

MANAGEMENT SERVICE FEES – Transfer Pricing Aspects

How to defend your Management Service Fees Payment before Tax Authorities?



Article – August 2020

By Nilesh Patel CPA (USA) – nilesh@taxwize.in

How to defend your Management Service Fees Payment in Transfer Pricing Audits?

1. Background

- 1.1. The payment of Management Service Fees ('MSF') is a necessary modern day feature of Multinational Companies ('MNCs'). Centrally coordinated services are required by MNC Group entities in order to maintain global standards, quality, competitive edge, confidentiality, etc. and also to reduce cost.
- 1.2. Tax Authorities generally view the payments of MSF with suspicion. They routinely disallow the MSF payments by determining the Arm's Length Price ('ALP') as Nil on various grounds, such as, no services were received, no benefits were received, duplicative services were received, the services were in nature of shareholder activity, or only incidental benefits were received. According to the Tax Authorities no independent third parties would be willing to make payment for availing management services, and so the ALP is determined as Nil.

2. Objective of this Article

This Article explores the issue of MSF, with the objective of empowering the Taxpayers to argue persuasively before the Tax Authorities in support of payment of MSF to foreign affiliates.

Specifically, this article discusses the following:

- I. What Documents, Agreements, and Evidences should you maintain in order to:
 - Prove the receipt of services, and
 - Demonstrate ALP Benchmarking i.e. the payment made is at arm's length
- II. How should you benchmark the payment of MSF?

- III. What principles apply on the claim of payment of MSF to Foreign Related Parties (or Persons under Common Control or Associated Enterprises), and on determination of ALP of such payment?
- IV. What counter-arguments can you make to rebut the Tax Authority's arguments?

The above points are discussed below.

I. What Documents and Evidences should you maintain in order to demonstrate that management services were indeed rendered by the Foreign Related Parties ('RPs') or Associated Enterprises and received by the Taxpayer Entity?

Ideally, the following documents and evidences should be maintained.

- a. Agreements – Clauses of the Agreement should specifically include the below mentioned information:
 - Capability and Infrastructure of the Foreign RP to provide management services
 - Why the Taxpayer Entity needs to avail the management services?
 - Detailed description of various services, and nature of services received from RP
 - Mode of rendering and receiving of services
 - Fees for the services and the basis of arriving at the fees
 - Working of costs-allocations (Direct as well as Indirect charges), including allocation keys. Some examples of allocation keys are given below:
 - IT: number of PCs
 - Business management software (e.g. SAP): number of licences
 - Human Resources: headcount
 - Health and safety: headcount
 - Management development: headcount
 - Tax, Accounting, etc.: turnover or size of balance sheet

- Marketing services: turnover
 - Vehicle fleet management: number of cars
 - The Agreement should clearly state these aspects: What exactly is provided by the RP? In what manner? And at what cost?
- b.** Wherever feasible, the following record of services received during the year may be maintained. Such record should preferably be contemporaneous i.e. as and when the services are received.
- Visits of RP's Personnel
 - Trainings, Workshops, Seminars, etc. conducted by the RP
 - Research Reports made available by the RP
 - Expert Presentations shared by the RP
 - Access to IT Systems, Websites, Databases, Intranet, etc.
 - Screenshots of login by users of taxpayer entity
 - Logbook of users of IT Systems, ERP, Accounting Systems, E-learning, etc.
 - Certificates of Experts of RP
 - Certificates from RP's Management
- c.** Evidence of the RP's Capabilities, Cost Centre, Infrastructure, etc.
- RP's Profit and Loss Account and Balance Sheet
 - Certificate from RP's Auditors
 - Certificate from RP's Management
- d.** Proof that Services were rendered by the RP
- Record of Personnel employed by the RP
 - Costs incurred by the RP
 - Assets and Infrastructure deployed by the RP
 - Mode through which services were rendered by the RP. For example, emails, expert presentations, research reports, conference-calls, workshops, trainings, site-visits, recommendations, access to databases, etc.

