VISION: Journal of Indian Taxation
Vol. 5(2), Jul-Dec 2018, pp. 84-94
DOI: 10.17492/vision.v5i2.14517
www.journalpressindia.com/vjit

Intra Group Services: Need for a Uniform Transfer Pricing Regime

*Lakshana Radhakrishnan**

ABSTRACT

Intragroup services form one of the trickiest areas in transfer pricing regulation owing to the internal and routine nature of these activities. Instances of false invoicing and tax evasion are rampant as national tax authorities scramble to detect malpractices. Apart from the transfer pricing challenges inherent in intragroup services, external problems arise in the form of inconsistencies in domestic taxation regimes. The lack of adequate coordination among national tax regulators further aggravates the problem. This research paper seeks to delve into this issue and stress the compelling need for a uniform global approach. The introduction is followed by a brief analysis of the existing legal framework under the Organization for Economic Cooperation and Development (OECD). The subsequent section will discuss major Indian case laws to understand the judicial approach towards transfer pricing adjustments made to intragroup service transactions. The conclusion will highlight the shortcomings and inconsistencies in the existing regulatory framework and emphasize the need for a uniform transnational approach.

Keywords: *Transfer Pricing; Intra Group Service; OECD; Arm's Length Price; Controlled Transaction' Transfer Pricing Officer.*

1.0 Introduction

Intragroup services are the most common controlled transactions among cross-border associated enterprises. They refer to centralised services rendered by certain members of a group for the benefit of all members of the group. Centralisation of service renderings helps multinational companies (MNCs) capitalise on the cheaper labour and capital available in certain jurisdictions and avoid duplication of work. They cover a

**Student, V Year, National Academy of Legal Studies and Research (NALSAR), University of Law, Hyderabad, India. (Email: lakshana@outlook.in).*

wide range of services ranging from traditional operations proper, to management contracts, technology transfer, technical assistance agreements, licensing arrangements, repatriation or remittance of dividends, payment of royalties and fees for included or technical services (Mitra et al., 2014).

Intragroup services are significantly different from inter-firm service trade. The cross-jurisdictional intrafirm transfer of services is asymmetrically located since they are 'hierarchical' unlike open-market transactions. Intragroup services are generally offered through global value chains created by offshoring of business activities. Hence, value chain activities like design, production, marketing and distribution could be dispersed across the world and located in different sites depending on the suitability of the local political and economic conditions.

Intragroup service transactions are required to be conducted at arm's length price (ALP) but there is ample scope for financial manipulations as compared to controlled transactions in intangible and intangible goods and financial arrangements (Eden et al., 2011). Operationally, the financial manipulations in cross-border intrafirm transactions are effected through the creation of false invoices that reflect an inflated or deflated price for imports or exports based on the tax favourability of a specific jurisdiction (Radhakrishnan, 2016). Hence, false invoicing is the process of tax evasion by artificially reducing the tax incidence in certain territories by means of an invoice that does not accord with economic facts. The practical problems involved in false invoicing such as profit shifting and consequent loss of tax revenue are significant in intragroup services. This creates a need to strictly regulate intragroup services.

Systems exist to check anti-competitive activities in controlled and open market transactions. Generally, customs departments adopt valuation systems with comparable prices and when transactions do not correlate, they penalise the concerned parties and blacklist serial offenders. However, in the case of intragroup services, detection is harder still owing to the lack of a clear exchange of goods and the usage of indirect-charge method.

International and domestic legal regimes continue to grapple with the unique transfer pricing challenges in intragroup services. The following section provides a brief overview of the legal landscape.

2.0 Regulatory Framework

The OECD Transfer Pricing Guidelines for Multinational Enterprises & Tax Administrations, 2017 (OECD Guidelines) provide an overarching international transfer

pricing regime. In India, the transfer pricing regulations were introduced by the Finance Act, 2001. Chapter X of the Act contains the relevant provisions from Sections 92 to 92F. The substantial provisions need to be read in consonance with Rules 10A to 10E of the Income Tax Rules 1962. The Indian transfer pricing regulations do not provide specific guidance on allocation of service charges. Hence, reliance is generally placed on OECD Guidelines.

