Sub-contracting, referrals and global contracts for services firms

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Adapted from a chapter in BNAI's new Transfer Pricing Manual, this articles addresses the issues arising from providing services to the same MNE in more than one country

BNAI's new transfer pricing reference book, Transfer Pricing Manual, includes a chapter that sets out to consider an area of transfer pricing that has hitherto received little attention: the transfer pricing issues that tend to be encountered particularly by services firms. This article has been adapted by the author from one of the topics covered in that chapter, being the issues that arise from providing services to the same multinational client in more than one country.

Other topics covered in that chapter include secondments of fee-earning staff, the network effects that sometimes arise for services groups and special issues for partnerships. We use the loose term "services firms" to mean those groups whose primary business is to provide services to external customers. Examples include lawyers, management consultants, advertising, IT outsourcing, and many more. In this article, we will use the terminology convention that "firm" means the global firm, which may consist of more than one legal entity; we will refer to that firm's presence in a country (whether through a subsidiary, branch, or otherwise) as an "office". These issues are by no means exclusive to services firms and this article may be of interest in relation to any firm in which work is subcontracted or referred or bid for on a multi-country basis.

I. Subcontracted work

Gareth Green is the technical editor of BNAI's Transfer Pricing Manual

Many services firms that operate in more than one country will perform services in multiple countries for the same client (or for affiliates of that client). Indeed, one of the main reasons why a services firm might open an overseas office is to service its clients (or their affiliates) in other countries.

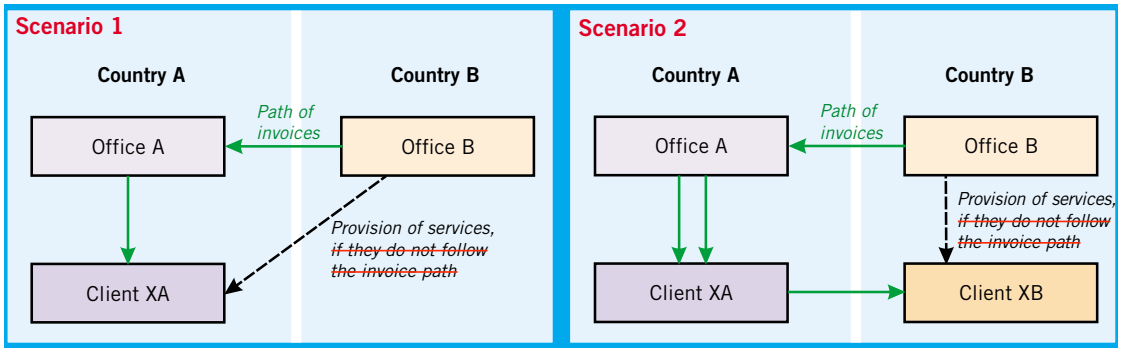
There are many ways in which this might happen. This is best illustrated with the diagrams spread through the article. Each diagram relates to a firm with an office, A, in country A and another office, B, in country B, the two being connected for transfer pricing purposes. Office A has a client, XA, in country A, which is a member of group X. Company XB, in country B, is also a member of group X. The arrows show the invoicing for services. The dotted line shows the actual services, if they do not follow the invoicing path.

The first two scenarios, illustrated overleaf, relate to subcontracted work. In the first scenario, B's work relates to A's client in A's country, whereas in the second scenario, B's work relates to a local affiliate of A's client, but is billed via A.

In some cases, the services supplied by office B are negotiated on a standalone basis, but in other cases there may be a global arrangement with group X (see global contracts below). Of course, these scenarios are a simplified version; in many cases there will be more than two countries involved.

II. Pricing of subcontract work

In cases where office B performs work for office A, it is necessary to determine what price B should charge to A for that work. This may not necessarily be labelled as a subcontract arrangement, but in effect A is subcontracting to B.



Unlike other intragroup services, the services performed by B are of the type of services that B is in business to provide to external customers. Often, the starting point for the transfer price will be the fee that B would have charged if it performed the same work direct for a third party. On the face of it, this would allow the CUP method to be used. For instance, many services are charged to clients on the basis of an hourly rate for time worked by staff, so if the same hourly rate is used for work that is billed to another office of the firm, the fee on the face of it meets the arm's length test. However, as we shall discuss, there are a number of factors that might require an adjustment to that CUP.