- Document it all: Details of services rendered by the RP? When? In what manner?
 - Services rendered by the RP to other group entities
- e. Proof that the services were received by the Taxpayer Entity
- Invoices
 - Ledger of RP
 - Benefits that accrued due to services
 - No corresponding Expenditure of the same or similar nature debited to the Taxpayer's Profit and Loss account
 - No corresponding Assets in the Balance Sheet
 - Emails and Correspondence, linked up with the Invoices.
 - Conference calls
 - Visits of RP's personnel
 - Screenshots of websites, databases, Intranet, etc.
 - Expert Presentations and Research Reports provided by the RP
 - Certificates from RP's Personnel, RP's Management, or RP's Auditors
- f. Detailed Chart showing description of services, mode of receipt of services and proof of receipt of services
- g. Transfer Pricing Study Report - Following details must be included in the Transfer Pricing Study Report:**
- Detailed description of services, benefits from services and rationale for availing services from the RP
 - ALP Benchmarking of the MSF paid to the RP

II. How should you benchmark the payment of MSF?

- a. To determine the ALP you can benchmark the payment of MSF by performing aggregated Transactional Net Margin Method ('TNMM') analysis. That is, you can bunch or combine MSF with other internal transactions (sales, purchases, etc) and

apply TNMM in a combined manner. Thus, all international transactions, including MSF, can be benchmarked together, by way of comparison of Taxpayer's Profit Level Indicator ('PLI') at entity level, with the PLI's of comparable companies. The OECD Transfer Pricing Guidelines (July 2017) recognize bunching of closely related transactions.

- b. The benchmarking under TNMM can further be corroborated by using the Other Method (the 6th Method) by using quotations of third party suppliers providing same or similar kind of services.
- c. Cost Plus Method - or TNMM - can also be applied by taking the Service Provider RP as the Tested Party. Of course, to do that you will have to identify Foreign Comparables using Foreign Databases.

III. Applicable Principles

The following principles apply in regard to payment of Management Service Fees:

- i. Evidence filed by the Taxpayer should not be ignored by the Tax Authority
- ii. Necessity to avail of Services from RP should not be questioned by the Tax Authority
- iii. Taxpayer's Business Judgement and Commercial Expediency should not be Questioned
- iv. Whether the Taxpayer received any Benefit from the Services is not a relevant consideration – please see Point 3 in the Chart below
- v. Tax Authority should not compute ALP of services at NIL
- vi. Burden is initially on the taxpayer to determine the Arm's Length Price (ALP)
- vii. It is the Taxpayer's burden to prove receipt of Service from the RP
- viii. Cost-Allocations are acceptable; direct-charge is not required in all cases
- ix. The Taxpayer can Benchmark the Management Services by applying Entity Level TNMM, by aggregating management service transactions with other transactions

IV. Counter Arguments which the Taxpayers can make against the Arguments commonly raised by Tax Authorities

Below we provide the counter-arguments which the Taxpayers can make, to rebut the arguments commonly raised by the Tax Authorities while disallowing the MSF:

Tax Authority's Arguments	Taxpayers' Counter-Arguments
<p>1. The Taxpayer has not filed any contemporaneous documentation to prove receipt of services</p> <ul style="list-style-type: none"> • Documentation of Taxpayer is too generic • Emails and correspondence submitted by the Taxpayer are routine correspondence and no services were rendered by RP/received by Taxpayer 	<p>Maintain contemporaneous documentation as discussed above in Point "I" on <i>Pages 2 - 4 of this Article</i></p>
<p>2. The Taxpayer did not need these services <i>at all</i>, as the Taxpayer had sufficient experts of his own who were competent enough to do the work</p> <ul style="list-style-type: none"> • The Taxpayer Company has not derived any specific benefit from the management services stated to be advanced by the RP/Parent Company, especially because the Taxpayer Company has already incurred separate head-wise expenses for professional and consultancy services • Enough expenditure is already incurred 	<p>2.1 Taxpayer has availed of only those services from RP which the Taxpayer does not perform in-house or does not procure locally</p> <p>2.2 Though the Taxpayer has capabilities, manpower, and experience in its own Country, the Taxpayer does not have these in Foreign Locations where RP renders services – RP has these in those locations</p> <p>2.3 The guidance, advice and support obtained from the experienced and knowledgeable team of the RP helped in management of the operational and corporate activities, reducing significantly the level of senior personnel required locally, and also provided for a higher degree of co-ordination of the activities among Taxpayer and its foreign affiliates</p> <p>2.4 Expenses paid to RP are very low (say, less than 1 %) in proportion to total expenses of the Taxpayer</p> <p>2.5 By virtue of receiving the services from Parent Company, the Taxpayer got the</p>