The Central Board of Direct Taxes introduced Safe Harbour Rules in 2013 as a response to the growing number of transfer pricing audits and lengthy legal proceedings. The categorisation of services in the Rules are unclear and the margins cited are on the higher side. Consequently, there has been no significant reduction in intragroup service related litigation after the introduction of the Safe Harbour program.[1]

From an evidentiary perspective, ample documentary proof is required to demonstrate the nature of the intragroup service transactions at the time of audit and litigation. The taxpayer must maintain a clear record of its internal legal contracts by detailing its functions, the assets it uses and the risks it undertakes, as mandated under Section 92D and read with Rule 10D. This compliance is called as functions, assets and risks (FAR) analysis[2] and it helps understand whether the controlled transactions were at ALP or not.[3] However, as seen in judicial decisions, despite best secretarial practices and increasing efforts by taxpayers to maintain transparency in internal controlled transactions, tax authorities continue to make adjustments and disallow certain income or make deductions, as applicable.[4] There are two factors involved in assessing transfer pricing of intra-group services: (1) whether the service was actually provided/rendered; and (2) whether intra group charge was in accordance with ALP costs.

2.1 Determining whether intra-group service was rendered

The OECD Guidelines provide the benefit test to identify whether the service rendered conceivably appreciates the recipient's position by supplying economic or commercial value. In order to qualify as an intragroup service, the beneficial activity must meet a twofold criteria: (a) an independent enterprise must be willing to pay for that service if it's procured under similar circumstances from an independent third party; and (b) an independent party must be willing to make the service available by performing it in-house (Kumar et al., 2016).

The crux of the benefit rule is that the supposed benefit must be real and direct; not illusory or perceived. The supposed benefit must not be so distant or incidental that unrelated parties would not have charged for the service. The service fee should be

consistent and commensurate with the benefit received and the transaction should not be subject to benefits that might be realised in the future (Blankenship et al., 2015).

For instance, one group entity might train all of the employees in a particular MNC and then post them across group companies. Such, services accrue benefit to the recipient company in terms of human skills. Further, the benefit is not incidental as the service was done for the purpose of each of these business entities. In the case of managerial services like marketing, unless that particular branch office was specially promoted, there can be no need to independently compensate the Head Office since ultimately it is the brand image of the whole company, which will benefit.

The OECD Guidelines list out certain non-beneficial services, which cannot be charged:

2.1.1 Shareholder/ custodial activities

These are practices undertaken in view of the ownership interests. The European Union's Joint Transfer Pricing Forum, February, 2010, classified costs of central coordination and managerial activities generally to be in the nature of shareholder costs. These activities should be related to the management and protection of the investments in participants and no independent party should be willing to pay for them or perform those activities by itself (EU JTPF, 2010).

The services that are generally regarded as shareholder or custodial activities are mentioned below:

Services concerning the corporate structure of the mother entity, not excluding the costs involved in share issue;

Reporting and other legal requirements of the parent company;

Reviewing, assessing and tracking the subsidiary's performance regularly; and

Activities relating to financial injections in the subsidiary or refinancing the mother entity's equity in the subsidiary.

Not all shareholder activities that accrue benefits to the owner are barred from being made chargeable. It is a question of fact and the nature of the activity performed should be seen.

2.1.2 Duplicative/ Stewardship activities

Duplication of services occurs when there is rendition without any actual need. Though the regular will not interfere with the business wisdom and commercial prudence of the taxpayer to the maximum extent possible, if there are situations where the recipient performs the rendered service per se or received them from an unrelated third party, there is an appearance of duplication.

For example, redundant services supplied by a group entity when the recipient possesses adequate human resource to handle a technical issue by itself, create suspicion of duplication. However, the suspicion can be removed by demonstrating a special circumstance. If there is an exceptional business need and the taxpayer has to evade critical risk, paying group entities for a second legal opinion or an independent audit might be justified.

2.1.3 Services that provide incidental benefits

The OECD Guidelines state that activities that only indirectly enhance a group entity cannot be made a chargeable intra group service. For instance, a reorganisation decision or acquisition/disinvestment deal being carried out by a parent or a sister company might result in economies of scale or some other benefit for some other group member not directly involved in the process/deal. In this case, though there is a service element, the same cannot be charged for, since it only provides an indirect benefit.

2.1.4 Passive association benefits

Benefits that group members receive merely by virtue of being part of a group do not generally justify payments since they result on account of passive association (Gill et al., 2015). Nevertheless, when a group entity receives higher credit firm ratings on account of the guarantee provided by the parent company, an allocation could be warranted on account of the benefit accrued.

