
DEMYSTIFYING INTRA - GROUP SERVICES IN TRANSFER PRICING

Introduction

The international transaction of Intra-group service ('IGS') has been and continues to be one of the most litigated transactions in the transfer pricing landscape. Issues regarding arm's length pricing and benefits derived from such transactions are constantly under the scanner of transfer pricing officers ('TPO'). IGS are frequently undertaken by most MNE groups and payments towards the same are generally categorised as 'Management charges' by taxpayers despite covering multiple services. There is no specific guidance in



Nithya Srinivasan & Nitya Joseph

India on considerations for IGS unlike other jurisdictions, hence the OECD Transfer Pricing Guidelines ('OECD guidelines'), UN guidance and judicial precedents are relied upon by taxpayers and authorities.

In this article, we seek to explore when an IGS has been rendered, how the same is remunerated in accordance with the arm's length principle, documentation requirements, global practices,

as well as local and global jurisprudence covering this issue.

What are intra-group services?

Every entity requires various services in connection with the operations of its business. While independent entities may acquire these from a specialised service provider or perform the service in-house, an MNE group in need of a service may opt to acquire the same from one or more members in the same MNE group (i.e. intra-group). This centralization of activities is carried out to ensure consistency and achieve economies of scale and the services are usually performed

by the headquarters or by a regional hub. Examples of such services include IT, accounting, payroll, legal, HR services.

The OECD guidelines emphasize that in any IGS, two important issues need to be addressed—One, whether IGS have actually been rendered and second, to determine whether the charge for such IGS is in accordance with the arm's length principle.

Determining whether IGS have been rendered

The determination that IGS have been actually rendered by related parties, is the first critical step as it lays the

foundation for transfer pricing analysis. Further during the course of transfer pricing audits, benchmarking these services alone would not be sufficient, and detailed analysis will have to be undertaken to demonstrate that services have been rendered.

Need-Benefit Test

It is imperative to understand whether services availed from related parties are required by the recipient i.e. necessity of the services for operations as well as the benefit derived from the services. This is analyzed by understanding whether the activity performed by related

parties provide an economic or commercial value to enhance or maintain an entity's business position. Under the arm's length principle an activity can be ascertained to be an IGS only when an independent party would be willing to pay for such services or perform the same by itself. The benefit test has been adopted by multiple countries and is routinely applied by Indian tax authorities while scrutinising IGS.

Non-chargeable activities

Not all activities performed by MNE Group members can be considered as IGS as third

parties would not be willing to pay for these activities. Hence, one would need to carefully evaluate nature of activities before categorizing them as IGS. Certain non-chargeable activities are noted below:

- **Shareholder activities**

These are activities performed by one of the MNE Group members (typically the parent or a regional holding company) solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder. As per the OECD guidelines, examples include costs relating to the juridical structure of the parent

company (such as meetings of shareholders of the parent, issuing of shares in the parent company), costs relating to reporting requirements of the parent company (including financial reporting and audit of the parent company, consolidation of reports) etc. It is critical to evaluate activities on a case-to-case basis. Eg: Whether management services rendered could be classified as shareholder services or whether the same would be a chargeable service.

- **Duplication**

This refers to situations where services rendered by a service

provider to a group member duplicate the activities being performed by the service recipient in-house or services availed from third parties. At arm's length, an independent entity would not consider availing services where it would duplicate the existing services availed or already being performed in-house. IGS need to be different, additional, or complementary to the activities performed in-house. Hence, mapping of the services with the departmental chart of the service recipient and differentiating the services provided by HQ with the inhouse personnel is very critical.

- **Incidental Benefits**

These are services performed by the parent or a regional hub to some of the group members which incidentally provides benefits to other group members. Any benefits from passive association (benefit merely on account of association with the Group without any specific activity being performed) would also be an incidental benefit. For example, higher credit rating due to association with a particular Group.

Determining an arm's length charge

Post ascertaining the IGS, the next step would be to determine whether the charges for the services are at arm's length. Broadly there are two methods of charging viz., Direct-Charge method and Indirect-Charge method.

Direct-Charge Method

Under this method, the arrangements made for charging for IGS can be readily identified, and Group members are charged for specific services. The direct-charge method would be most reliable as the basis for the payment can be clearly identified. However, this may not be practically possible

since MNEs may not record the time spent or costs incurred separately for each service recipient, or services rendered to Group members may not be rendered to third parties.