<p>by the Taxpayer on various services</p>	<p>benefit of being serviced by specialized personnel who are experts in their respective fields and are well versed with the intricacies of business requirement</p> <p><i>As regards the benefits derived please refer to Point 3 below.</i></p>
<p>3. The Taxpayer is unable to prove the benefits derived from services</p>	<p>3.1 Demonstrate tangible benefits in form of increase in sales, profit, profit margins and reduction in cost</p> <p>3.2 Arguments pointing out intangible benefit can also be made on the following lines:</p> <ul style="list-style-type: none"> • MNCs generally centralize services for the entire group to maintain uniformity, quality, high standards and to meet client expectations, as well as to retain competitive edge in the global market. And procuring similar high quality services from third party may prove to be expensive. • Due to globalization and specialization, the outsourcing of routine activities have become an established global business methodology due to number of business advantages <p>3.3 If no tangible benefit can be demonstrated, say for example in cases of loss/continuing losses, the arguments regarding intangible benefits as mentioned above can be made.</p> <p>Legal Arguments:</p> <p>3.4 It is not necessary for Taxpayer to show that any expenditure incurred by him for the purpose of business carried on by him has actually resulted in profit or income either in the same year or in any of the subsequent years. The only condition is that the expenditure should have been incurred "wholly and exclusively" for the purpose of business and nothing more.</p> <p>3.5 The answer to the issue whether a transaction is at an arm's length price or not is not dependent on whether the transaction results in an increase in the Taxpayer's profit. Business decisions are at times good and profitable, and at times bad and unprofitable. The question whether the decision was commercially sound or not is</p>

	<p>not relevant. The only question is whether the transaction entered into was bona fide or not or whether it was sham and only for the purpose of diverting the profits.</p> <p>3.6 The benefit derived or accruing to the company must also be considered from the angle of a prudent businessman. The term "benefit" to a company in relation to its business has a very wide connotation and may not necessarily be capable of being accurately measured in terms of pound, shillings and pence in all cases.</p>
<p>4. If at all any benefit is accrued as a result of the services said to be rendered by the RP/Parent, the benefit accrued to the MNC Group as a whole and not exclusively to the Taxpayer Company alone</p>	<p>4.1 Though the services provided at the group level benefit all the entities, including the Taxpayer, the cost of services are allocated to all the entities of the Group, in proportion to the services availed by each entity. So, the Taxpayer has been allocated/cross-charged only those costs incurred by the RP/Parent company which specifically pertained to service rendered to the Taxpayer</p> <p>4.2 Detailed working of cost allocation should be filed</p>
<p>5. Only incidental benefits derived by the Taxpayer</p> <ul style="list-style-type: none"> • Though some incidental benefits accrued to the Taxpayer, yet such benefits would not be ones for which an independent enterprise would be willing to pay 	<p>5.1 The key benefits to the Taxpayer by availing the Intra-Group services include, but are not limited to: -</p> <ul style="list-style-type: none"> • Access to high quality services on "as and when such a need arises" basis; • The staff providing the services have unequalled knowledge of the business and the issues, compared to third party providers; • Some of the services provided by the RP would not likely be obtainable from third party service providers, and it may not be prudent from a business as well as commercial perspective to avail some of the services provided by the RPs, directly, from third party service providers; • It is practically and financially not possible for the Taxpayer to employ such experienced personnel on a stand-alone basis. Further, procuring such assistance from third party consultants would prove to be extremely costly for the Taxpayer: • Further, due to the direct involvement of administrative and executive management teams, the level of staff and management required at the