2.1.5 On-call services

There could be a support group established by the group entities, which might always be ready and prepared to provide any, legal technical, financial or tax related service, on an on-call basis. These groups might charge a stand-by charge and upon request, they supply experts based on specific needs. The special charges that are paid for constant availability cannot be justified if similar service can be availed from external sources. It is important to conduct a factual analysis to understand if the stand-by service is genuinely necessary and special payments warranted. Certain businesses may have sporadic and unique needs that their group entities are probably best placed to understand. Hence, such stand-by charges are generally not subject to transfer pricing adjustments.

2.2 Determining whether the service was charged at ALP

Generally, the assessee employs an allocation key in its FAR analysis to divide costs and reveal the economic value obtained. The OECD Guidelines prescribe two charging systems that the transfer pricing officer (TPO) may adopt to review the cost allocation keys i.e. direct and indirect charging.

Direct charging is resorted to when a specific service is directly provided by one member of the group to another member. Here, the third party quote for the same or a 'comparable service' are found, to analyse the ALP for that particular transaction. Direct allocation is possible only when the specific service is clearly identifiable and quantifiable. The advantage of this method is the convenience is provides to tax authorities in delineating the costs and the time involved in supplying the service.

The indirect charging methods are used when the service provided in only approximately estimable. Basis of charge is a factor of cost allocation or apportionment and considers the specific commercial features of the case. The Comparable Uncontrolled Price (CUP) Method and the Cost Plus method fall under this category.

The CUP method can be used in two situations: (a) when the service provider provides the same service to independent enterprises under similar circumstances; or (b) when the recipient could procure/ procures a comparable service from an independent enterprise (Pagan & Wilkie, 1993). If the CUP method is found to be inapplicable, the Cost Plus method can be made use of. This method only requires a simple analysis of the costs incurred in the process with an appropriate mark-up. Transactional net margin method is another unique calculating approach that is frequently adopted by the assessee.

3.0 Judicial Trends in India

The Tribunals and Dispute Resolution Panels (DRPs) are required to pass reasoned orders since they are quasi-judicial authorities.[5] Section 144(6) further requires that the DRP not reject objections in a summary manner without duly analysing the evidence. Following this principle, the Mumbai ITAT in Dresser-Rand India Private Limited set aside the DRP ruling. Tribunals are thus bound to pass reasoned orders that involve application of various judicial and legislative standards to decide cases. Earlier, the tests adopted in India and the reasoning supplied were largely based on the OECD framework. However, the Indian adjudicatory bodies are shifting away from the uniform OECD regime.

3.1 Benefit rule & commercial expediency

The Indian tribunals and courts have largely adopted the benefit test to confirm the existence of a service without questioning business wisdom. However, the latest

Indian decision on intragroup services strays away from the OECD benefit test and seeks to merely look at rendition of service and not question the charges by making them a matter of commercial prudence.

In of the first major cases, the Delhi High Court[6] held that the legitimate business needs of the taxpayer and the benefits obtained from satisfying them, must be judged from the viewpoint of a 'prudent businessman.' It has been repeatedly affirmed that the word 'benefit' should be subject to a wide interpretation,[7] which cannot be restricted to 'shillings, pounds or pence.'[8]

In Safran Aerospace India Private Ltd.,[9] the commercial expediency test was narrowed down and the assessee was required to establish that the services received were 'wholly and exclusively for the purpose of business'. As far as the benefit ensued is concerned, it was not required to demonstrate that profits accrued on the basis of the service in question.

The benefit rule was disregarded by the Mumbai ITAT in Dresser-Rand India Pvt. Ltd.[10] when it said that it is not for the TPO to pore into the business reasoning to decide if the service is warranted and whether it actually accrues benefits to the taxpayer. The TPO must merely examine whether the service charge is at equivalent to what unrelated parties would contract for a similar service. Despite having qualified accountants and management experts, taxpayer may avail the services of external experts. This is a matter of commercial wisdom and questioning the same would count as unjustified interference in business practices. The ruling overturned the disallowances made under Sections 37(1), 40A (2) and 40(a) (i) of the Income-tax Act, 1961.