A. Different rates in different countries

The going rate for certain services can vary from country to country. For instance, a tax manager with one of the large multinational accountancy firms in, say, London has an hourly charge out rate several times higher than his counterpart in, say, New Zealand. This differential can give rise to issues in high rate countries and in low rate countries, as discussed in the following two sub-sections.

B. Subcontractor has higher rates

Consider the arrangement illustrated in scenario 1, above. Let us assume that Office A has won an assignment to provide advice to its client XA but the advice relates to country B, so the advice must necessarily be given by the overseas office B. Office A's charge out rate to client XA is half office B's standard charge rate, so office A wants office B to do the work at a 50 percent discount. It is quite common for this situation to arise in services firms, but there is a risk that office B could be considered to be charging less than an arm's length fee to office A. Whether or not the lower fee is justifiable as meeting the arm's length test will depend on a number of factors:

- Does office B generally get full recovery of its fees at this standard rate, or is it reasonably common to grant a 50 percent discount to local clients? If the latter, under what circumstances are discounts given and do these circumstances apply to the work performed for A? For instance, are discounts reserved for the largest clients, and if so, would office A count as large?
- Is office A carrying out non-chargeable tasks in relation to client XA that would normally be incurred by B on work for local clients? Examples would be client relationship management, selling the specific project, billing, and project management. This might justify B giving a discount on its normal rates to reflect the fact that this work has lower overheads than on work for its local clients, so there is more scope to give a discount.
- Is office A bearing risks that would normally be borne by B on work for local clients? Examples would include the risk of being sued for poor or negligent work or the risk that there might be a write-off of costs or time on the project. How significant are these risks and therefore how much effect should they have on fees? (For instance, these risks are likely to be more significant for an audit firm than for an office cleaning firm.)
- Does office B have spare capacity? If yes, their opportunity costs are close to zero, so it might be in their interests to carry out work for A at a 50 percent discount, rather than earn nothing. (This is unlikely to be a viable explanation if the situation continues over the long-term, however.)
- Would office A suffer losses if it had to pay full rates to office B and would this happen sufficiently often that office A would be unviable? If yes, are there indirect benefits derived by office B from the existence of office A that are sufficient to justify office B subsidising office A? For instance, do office B's clients value being able to obtain advice about country A without having to find a separate adviser in that country? Does this allow office B to win or retain local clients? Will carrying out the work for client XA give office B an opportunity to get to know, and win work from, client XB, charged at full rates?
- Does office A subcontract work to any independent firms in other high-fee rate countries, and do they give 50 percent discounts to office A? Does office B perform work under subcontract to other independent firms in low-fee rate countries and does it give discounts as high as 50 percent? Are there other members of the same firm that might have subcontract relationships with independent firms in other countries and does this provide evidence for or against discounts?

C. Subcontractor has lower rates

There may also be situations that are the opposite fact pattern. For instance, with scenario 1, assume that rather than being double, office B's charge rate is half that of office A, so there is an opportunity to charge a premium to the client. (Assume this is a case where it is ethical and commercially appropriate to bill at the higher rate. Some firms have "international" rates, which are higher than the local rate, for this purpose.)

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In such cases, it is necessary to determine whether A should pay B only its normal local rate or should pass on the higher amount that was actually billed to the client. Again, there is a range of possible factors to consider:

- Does B deserve to receive more than its normal fee for the service in question? Has B done anything extra that entitles it to receive a higher fee?
- Does B ever bill a premium to its own overseas clients?
- Would it be permitted for B to bill a premium to a local client, in view of ethical, regulatory or legal considerations?
- Do A or B (or other members of the firm) have any subcontract arrangements with independent firms which would indicate how firms deal with this situation on an arm's length basis?

This assumes that the work contracted by office A to office B arose in the normal course of office A's own work for client XA. If, however, office A was primarily set up for the purpose of selling work in country A on behalf of office B, then this may suggest a different answer. (Think for instance of some of the Indian IT companies that have set up or acquired operations in Europe and North America with the primary purpose of marketing their low-cost services in high-cost countries.) In such circumstances, it might be more appropriate to view office A as a distributor selling on behalf of office B, in which case it should probably earn a resale margin or a sales commission.

III. Referrals

Similar differential charge rate issues to those above arise in circumstances such as those described in scenarios 3 and 4, where office B is billing the client direct, but it won the work as a result of office A's relationship with client XA.

However, the referral of work also gives rise to the additional issue of whether B should pay a commission to A for the extra work. In some cases, the answer may be yes, but this is highly fact-dependent. Many of the factors discussed above should be considered in forming a view.