	<p>recipient entity levels gets reduced. This further provides for a higher degree of coordination of the activities among the foreign affiliates. This greater degree of coordination in turn facilitates increased sales and more efficient use of the resources;</p> <ul style="list-style-type: none"> • Provide operational efficiencies (e.g. better training, staff recruitment and retention and IT platforms) and promote opportunities of cross selling to maximise revenues; • Reduced costs - Many functions can be carried out centrally for the benefit of the entire group, by reducing duplication, by providing dedicated resources and by providing the benefits of economies of scale.
<p>6. Services are duplicative in nature</p>	<p>6.1 The services cannot be duplicated in Taxpayer's Country in so far as they require interaction abroad</p> <p>6.2 Taxpayer does not have infrastructure, office, and manpower outside its own Country, where RP renders services, like marketing support services. RP has the network, presence, infrastructure and manpower in foreign locations</p> <p>6.3 Show direct/immediate relevance of services to the Taxpayer's business</p> <p>6.4 Argue, if feasible, that the Taxpayer is in initial stages of business, and does not have expertise to meet the clients' requirements/expectations</p> <p>6.5 Taxpayer has availed of only those services from RP which the taxpayer does not perform in-house or does not procure locally.</p>
<p>7. Services fall in the category of Shareholder services</p> <ul style="list-style-type: none"> • The services rendered by Parent Company are more in the nature of directions/management decision/routine advice which were provided to the 	<p>7.1 The types of services which can be categorized as shareholder services have been illustrated by the OECD Transfer Pricing Guidelines (July 2017). In Para 7.9 and 7.10 of those guidelines following services can be treated as shareholder services:</p> <ul style="list-style-type: none"> • Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the

<p>Taxpayer by the Parent Company to take care of the Parent's own interests rather than to meet the identified needs of the Taxpayer.</p>	<p>parent company and costs of the supervisory board</p> <ul style="list-style-type: none"> • Costs relating to reporting requirements of the parent company including the consolidation of reports • Costs of raising funds for the acquisition of its participations <p>7.2 The Taxpayer should file detailed description of services to show that the services received from the RP are not of the type described above</p>
<p>8. No proof filed to show that RP incurred expenses required to render services</p>	<p>Following evidence can be filed:</p> <p>8.1 Certificate of CFO/CEO of RP regarding rendering of services – Certificate should describe the infrastructure installed, manpower hired, costs incurred (certified by Independent Auditor), assets deployed (certified by Independent Auditor), nature of services (must match with Agreement), mode of delivering services, computation/basis of cost-allocation/cross-charge (with appropriate allocation keys)</p> <p>8.2 Affidavits of personnel of RP stating that their activities are devoted to the work for the Taxpayer Entity, clearly stating what kind of work they do for and on behalf of the Taxpayer Entity.</p> <p>8.3 Financial Statements of RP/Cost Centre as certified by Independent Auditor</p> <p>8.4 Certificate from Finance Director of RP containing the nature of services rendered by the RP to the Taxpayer and also to other Group Entities, including the personnel/department engaged in rendering service, expenses incurred by various personnel/departments in rendering services and the intra-group service fees charged (billing) by the RP to various Group Companies, including the Taxpayer company</p> <p>8.5 For cost-contributions, a detailed report (obtained by MNC Group) from the independent auditors documenting the manner and the methodology for computing the contribution made by each participating group entity.</p>