The benefit rule was reinstated in M/s Cushman & Wakefield India Private Ltd.[11] The taxpayer was an Indian real estate company that availed some services from its group entities in Singapore and Hong Kong for liaison and referral of clients. Actual costs were charged for the services and referral fees was paid according to international standards. The Tax authorities disallowed the costs by reasoning that no advantage accrued to the taxpayer apart from indirect or incidental benefits.

The taxpayer argued that only the costs were compensated without any mark-up and the tax liability in India would only decrease if the services were charged at ALP. Such reduction in tax liability was argued to be in violation of the spirit of section 92 (3) which negates the applicability of transfer pricing provisions if the computation of ALP tends to decrease the final tax liability in India.

The Delhi High Court affirmed the application of the transfer pricing provisions and stated that the ALP must be determined. Erosion of tax base cannot be automatically presumed and even controlled transactions involving pure reimbursement must be

examined to understand the basis, the nature of service and benefit accrued before we can conclude whether ALP criteria is met.

However, in the case of SABIC Innovative Plastics India Pvt Ltd. v. ACIT,[12] the Ahmedabad ITAT bench held that the worth of the service could not be correlated with the benefit accrued. The TPO must provide comparables to justify adjustments in mark-ups and the business wisdom of the taxpayer cannot be challenged. This April 2017 ruling has shaken the well-established benefit test but the commercial expediency jurisprudence continues to hold firm.

3.2 Passive association and incidental benefits

In Knorr-Bremse India Pvt Ltd.[13] the tribunal decided in favour of the revenue on the grounds that the perusal of the documents reveal that the activities are in the nature of shareholder activities and the intra-group services provide only incidental and passive association benefits. The Tribunal followed the TPO who held that the assessee should have shown an increase in profits subsequent to receipt of the service. Upon challenge, the Punjab & Haryana High Court remanded the matter back to the tribunal.[14] The High Court opined that the TPO has adopted an erroneous standard and unnecessarily questioned the commercial soundness of the services procured. The relevant question is whether the service is bona fide or whether it was engaged for profit shifting purposes.

It is noteworthy that the assessee could not provide strong documentary proof in this case to substantiate the nature of the activities and the benefits received. This could have been the major reason behind disallowance. Similarly, in Gemplus India Pvt. Ltd.[15] adequate proof could not be produced to establish that the service charges are commensurate with nature, quality and volume of management services provided. Hence, based on available proof, only the actual services rendered and proportionate charges were allowed. This decision was a major set back to several MNCs who were not in the best position with respect to documentary evidence for intragroup services.

3.3 Past gratuitous services

In Dresser-Rand India Pvt. Ltd the taxpayer had on a previous occasion availed certain intragroup services free of charge and that fact was used by the tax authorities to argue that the particular service should not have been charged. The Mumbai ITAT rejected this argument and affirmed the impertinence of past gratuitous services in transfer pricing assessments. However, under the OECD regime, the charging of similar services in the past would be a relevant factor.

3.4 Reimbursements

In CIT Vs. Dunlop Rubber Co. Ltd[16] the taxpayer was charged for availing the benefits of the research and development work undertaken by the group and the Calcutta High Court held it did not amount to assessable income. A slightly different perspective was taken in in Danfoss Industries Pvt. Ltd.[17] wherein the Authority for Advanced Ruling opined cost reimbursements are assessable unless it can be demonstrated that there is no income element.

In May 2017, Gemological Institute International Inc. v. DCIT[18] cleared the confusion by laying down the profit standard. In that case, there was some training arrangement between group entities that led to travel expenses. Further, health insurance and incidental expenditures were also part of the technical service agreement. It was held that the reimbursement expenses are not taxable as fees for technical services since there was no profit element.[19]

3.5 Corporate guarantee

Corporate guarantees provided by one group entity to another are chargeable as per the OECD framework.[20] However, in TVS Logistics Services Ltd. v. DCIT,[21] the Chennai Bench of the ITAT held that corporate guarantees and letters of comfort extended by the assessee to an associated enterprise should not be subject to transfer pricing adjustments. It was found that such transactions have no bearing on profits, income, loss or assets of the taxpayer and do not qualify as international transactions within the meaning of the Indian transfer pricing regime.

