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Cost Plus Markups for Low-Value-Adding Intercompany Services

The authors analyze arm's-length profit markups for low-value-adding services based on a broad database study.



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One of the most common transactions between affiliated companies is the intercompany provision of services. Transfer prices for so-called low-value-adding services come under regular scrutiny by tax authorities. Key discussion points are typically the evidence of the actual benefit for the service recipient—the benefit test—and the determination of an arm's-length profit markup for the service provider. The cost plus method is the most commonly used transfer pricing method. However, it is crucial for taxpayers to prove that the profit markups on costs applied meet the arm's-length principle.

What Are Low-Value-Adding Services?

In the course of its project to combat tax base erosion and profit shifting (BEPS), the Organization for Economic Cooperation and Development deals with low-value-adding services in Action 10, one of the three transfer pricing action items that were later consoli-

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dated.¹ The OECD defines these services as services that (i) are of a supportive nature, (ii) are not part the core business of the company, (iii) do not require or create valuable intangibles and (iv) do not involve or lead to the assumption or control of substantial or significant risk for the service provider.

The EU Joint Transfer Pricing Forum (EU JTPF) describes low-value-adding services more vaguely as “the glue that holds the corporate structure together to support its main functions.”¹ They are, according to the EU JTPF, “of an administrative nature and auxiliary to the business of the recipient.” Because they are “commonly available or can readily be acquired,” these services can be classified as routine functions that add only limited value.

Both the EU JTPF and the OECD provide a list of positive examples for low-value-adding services. The OECD also names negative examples—services that cannot be classified as low-value-adding—in its BEPS action plan. The first table provides an overview of the most important positive examples of OECD BEPS Action 10 and of the positive possible examples of the EU JTPF. However, it should be emphasized that the following examples are of an exemplary nature and should not be understood as definitions.

¹ The OECD's initial report on Action 10 is available at 23 Transfer Pricing Report 929, 11/13/14. The report issued on Actions 8, 9 and 10 released at the close of the BEPS project is available at <http://src.bna.com/tx>.

¹ See 2011 EU JTPF guidelines on low-value-adding intra-group services, <http://src.bna.com/kb5>, para. 11.

Low-Value-Adding Services: BEPS, EU JTPF

	BEPS	EU JTPF
Service category	<i>positive example?</i>	<i>possible low-value-adding</i>
HR	Yes	Yes
Accounting	Yes	Yes
IT	Yes	Yes
Tax	Yes	Yes
Legal	Yes	Yes
General administration	Yes	Yes
R&D	No	Yes
Manufacturing	No	Yes
Sales and marketing	No	Yes

Source: Summary of EU JTPF und OECD BEPS Initiative Actions 8-10

Even though OECD BEPS Action 10 generally announces a simplification of documentation requirements for intercompany services, the above-mentioned examples lead to differentiation problems. Against the background of the announced simplification in the course of the EU JTPF, it is questionable whether the OECD BEPS Action 10 will actually lead to more practical documentation requirements and an actual improvement with regard to prospective tax audits.

The following analysis will focus specifically on the arm's-length character of transfer prices for low-value-adding services.

Transfer Pricing Methods for Services

In general, the comparable uncontrolled price (CUP) method and the cost plus method are the preferred methods for evaluating the arm's-length character of transfer prices for intragroup services. In practice, due to the diversity of commercial services, determining comparable uncontrolled prices is only feasible for substitutable services or services in specific fields (such as transportation and insurance). In the absence of comparable prices, the cost plus method is generally applied in practice.

The cost plus method determines transfer prices by adding an appropriate profit markup on the costs incurred by the service provider (fully loaded costs approach). To evaluate the arm's-length character of the transfer price, it is common to use external data base studies and the transactional net margin method (TNMM). TNMM compares financial figures of comparable uncontrolled companies with financial figures of the tested party performing the analyzed transaction. In this context a typical return indicator for service transactions is the quotient of earnings before interest and taxes (EBIT) to fully loaded costs.

Arm's-Length Character of Transfer Prices

Intragroup transactions lack the free market mechanism of the balance of interests. Hence, transfer prices for intercompany services can be influenced by economic and legal ties within a multinational group. Therefore, transfer prices need to fulfill the arm's-

length principle—that is, those prices agreed between affiliated companies would also have been agreed upon between unrelated parties under comparable circumstances.⁴

Approaches to analyze arm's-length character

There is an ongoing debate over the correct point in time to prove the arm's-length character of transfer prices. More precisely, the question is whether the transfer prices should be tested while the transaction takes place (price setting or ex ante approach) or later in the course of a general review (outcome testing or ex post approach).

