recent discussions at the UN indicate that some countries believe the "source" of services income is the jurisdiction of the residence of the payor or the jurisdiction in which a PE that bears the cost of the service is located.

payments. USCIB believes there is an important distinction to be drawn here. All cross-border deductible payments reduce the tax base of any country that permits the deduction. If businesses are recovering costs or the payments are for services received and are not excessive, that country's base has not been eroded. That country's tax base has been appropriately reduced because the value was created in the jurisdiction of the service provider. If an appropriate payment is not made to the service provider and taxable there, then it is the jurisdiction of the service provider that is being inappropriately "eroded".   Cross-border services benefit the recipient of those services, which in turn benefits the local economy, including the local tax base.

Base erosion should not be defined based on whether the tax loop is closed in any one jurisdiction. The principle of coherence that the OECD has been articulating as part of the BEPS project is that deductible payments in one jurisdiction should generate a corresponding inclusion either in that jurisdiction or in another jurisdiction. If deductible payments are not excessive and generate a corresponding inclusion in another jurisdiction where the recipient is subject to tax, then there is no base erosion even though taxable income in the country from which the payment originated is reduced. Countries need to agree with this or principled resolution of BEPS issues will be impossible.

USCIB believes these three implicit points are the foundation of proposed Chapter VII and should be made explicit.

Specific Comments

In USCIB's view the most important point is to achieve clarity on the operation of these rules. Important steps have been taken in that direction but further guidance is needed.   One point that runs through Chapter VII is that costs are undefined. Business would appreciate guidance providing examples of the types of costs that ought to be included in the cost pools.

<u>B.1 Determining whether intra-group services have been rendered</u>

Paragraph 7.11 of the discussion draft sets forth examples of shareholder activities. This list has been expanded but remains ambiguous. The draft would be more clear if subparagraph c) were divided into two items (since the combined items do not really seem to be related). Subparagraph d) is also unclear. What are the costs of the parent of complying with relevant tax laws? If a company has significant expenses relating to establishing systems to support tax reporting for a PE of an affiliate do those relate to the compliance of that company or the affiliate? We believe these costs relate to the compliance *of* the affiliate. Subparagraph e) seems broad enough to include virtually anything.

The additions to paragraph 7.12 would be helpful clarifications and USCIB supports their inclusion in Chapter VII.

It is not clear what paragraph 7.27 means, perhaps it could be rephrased to make the point more clearly. We think this paragraph is intending to make a point about the availability of a deduction when the service charge is computed using an indirect method. As stated above, it should be clear that a deduction should be available to the service recipient when an indirect charge is appropriately determined.

Paragraphs 7.31 and 7.32 are essentially unchanged from the current guidelines. These paragraphs raise significant problems in their current application. Some countries that may have lower cost service providers and may disallow charges for services from service providers outside of the local country asserting the local affiliate should use lower-cost local providers. The argument, in these cases, is not whether a service was provided, or a benefit received; it is an argument whether the taxpayer provided the service in a cost efficient way. There are frequently cases where it is not appropriate to use a local service provider and the higher cost of providers from other countries is justified because of concerns with quality, reliability and confidentiality. Thus, the local service provider is not comparable to the non-local service provider and mark-ups should not be based on local comparables but should include regional or global comparables.

Some examples illustrate these points. If the service provider is repairing equipment and the MNE wants to ensure that the service provider is properly trained on that equipment, the warranty is not invalidated or MNE remains complaint with a maintenance agreement, then it may use a service provider in a higher-cost location. As another example, a central legal team may be a higher cost on an hourly basis than a local lawyer but the experience and consistency gained with centralizing this expertise will help reduce costs overall. As another example, local auditors are not interchangeable with internal auditors with specialized knowledge of the MNE's business. Accordingly, we urge the OECD to adopt language to clarify that it is not appropriate for tax examiners to substitute their business judgment for the business judgment of the taxpayer.

C. Some examples of intra-group services

The revisions to paragraphs 7.41 and 7.42 concerning debt-factoring activities and manufacturing activities are helpful and USCIB supports their inclusion in Chapter VII.