IV. Write-offs

For groups in which such transactions are common, it would be advisable to have a policy about how write-offs (of billed or unbilled work) should be treated where more than one office is involved. Should they be borne by the office that directly bills the client or should they be allocated to the office (or offices) that performed the work? If the offices were not related to one another a write-off would probably be borne by whichever office was responsible for causing the write-off. For instance, if the write-off arose because the work took longer than budgeted, was this because office B (the office that performed the work) was inefficient or because office A (the one that arranged the work with the client) quoted an unrealistic fee or did not communicate the fee limitations to office B? Some firms make it a practice to analyse the cause of write-offs, so as to learn from them. In such cases, they will already have suitable information to allow them to allocate the write-off accordingly.

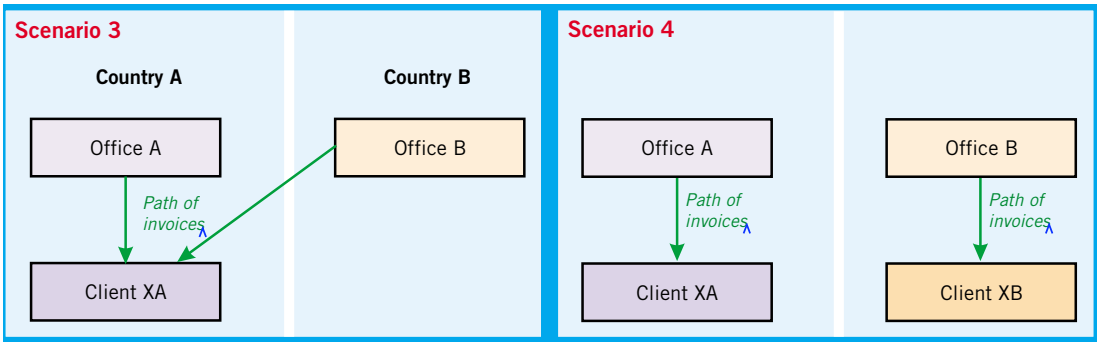
Other firms may be concerned that such discussions might lead to discord between offices and be inconclusive because each office naturally considers that the other is to blame. This isn't necessarily non-arm's length behaviour; unrelated parties in a contractor-subcontractor arrangement might also be concerned that allocating blame might undermine their business relationship. However, arm's length parties would also be likely to have a contract under which there are clear terms setting out which party is to bear write-offs, whereas within a service firm there may not be a clear policy.

It may therefore be helpful if a formal policy is decided, and ideally recorded in writing and dated (including an explanation of why it is considered to meet the arm's length test). This might make it far easier to deal with exceptional events, should they occur. In the absence of any clear policy, set before the write-off arose, the tax authorities in country A and country B are both likely to argue that the loss should be borne in the other country. This is a recipe for endless dispute and even double taxation.

V. Global contracts

Some services firms take the above fact patterns a step further, by actively setting out to bid for contracts to perform services for a client on a multinational basis. In some cases, the scope of the services spans the globe and covers dozens of countries. In other cases, the contract might cover a certain region or just certain specified countries. This could include a wide range of fact patterns, such as:

- a contract to be the global audit firm for, say, a pharmaceutical multinational
- an IT outsourcing contract under which the IT firm takes over desktop support for all the European subsidiaries of, say, a global bank for 10 years
- a contract to design and implement the global advertising campaign for, say, a sportswear group.



A. Bid costs

The fees from such contracts can run into many millions (even billions) of dollars/euros/pounds etc, and they may generate significant profits for members of the firm in many countries. All the issues already mentioned can apply, but there is an additional issue that is more likely to arise where there is a global contract, because the bid process is often very lengthy and costly (running, sometimes, to tens of millions of dollars/euros/pounds, etc). Often, the bid may be against several competitors, so the chances of success may not be good. Of course, the bid costs are rarely billable to the client; they are an investment the group must make in the hope of winning a contract that is sufficiently profitable to offset the bid costs and to reward the group for the risk that the bid might not have succeeded. It is therefore necessary to consider the impact of bid costs on the transfer pricing of the services performed under the global contract by the members of the services firm.