4.0 Conclusion

There is a marked contrast between the standards adopted in India in relation to intragroup services as compared to the OECD framework. Further, there is significant inconsistency and ambiguity with respect to the applicable judicial standards. The Safe Harbour Program introduced in 2013 sought to provide finality to taxpayers who adopt the prescribed rates for the concerned intragroup services. Owing to ambiguity in the classification of services, the Rules were not received with enthusiasm. The CBDT has revamped the Safe Harbour Program in June 2017,[22] providing revised rates and detailed circumstances in which the arm's-length price as declared by the assessee will be accepted without detailed examination. The new Safe Harbour Rules cover low-value adding services as well, thereby streamlining the pricing and auditing of the whole spectrum of intragroup services. The renovated Safe Harbour Program is a good attempt

to being certainty to transfer pricing of intra frim service trade. Only time will tell how efficient it will be in creating a uniform transfer pricing regime for intragroup services.

Endnotes

1. CBDT notifies the much awaited revised Safe Harbour Rules, KPMG Tax News Flash, June 2017.
2. TNS India v. Assessee ITA No. 1875/Hyd./2012.
3. Development Consultants vs. DCIT (ITAT Kolkata) (2008).
4. Knorr Brense India ITA. No. 5097/ Del./ 2011.
5. Union of India v. ML Kapoor AIR [1974] (SC) 87.
6. Hive Communication Pvt. Ltd v. CIT [2011] 201 TAXMAN 99 (Del).
7. McCann Erickson India Pvt. Ltd. v. ACIT (ITA No. 5871/Del/2011).
8. CIT v. EKL Appliances (ITA No's 1068/2011 & 1070/2011); Indigene Pharma v. ACIT [TS-46-ITAT-2014(HYD)-TP]; AWB India Private Limited v. ACIT (ITA No 4454 of 2011) (Delhi ITAT).
9. Safran Aerospace India Private Limited v. DCIT (ITA No. 1261/Bang/2010).
10. Dresser-Rand India Private Limited v. ACIT (ITA no. 8753 / Mum /10) dated 7 September 2011.
11. TS-150-HC-2014(Del).
12. ITA No. 1125/Ahd/2014.
13. ITA No. 5097/Del/2011.
14. ITA Nos.182 & 172 of 2013.
15. Gemplus India Private Limited. V. ACIT (ITA No.352/Bang/2009).
16. 10 Taxmann 179 (Cal.).
17. (2004) 138 Taxmann 280.
18. ITA 4659/Mum/2014 and ITA 385/Mum/2016.
19. Reimbursement of expenditure pursuant to training and technical agreement is not taxable as FTS, KPMG Tax News Flash, May 2017.
20. American Bar Association's Comments and Recommendations for Guidance to the Transfer Pricing of Related Party Guarantees, Internal Revenue Service, Section of Taxation (2012).
21. ITA No. 458/Mds/2016.
22. Notification No. 46/2017/ F. No. 370142/6/2017-TPL.

References

Blankenship, S., Vishveshwar, M., & Sadowski, R. (2015). Low value adding Intra group services. *Global Transfer Pricing- Deloitte*, November, 1-3. Retrieved from

https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-beps-changes-transfer-pricing-low-value-adding-intragroup-services.pdf

Eden, L., & Smith, R. (2011). Not at Arm's length: A guide to transfer pricing resources. *Journal of Finance & Business Librarianship, 6*(4), 3-22 at 4.

EU JTPF. (2010). European Union joint transfer pricing forum report: Guidelines on low value adding intra-group services. Brussels: CCAB. Retrieved from https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/jtpf_020_rev3_2009.pdf

Gill, G., Gale, K., & Yohana, B. (2015). Passive association. *Global Transfer Pricing-Deloitte,* November, 1-6. Retrieved from https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-beps-changes-transfer-pricing-passive%20association.pdf

Pagan, J.C., & Wilkie, J. S. (1993). *Transfer pricing strategy in a global economy*. Amsterdam, Netherlands: IBFD Publications.

Radhakrishnan, L. (2016). Benchmarking marketing intangibles: Need for coordinated transfer pricing regimes. *VISION: Journal of Indian Taxation*, *3*(2), 92.

Mitra, R.K., Hans, A., & Jain, A., (2014). Intra group services for shareholder activities. *Transfer Pricing International Journal, 15*(8), 1-8.

Kumar, S.B.P. & Abdullah, O. (2016). Benefit test in transfer pricing. *Manohar Chowdhry & Associates-Newsletter,* April, 1-5. Retrieved from http://www.mca.co.in/knowledge-centre/benefit-test-in-transfer-pricing