If changes are made to Article 5 paragraph 4 such that delivery may result in the creation of a PE, particularly if delivery is deleted from subparagraph 4 a) and b), then guidance would be required on the amount of profit that is attributable to the delivery function. The OECD should consider adding a paragraph to Chapter VII on delivery. Given the recent focus on delivery, we believe it is important to acknowledge that in many cases delivery is a low-risk low value-adding function.

Paragraph 7.43 covering research has been substantially revised. We view this as a place holder for the ongoing discussion on intangibles under Chapter VI and Chapter IX and, therefore, do not provide substantive comments here.

D. Low value-adding intra-group services

USCIB strongly supports the addition of an elective simplified approach for dealing with low value-adding intra-group services. We believe that adoption of rules along these lines would significantly reduce controversy in this area and provide needed certainty with respect to transactions that are covered by these rules. If anything, USCIB members would like to see this method expanded. We strongly supported the adoption of multilateral MOUs, but it seems there has not been any real progress on that initiative. Expansion of this elective method might be a reasonable alternative at least for low-cost services.

D.1 Definition of low value-adding intra-group services

USCIB generally agrees with the standards set forth in paragraph 7.46 for defining low value-adding intra-group services, but believes that the exclusions provided in paragraph 7.47 are unnecessarily broad. For example, the 2014 Action 8 deliverable recognizes that "not all intangibles deserve compensation separate from the required payment for goods in all circumstances and not all intangibles give rise to premium returns." For example, if an MNE internally developed software for accounting purposes, would those services be excluded because they are "development services" or be included because they are accounting and auditing costs? We believe that such costs ought to be included, but the exclusion for research and development might lead to their exclusion. It would seem that the R&D exclusion ought to be limited to R&D that is intended to lead to "unique and valuable intangibles" described in paragraph 7.46.

We also believe that the exclusion for services of corporate senior management is overbroad. It is not clear where the dividing line is between senior management and other management. This lack of clarity may lead to disputes. In our view, a better way of limiting this would be to look at the activity, to the extent that management is involved in the types of activities listed in paragraph 7.48 those services should be in the cost pool and compensated under these rules.

USCIB also believes that paragraph 7.48 should include warehousing, delivery and logistics (if that is not the core business of the MNE) and marketing procurement.

D.2 Simplified determination of arm's length charges for value-adding intra-group services

Business accepts the need to make a global election if this simplified method is going to work. This implies, however, that countries will accept this globally.[3] Acceptance of this simplified method acknowledges that the transfer price determined will not reach the same result as application of the regular transfer pricing rules and countries must be willing to accept these results under the simplified calculations for all purposes. In USCIB's view, however, accepting this method would be fundamentally inconsistent with asserting the right to impose a gross basis withholding tax on the services covered by Chapter VII, Part D.

As discussed in the general comments section of this letter, implicit[4] in any agreement to the proposals in this discussion draft is that the jurisdiction where the services are performed has the primary right to tax income from these services and the appropriate basis for taxation is net income. Under the simplified method, the amount of that net income will be relatively small,

[3] To the extent that some countries do not accept these rules, appropriate adjustments would need to be made to account for non-conforming local requirements.
[4] To reiterate, we believe agreement to these principles should be made explicit.

between 2 and 5 percent[5]. The only conclusion that can be drawn from this is that a gross basis withholding tax imposed by the jurisdiction of the service recipient is insupportable in these circumstances. When the profit attributable to these activities is only in the range of 2 to 5 percent, any gross basis taxation would more than offset the total profit. Absent such an agreement at the OECD/G20 level that gross basis withholding will not apply to these fees, these rules could be rendered meaningless by the imposition of gross basis withholding taxes on low-value intra-group services.

D.2.1 Determination of cost pools

For these rules to be fully effective more guidance is needed on how costs should be determined otherwise disputes may simply move to the definition of costs, rather than being eliminated. Clearly payroll and travel expenses ought to be included. Business believes that stock based compensation should also be included, as well as an allocation of overhead such as rent and utilities.