The idea of the price setting approach is to simulate the behavior of unrelated parties in comparable circumstances. It shall enable the taxpayer to demonstrate the arm's-length character of the applied transfer prices with regard to the information available at the time of the price setting.⁶ Especially in the case of so-called routine companies that are not supposed to generate losses, it is important to exclude loss-making companies in a benchmark sample of comparable companies. The reason for this is that planning on the basis of losses contradicts the principle of sustainable profits associated with the classification as a routine company.

In contrast to the price setting approach, the aim of the outcome testing approach is to rationalize the transfer prices ex post. Taxpayers demonstrate the arm's-length character of transfer prices by proving the prices are within an arm's-length range of prices in comparable transactions.⁷ In this case, loss-making companies can be included in the benchmark sample, as the actual profit of the company under review is compared to actual profits of comparable uncontrolled companies. Therefore it is no surprise that the OECD indicates that both approaches can lead to different results. Since an arm's-length price setting mechanism is hard to simulate, taxpayers in practice prefer the outcome testing approach.⁸

Arm's-length markup

In 2011, the EU JTPF determined markups of between 3 percent and 10 percent as appropriate for low-value-adding intragroup services, adding that typical markups on costs are frequently about 5 percent. In its 2015 report on Action 10, the OECD indicated a markup of 5 percent as appropriate from a tax perspective.

These figures are not based on anecdotal evidence, but were verified by a broad database study performed in 2009.⁹ The EU JTPF study analyzed actual markups of a very large sample of different service companies and is regularly seen as the generally accepted reference for the transfer pricing of management services. However, the benchmark analysis is based on markup

⁴ German Foreign Transactions Tax Law, sec. 1 para. 1; OECD Model Tax Convention, sec. 9 para. 1; OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD guidelines).

⁶ OECD guidelines, sec. 3.69.

⁷ OECD guidelines, sec. 3.70.

⁸ OECD Model Tax Convention, sec. 9, ref. 97.

⁹ EU JTPF meeting Oct. 27, 2009, and related study, "BM contribution to illustrate available generic evidence relating to intra group services profit margins—European Service Provider Profit Margin Analysis," <http://src.bna.com/koO>.

data collected for the years 1999 to 2007 and has not been updated or replicated since then.

The following benchmark analysis is a replication study inspired by the EU JTPF publication and is supposed to test its results and the 5 percent markup proposed by OECD BEPS 10 Action on the basis of actual data. The analysis will answer the following questions in detail:

1. How did the range determined by the EU JTPF evolve over time, and is the cost plus markup of 5 percent postulated by OECD BEPS Action 10 still close to the median of the new benchmark?

2. Are there any deviations in markups between different service categories that are statistically significant and economically relevant?

Databases

Publicly accessible databases are a common source of information for determining financial indicators of comparable unrelated companies.¹⁰ Despite criticism regarding data availability and quality in these databases, benchmark analysis established itself as a tool for documenting and planning transfer prices.

Related to this, the OECD guidelines define comparability factors.¹¹ Regarding these factors, it should be noted that comparable companies included in a benchmark analysis are generally not completely comparable to the tested party in all dimensions. Because relevant information is often not available, not all “comparability factors” (for example, contract details of a comparable transaction or the business strategy of a comparable company) can be considered in principle. To address this issue, the range of results is usually narrowed to the interquartile range—the middle 50 percent of values, excluding the upper 25 percent and lower 25 percent.¹³

Quantitative Analysis

Indicative cross-sectional analysis including all services

The following study is based on version 13.03, update 257 of the Amadeus Neo database. The sample includes up to 15,861 unrelated service companies¹⁵ located in the EU28 countries¹⁶ as well as Norway, Iceland and Switzerland, that can be assigned to a number

¹⁰ OECD guidelines, sec. 3.30 et seq. concerning the use of databases; German Federal Ministry of Finance, Principles for the Examination of Income Allocation Between Related Parties with Cross-Border Business Relationships as regards Duties of Investigation and Cooperation, Adjustments, Mutual Agreement Procedures, and EU Arbitration Procedures, 2005 (Principles), sec. 3.4.12.5.

¹¹ OECD guidelines, sec. 1.36 et seq.; Principles, sec. 3.4.12.7.

¹³ OECD guidelines sec. 3.57; German Federal Ministry of Finance, Principles, sec. 3.4.12.5.