In some cases, the bid costs are borne by members of the firm in proportion to their expected relative benefit from the contract, because the bid team is drawn from the offices that will perform the work if the bid is successful. However, in many cases, one office (or sometimes more than one) may take the lead in making the bid, perhaps because its staff have the primary relationships with key buyers at the client, or because the client has its own head office in that country. Increasingly, services firms are setting up specialist teams (often in their global or regional head office) whose purpose is to lead the bid process for the largest contracts. The bid costs therefore fall disproportionately to one particular office (referred to henceforth as the "lead office").

In many cases, the lead office will also be responsible for ongoing client relationship management after the project is won, ongoing liaison with the other offices and overall project management. These activities are rarely explicitly billable to the client, so although we refer below only to the bid costs, the comments often apply equally to the cost of these other non-billable activities.

We discuss below a number of ways to deal with this, but whichever option is chosen, what is clear is that there should not be a mismatch: it would not normally be acceptable for the lead office to bear all the bid costs and for the other members of the firm to book all the profit from performing the local work under the contract. The question to ask is whether the lead office would be willing to do this if the other offices were in fact independent from it.

1. Lead ~~firm~~ bears bid costs

If the lion's share of the contract work is to be performed by the lead office, it might perhaps be arguable that the lead office will be the primary beneficiary if it wins the contract, so it might be willing to bear all the bid costs. Perhaps the lead office would be happy to let the other offices keep all the profit on the small amount of work they perform, even if the offices were independent from the lead office, as the lead office would be more concerned to have a commitment from the other offices that they are willing to provide the services required so that it can offer a comprehensive service to the client.

Another possible justification might be that each office acts as lead office on different bids, so the benefits are reciprocal and, over time, any mismatches should balance out. However, tax authorities may expect some sort of numerical evidence to support such an assertion. They may also challenge whether independent firms would be willing to rely on uncertain trade-offs of this type, though it would be the author's observation that businesses are often willing to accept quite a high degree of uncertainty, particularly in relation to a transaction that is fairly small compared to the business's core activities.

Normally, however, it will be necessary to find a way to match the costs with the benefits. There are two broad ways to do this. Either the bid costs should be spread amongst the offices that will benefit from the contract (if the bid succeeds) or the lead office should be entitled to an extra level of profit on successful bids to reward it for the extra entrepreneurial risk it has borne and for the contribution it has made in winning the contract. Both options are considered below.

2. Bid costs are shared

Under this model, the bid costs would be borne by all the offices that are expected to benefit from performing the contract, if it is won. It is inherent in this approach that it should be agreed in advance. If it is decided, after a bid has failed, that the bid costs should be spread, the tax authorities outside of the country of the lead office might argue that as there was no prior agreement to the charge, the local office would not, if it were independent, agree to a retrospective charge. The tax authority will contend that the lead office must have been acting entrepreneurially and would have deserved reward if the bid had succeeded, but it cannot retrospectively claim the right to make a charge for the costs of the failed bid. On the other hand, if the bid succeeds, the tax authority of the lead office might be the one to insist that the lead office must have been acting as entrepreneur and it therefore deserves a bigger share of the global profits from the contract (see below).

One way to share the costs would be for the lead office to charge a fee to the other offices for performing the service of leading the bid. In the absence of any comparable independent transactions with which to use the CUP method, the fee would probably be determined using the cost plus method. The mark up percentage should reflect the functions performed by the lead office in leading the bid, but not a reward for risk, as the charge means that the bid risk is effectively being shared with the other offices. The fee would probably be split between the offices in proportions that reflect their likely benefit from the contract. In some cases, there may be many bids and it would be impractical to split each one separately, so they may have to be aggregated and split according to likely benefit from the average contract.

A possible alternative would be to use a Cost Contribution Arrangement ("CCA"). This would probably not include a mark-up. Space does not allow for a discussion of the circumstances under which a CCA or a cost plus fee would be appropriate and the likely differing views of tax authorities on this, depending on whether they are in the lead office's country or not.

3. Lead office is entrepreneur

The other possible approach is that the lead office bears the bid costs on an entrepreneurial basis. If the bid fails, the lead office bears the full loss on the bid costs. If the bid succeeds, it should be entitled to a reward for the entrepreneurial risk it has borne: a

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share of the profits that will be made by the other offices from the contract. Again, it can be appreciated that this will be easier to support if it is documented in advance, so that it is harder for tax authorities to argue that it is more likely that the bid costs would, on an arm's length basis, have been shared. (This of course also means that it will be difficult for the taxpayer to argue for a different treatment, even if the facts do not turn out as expected and a different treatment would have been more tax-effective. Most taxpayers will consider this to be a reasonable trade-off.)