USCIB believes that determination of the cost pools may over allocate expenses to certain members of an affiliated group in some cases and that taxpayers should be able to compute the pools using the method suggested in the Discussion Draft or using an alternative method[6]. Under the alternative method the calculation would be as follows: all of the expenses would be included in the pool, the entire amount of the expenses would be allocated based on the allocation key, and any company that performed in-house activities would reduce the amount of its allocated expense by that amount. A simple example illustrates this problem. Assume four affiliated entities with a total of 200 costs in a pool and the allocation key indicates that the expenses should be shared equally. If Affiliate 1 incurred 40 of in-house expenses, then under the proposed rule the cost pool would be reduced to 160 and each entity would be allocated 40 of that reduced expense. Affiliate 1 would effectively end up with 80 of expense, rather than an equal share of the 200 total or 50. If instead, the direct cost pool is not reduced, then Affiliate 1 would be allocated 50 of expense. That amount would be reduced by the 40 of in-house expenses. The effect of this calculation would be that Affiliate 1 bears an appropriate share of the total expense and pays the service provider the appropriate mark-up on 10. USCIB believes that this gives a proper result.

The same problem may exist with respect to direct-charge expenses. The resolution of that issue may be complicated by the existence of a profit element in the direct-charge. That is, the cost pool and the expenses allocated to an affiliate probably should not be reduced by the profit element in the direct-charge expenses. It is not clear how to solve this problem, but it exists whether the direct charges come out of the pool or reduce the allocation to a particular affiliate.

[5] Although see below, where USCIB recommends a broader range. Nevertheless, a gross withholding tax would likely still exceed any profit.

[6] The differences between the two methods may be relatively insignificant and companies may currently be using both methods. So requiring either method may cause some taxpayers to incur significant costs to reconfigure the way they account for these expenses.

D.2.3 Profit mark-up

As noted above, it is important to the effectiveness of this method that there be global acceptance by countries. USCIB is concerned that the profit mark-up rule will limit the willingness of countries to accept the results under this method. We believe that the results are both too high and too low and the requirement to use the same mark-up for all low value-adding services will result in countries rejecting the results under this method. In order to encourage greater acceptance by countries we believe that there ought to be different mark-ups on different categories of services, zero should be an acceptable mark-up in some cases, and the upper end of the range should be higher. This would be a more complex regime; but an overly simple regime that is not acceptable to countries will not achieve the important goals of the discussion draft. In USCIB's view, the OECD should clearly establish the range and expect countries to accept mark-ups within the range, whether their residents are service providers or service recipients. The scope of the range is less important than that countries accept the mark-ups,

D.3 Documentation and reporting

USCIB believes the documentation requirements generally seem reasonable. We think, however, it is necessary to add some language concerning penalty protection and the interaction of these rules with the generally applicable transfer pricing documentation rules.

In order that the simplified method is effective, it has to be clear that if the reporting and documentation requirements are complied with them, the benefits test has been met. USCIB believes that the use of the word "should" in paragraph 7.60 is too vague. This might be interpreted as allowing countries to treat the satisfaction of the benefit test as a presumption and countries might still ask for proof that a benefit was provided in a particular case. Since one of the principle reasons for the simplified approach is to eliminate these issues, countries should not be permitted to look behind the documentation.

Paragraph 7.61 should explicitly state that the documentation required by that paragraph is in lieu of transfer pricing documentation that might otherwise be required for the low value intra-group services under Chapter V. Further, it is not clear how this documentation requirement ties into the Master or Local Country files. We believe this documentation should not be part of those files, but should be a separate requirement. Further, we believe that the description of the categories, benefits and allocation keys should only be required to be revised if required by changes to the categories or every third year.

We are also concerned about the lack of guidance on the proper method for making the election. It seems that the taxpayer simply uses the method to determine the charge and only provides documentation upon request. This could lead to disputes on whether the taxpayer has in fact made the election. If the tax authorities do not accept that an election has been made and other transfer pricing documentation is not available, then there might be controversy over the availability of the method and the application of penalties.

USCIB also suggests the addition of a new paragraph 7.62. The new paragraph would provide that, provided a taxpayer reasonably believed that the transaction would be within the scope of Chapter VII, Part D, no penalties for failure to file transfer pricing documentation that would be required under Chapter V should apply with respect to that transaction. Penalty protection will be important to taxpayers' willingness to elect into this regime.

Sincerely,

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