¹⁵ Companies included in the sample are rated with one of the following independence indicators: A+, A, A-, B+, B, and B-.

¹⁶ Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Sweden, Slovakia, Slovenia, Spain and U.K.

of industry codes (the so-called NACE codes¹⁷). For these companies, selected financial indicators are included for the years 2012 to 2014.

In contrast to the usually small final set of comparable companies in a specific benchmark analysis, this study analyzes an indicative cross-sectional sample of a large number of service companies including several industries and countries over a period of three years. Because this study is built on the existing work of the EU JTPF, the authors followed a similar approach regarding the search strategy and filtering steps.¹⁸ In particular, ensuring that there are only routine service companies left in the sample, a filter was applied for intangible assets reported in balance sheets.¹⁹

The next table provides an indicative, cross-sectional overview of markups for the period from 2012 to 2014, showing the interquartile range²⁰ for each year as well as the weighted average²¹ for the full period. It excludes companies that suffered losses between 2012 and 2014. Deficient companies are usually excluded in benchmark samples that are analyzed to determine transfer prices from an ex ante perspective.

Overview of Markups, No Loss-Makers: Price Setting

Quartile	2012	2013	2014	Weighted average
1. Quartile	1.8%	1.9%	2.0%	1.9%
Median	4.4%	4.5%	4.7%	4.5%
3. Quartile	10.7%	10.3%	10.9%	10.1%
Observations	13,197	13,449	13,717	

Source: Calculations based on data taken from the Amadeus Neo database

It becomes apparent that the weighted average over the full period is 4.5 percent. The OECD recommendation of a 5 percent markup for low-value-adding services can therefore be verified. This result is particularly robust, and contrasts with a specific benchmark analysis that considers just a small number of companies. This approach considered a cross-sectional analysis of approximately 13,000 companies where single outliers exert only a small influence. As this study replicated the approach of the EU JTPF study, one can compare the results, especially concerning the interquartile range of 3 percent to 10 percent postulated by the EU JTPF. The authors' analysis of more recent data confirms this range as robust over the years.

¹⁷ The following industries, classified by NACE codes (Rev. 2), are included in the database: 1800, 3300, 4900 to 5310, 5800 to 6630, 6900 to 7990 and 8211 to 8230 as well as 8291 and 8299.

¹⁸ Results were screened using the following filters: (a) companies in which majority shareholders (more than 50 percent of shares) are industrial companies, banks, insurances, private equity investors, investment funds or other financial institutions are excluded; (b) only active companies are included (companies in insolvency proceedings are excluded); (c) only companies with at least six years of available financial data are included.

¹⁹ More precisely, companies with a share of intangible assets (compared to total assets) of more than 5 percent were excluded. This step was needed to ensure there are no entrepreneurial companies left in the sample.

²⁰ The interquartile range was calculated consistent with Principles, sec. 3.4.12.5.

²¹ The results are weighted based on sales.

Besides the price setting process, it is especially important to test if the realized markup of a company satisfies the arm's-length principle from an ex ante perspective. For this purpose, the loss-making companies are re-included in the sample. The third table shows, analogous to the second table, an indicative cross-sectional overview of results for all industries including loss-making companies. As mentioned above, the interquartile range of 3 percent to 10 percent and a median markup of 5 percent on costs seem reasonable.

Overview of Markups, Including Loss-Makers: Testing

Quartile	2012	2013	2014	Weighted average
1. Quartile	0.7%	0.9%	1.0%	1.0%
Median	3.2%	3.4%	3.7%	3.5%
3. Quartile	8.7%	8.8%	9.4%	8.7%
Observations	15,834	15,854	15,861	

Source: Calculations based on data taken from the Amadeus Neo database

Indicative cross-sectional analysis for specific service categories

A second step was to identify specific service categories and calculate median values as a typical reference value for each service category. The identification of categories was based on NACE codes,¹ closely following the approach of the EU JTPF study. Comparing the categories, each NACE code was assigned to one of the categories of the positive examples of OECD BEPS Action 10. The complete assignment of NACE codes to service categories can be seen in the fourth table, below.

Identification of Service Categories

Service category	NACE codes
Transport	4910 to 5310
IT	6100 to 6312, 6399
Marketing and PR	1800 to 1820; 5800 to 6020; 7300 to 7320
Finance	6400 to 6630; 7700 to 7740; 8291
Legal	6910
Accounting	6920
Management	7000 to 7022
R&D	7100 to 7220; 7400 to 7490
HR	7810 to 7830;
Back office	7900 to 7990; 8200 to 8230; 8299

Source: NACE codes based on the Amadeus Neo database

¹ The Statistical Classification of Economic Activities in the European Community (in French: Nomenclature statistique des activités économiques dans la Communauté européenne), commonly referred to as NACE, is a European industry standard classification system consisting of a 6 digit code.