<p>9. Cost Allocation vs Actual Usage - Cost allocation is on estimated basis regardless of actual usage of services</p> <ul style="list-style-type: none"> • The remuneration was fixed not with reference to any particular service. It was at a fixed amount, calculated at a fixed percentage of sales of Taxpayer, irrespective of which services were actually received by Taxpayer or whether any services were received by it or not. • There is no comparison between the volume and quality and services and the amounts paid by the Taxpayer company. The cost has been apportioned by the RP for different country centers on a mutual agreed basis and not on the basis of actual services rendered 	<p>9.1 The Taxpayer has, in accordance with the stipulations mentioned in the OECD TP Guidelines, adopted a rational, systematic and logical methodology for the payment of cost contribution charges. The allocation of intra-group charges by the RP to the Taxpayer adheres to the tenets of the indirect allocation mechanism provisions as stipulated under Paragraph 7.23 to 7.26 of the OECD TP Guidelines (July 2017).</p> <p>9.2 The methodology of allocation followed is standard, uniform, harmonized and consistent across the entities of the Group. The basis of allocation followed across group companies is identical to the one adopted for allocating intra group charges to the Taxpayer.</p> <p>9.3 It has been acknowledged in Para 7.23 of the OECD Guidelines (July 2017) that a direct-charge method for pricing of intra-group services is difficult to apply in practice for MNC Groups that such groups have developed other methods, for charging for services provided by Parent Companies or Group Service Centres.</p> <p>In such cases, according to the OECD, the MNC Groups may find that they have few alternatives but to use cost allocation and apportionment methods which often necessitate some degree of estimation or approximation. Such methods are generally referred to as indirect-charge methods. The allocation might be based on turnover, or staff employed, or some other reasonable basis.</p> <p>Note: Your case will be strong if the direct costs are specifically identified and cross-charged. The indirect costs may be allocated or apportioned. However, detailed workings of allocation of indirect cost should be filed specifying the appropriate allocation keys.</p>
<p>10. Benchmarking should be done separately, not by aggregating with other transactions under TNMM</p>	<p>10.1 It is infeasible and impractical to ascertain any independent value of these services. It is, therefore, desirable that the benchmarking of these services should be done on an over-all basis i.e. analyzing the net margin rate under TNMM, which would be most appropriate method to ascertain true picture of financial results of the organisation</p>

	<p>10.2 Aggregated TNMM can be applied if it is established that each transaction is so inextricably linked to the other that the one could not survive without the other, and if the receipt of services formed a part of a composite transaction. The Taxpayer would, however, have to prove that although each sale and each provision of service is priced separately, they were all provided under one composite agreement which constitutes an international transaction.</p>
<p>11. The comparables, identified by the Taxpayer company, under TNMM have not paid any management service fees</p>	<p>11.1 Items of expenditure incurred is not a criterion to judge comparability. So, it is not necessary that the comparables should also incur similar types of expenses as the Taxpayer. If, otherwise, the comparables meet the criteria of comparability (i.e. comparable FAR profile), no adverse inference can be drawn on the ground that payment of management service fees is not reflected in the financials of the comparables.</p> <p>11.2 Even after considering the expenditure on account of management service fees, the Profit Level Indicator (PLI) of Taxpayer is better than the PLI of the comparables.</p>
<p>12. How can the RP which renders the services have knowledge about the market of Taxpayer's Country and that Country's business conditions?</p>	<p>12.1 The Taxpayer may argue that because of presence in its own Country the Taxpayer might be aware of the local market conditions, including competitive companies and client expectations. Such knowledge would enable the Taxpayer to make an evaluation about the type of services needed to maintain competitive edge in the market and also to meet client expectations. However, the Taxpayer is free to avail of the required services from its own RP, so that uniformity, quality, best global practices and standardization can be achieved. Further, the services provide by the RP may not have any direct relevance to the market conditions of Taxpayer's Country.</p>

We hope you find the above chart of counter-arguments useful in defending your management service fees, before the Tax Authorities.

Closing

Payment of Management Service Fee (MSF) is widely prevalent in MNC Groups. That is because centralisation of management services provides distinct advantages, in the form of global best practices and competitive edge. Despite sound commercial rationale, Tax Authorities routinely disallow the payment of MSF on various grounds, as discussed in this Article. The Taxpayers can, however, defend the claim of MSF, by maintaining appropriate documentation; and by presenting their case in a persuasive manner with the help of sound arguments.

~ The End ~