There are a number of ways in which the lead office could be rewarded. One approach would be that the other offices should pay a sales commission to the lead office – perhaps a percentage of the fees each office bills on the contract. Another approach would be that the other offices are treated as subcontractors, who bill their work to the lead office which bills the client in turn. This would, of course, need to be reflected in the contractual relationship with the customer. The subcontractors bill at a discount, so that the lead office can make a margin when it rebills.

It might be difficult to find comparable uncontrolled transactions in order to set the discount or commission rate, however, so another variation would be that the other offices would be paid a fee equal to their actual underlying costs plus a mark up, to reward them for the subcontract work. The mark up could be set using a database search for independent companies carrying out comparable services. A cost plus fee would mean that the lead office is guaranteeing that the other offices will make a profit. If the project is unsuccessful, the lead office might make a low profit or even a loss; if the project is successful, the lead office might make a higher margin than the other offices. This solution would be a particularly good fit in cases where the lead office bears most or all the responsibility for the success or failure of the project (as opposed to just the bid). For instance, the lead office might have designed the way in which the global project will be performed, or it might be responsible for performing a key part of the contract on which hinges the likely profitability of the contract, or it might be responsible for overall global project management.

B. Standard global rates

Global contracts often guarantee the client a standard global rate for the service. This might mean that a given grade of staff has the same hourly rate in every country or that a certain service will be charged at, say, $300 each time the service is rendered, regardless of which country it is performed in.

However, the underlying costs of performing the service, and the going rate for performing the service, might vary considerably from country to country. This might have the result that some offices make windfall profits, because they are able to bill more than they normally could, whilst other offices might suffer poor profits or even losses. The decision to agree a standard global cost may make perfect sense for the group as a whole, as it generates satisfactory overall profits on a consolidated basis, but the way in which those profits are shared between the group members may be difficult to justify.

In cases where the client is billed centrally, this could be adjusted for by having the lead office pay each office on the basis of the fee they would have charged to an equivalent local client. Adjustments might have to be made for factors such as those discussed earlier in relation to subcontracted work. Another solution would be for the lead office to pay a cost-plus fee to the other offices for their work, as discussed earlier in this section.

If each office bills the local client, there might be a need for the lead office to subsidise offices that make an under-recovery and for those that make an extra premium to pay it over to the lead office.

C. Standard discount

A variation on the problem of standard global rates is that, in order to win the global contract, the group may have promised the client a discount on its normal fees, which is to be applied uniformly in every country. In some cases, this might seem fine, because, on the face of it, each office is bearing proportionately equal "pain".

However, there may be circumstances under which a standard discount does give rise to concerns. For instance, in some countries, discounts may be customary, so the official fees or hourly rates used by some offices may include an element that the office expects normally to give away as a discount. For these offices, it may be no hardship to grant a discount of that level, whereas in other countries the rates may have been set in the expectation that this is the amount that would ordinarily be billed to the client.

Another example might be that the discount has been agreed because certain key offices have excess capacity, so on an opportunity cost basis the discount makes sense, if it is necessary in order to win the contract. However, for other offices that are already busy, the discount may make no sense. Again, adjustments may have to be made in order that the discount is borne by the office/s that had an economic incentive to offer the discount. (The rationale should be documented.)

VI. Conclusion

As tax authorities mature in their experience of transfer pricing and expand their resources, they are increasingly turning their attention beyond the widget-makers and banks, so tax inspectors, multinational services firms and their advisers are more and more often having to consider how to apply the arm's length principle to issues such as these. Readers who found this of interest may wish to refer to the full chapter in BNAI's Transfer Pricing Manual.

Gareth Green's *contact details are available at www.tpsolutions.co.uk*

This article is adapted from a chapter in BNAI's recently published book, Transfer Pricing Manual*, a comprehensive guide to basic transfer pricing issues, and takes a global perspective on the subject with contributors from key trading nations in Europe, the US, Japan and Australia. Gareth Green, the technical editor, has extensive experience in transfer pricing, and contributors include partners at big four firms and specialist transfer pricing consultancies. The book looks at general principles, types of transactions as well as chapters focussing on specific industries such as banking, insurance, telecommunications, professional services and pharmaceuticals. With a Foreword by Caroline Silberztein, Head of Transfer Pricing at the OECD in Paris, this book will be of interest to all* TPI Transfer Pricing *readers. Contact marketing@bna.com for more information.*