Based on the identification shown above, the fifth table shows the interquartile range and the average markup for the full time period separated by service category. It becomes apparent that actual markups based on the price testing approach differ substantially between service categories. The table below lists the categories in descending order based on the median markup observed, showing that the value added as expressed by the markups varies even within the group for "low-value-adding" services. The economic significance results from the presented markups.

In addition, it should be noted that the spread of the observed markups varies substantially. Markups for HR services, for example, gather more closely around their own median in contrast to markups in the categories Finance or Legal. The ranges between the lower quartile and the upper quartile in the cases of Finance and Legal are 17.4 percentage points and 33.1 percentage points, respectively, while the range for HR services is only 3.6 percentage points. This indicates that the different services' profit levels vary substantially.

Interquartile Range and Mean by Service Category

Services	Quartile 1	Median	Quartile 3	Mean	Range
Legal	3.7%	12.5%	36.8%	21.6%	33.1
Accounting	2.9%	6.4%	15.0%	10.9%	12.1
Finance	2.1%	6.9%	19.5%	20.2%	17.4
R&D	2.4%	5.6%	11.9%	8.3%	9.5
IT	2.4%	5.2%	11.4%	8.3%	9.0
Management	0.8%	3.7%	9.7%	7.4%	8.9
Marketing & PR	1.1%	3.8%	7.8%	5.2%	6.7
Transport	1.0%	2.6%	5.4%	3.8%	4.4
Back office	0.6%	2.1%	5.0%	3.7%	4.4
HR	1.3%	2.7%	4.9%	3.5%	3.6

Source: Calculations based on data taken from the Amadeus Neo database

To test the statistical significance of the difference between the markups of specific service categories, the authors applied three non-parametric tests (the Wilcoxon signed-rank test, the Kolmogorov-Smirnov test and the Kruskal-Wallis test). The results are shown in the next table. Where all three tests showed a significant difference between the markups of the respective two service categories, results are marked with X. If only one of the tests failed to show a significant difference, it is marked with "—." For example, the median values for a markup on full costs between IT and Transport based on all three tests are statistically different, significant on a 1 percent level. In contrast, in the case of the service categories IT and Accounting, at least one of the three tests does not report a statistically significant difference between the median markups and therefore the respective cell is marked with "—."

It can be taken from the last table that with few exceptions, the markups earned with the provision of low-value adding services varies significantly from service category to service category. Thus, the arm's-length remuneration of low-value-adding services might deserve

Nonparametric Test, Difference of Median Values

	Transport	IT	Marketing & PR	Finance	Legal	Accounting	Management	R&D	HR
IT	X								
Marketing & PR	X	X							
Finance	X	X	X						
Legal	X	X	X	X					
Accounting	X	-	X	-	X				
Management	X	X	-	X	X	X			
R&D	X	-	X	X	X	-	X		
HR	-	X	X	X	X	X	X	X	
Back office	X	X	X	X	X	X	X	X	X

Note: X = Significance level 1%

a case-by-case analysis based on the individual service category considered.

Summary

Low-value-adding intragroup services are among the most frequently observed transactions between affili-

ated companies and transfer prices for these services are a recurring topic in tax audits.

The commonly applied transfer pricing method for service transactions is the cost plus method. With regards to the size of the applied profit markup on costs, OECD BEPS Action 10 postulates a markup of 5 percent as appropriate for low-value-adding services. This markup is within the range of 3 percent to 10 percent recommended by the EU JTPF. The most important findings are that:

1. Based on a benchmark analysis of up to 15,861 unrelated service companies, the authors calculated the interquartile range of cost plus markups for the period from 2012 to 2014 and thereby verified the EU JTPF range of 3 percent to 10 percent as well as the reference point of 5 percent postulated by the OECD BEPS report.

2. The analysis also finds significant differences— from a statistical as well as an economic point of view— between service categories that are usually commonly labelled as “low-value-adding.” The authors therefore conclude that a markup of 5 percent is a robust reference point for transfer pricing purposes of such low-value-adding intragroup services, but also a simplification. Depending on the transaction, deviations from the reference point are possible and can be justified in principle.