Indirect-charge Method

This method is more commonly used wherein cost allocation and apportionment methods are used as a basis for calculating an arm's length charge. Charging for IGS has to be supported by a foreseeable benefit for the recipients. Selection of reasonable allocation keys for costs allocation is a key point. Some allocation keys generally used

are number of users, heat tickets (for IT fees), headcount for payroll etc.

Cost pool and Profit mark-up

Service providers would need to calculate a cost pool annually including all the costs incurred in delivering the services. This includes both direct and indirect costs including a relevant portion of operating expenses. The above pool can broadly be categorized into costs that can be directly identified to the respective related party and costs which have been incurred for more than one related parties. For the costs incurred for various related parties, the costs can be

allocated based on an appropriate allocation key. The apportioned costs plus the costs directly incurred for the respective related parties will be the cost base on which the arm's length mark-up will have to be computed. To determine the profit mark-up to be applied, one can undertake independent benchmarking using Global databases from a service provider perspective.

To decide whether an arm's length mark-up on costs is necessary, the value addition of the service provider needs to be evaluated. In many business circumstances between two independent parties, there

might be some activities that would be undertaken/ certain costs incurred by the service provider solely on account of administrative convenience. These pass-through costs are usually recovered by the service provider on a cost-to-cost basis from the service recipient, without mark-up being charged.

More often than not, focus is more on mark-up charged on IGS, leaving behind big picture i.e., cost base/cost pool. Determining accurate cost base is essential to arrive at an arm's length cross-charge, and accordingly, directly

identifiable costs, pass through costs, etc., ought to be clearly identified for cost pool.

Simplified approach for low value-adding IGS ('LVAS')

The OECD guidelines have provided a simplified approach for low value-adding activities which aims to reduce efforts of taxpayers in meeting benefit tests and demonstrating arm's length charges as well as the efforts of tax authorities while performing review of IGS. This approach allocates the cost incurred in providing services to the respective service recipients and applies the prescribed mark-up.

For availing the simplified approach, the IGS should be low value-adding in nature. The OECD guidelines define LVAS as services performed by one/more members of the MNE Group on behalf of other members which:

- a) are of a supportive nature,
- b) are not part of the core business of the MNE Group,
- c) do not require the use of unique and valuable intangibles and do not result in creation of such intangibles, and
- d) do not involve the assumption of significant

risks by the service provider or give rise to creation of significant risks for service provider.

Further the OECD Guidelines provide a list of activities that are excluded under the simplified approach like services constituting the core business of the MNE Group, research and development services, sales, marketing and distribution activities, services of corporate senior management etc.

In addition, the OECD Guidelines also provide an illustrative list of LVAS which include Accounting and

auditing services, Human resources activities, Information technology services etc. While these may be the principal activity of the service provider, they should not relate to the core business of the Group.

Documentation

Maintaining proper documentation is critical for substantiating IGS payments before the tax authorities. Tax authorities generally request evidence to prove receipt, necessity and benefits derived from such services.

Some of the documentation that can be maintained include:

- Intercompany agreements
- Workings for cost allocation, basis for allocation keys
- Description of services and benefits derived. Clear identification of category of services (Technical or LVAS) to be done. In spite of receiving varied services from Group members, taxpayers customarily term them as 'Management charges', without emphasising the technicality of services, which might mislead tax authorities to categorise them as LVAS. Instead, one may look at adopting apt nomenclature,

eg: production support, technical support, marketing support etc., thereby demarcating from LVAS.

- Differentiation of services availed from different Group members to substantiate mark-up charged (eg: one Group member may charge mark-up on allocated costs while the other does not)
- Details of similar service availed from third parties in the past, to substantiate need for the service
- Copies of agreements entered by the Group members with third party service providers (eg: for IT

licenses cost recharge), details of software applications to which access is provided, details of heat tickets raised in case of IT helpdesk services

- Email correspondences, minutes of meetings/calls, travel details etc.

The above data should be sourced on a contemporaneous basis to handle litigation seamlessly.

Global practices

Several countries have laid down specific guidelines for IGS which follow the OECD/UN guidance. The LVAS simplified

approach has been adopted by the EU countries, New Zealand, UAE, Korea, Saudi Arabia etc. Some countries also have additional / different requirements in connection with IGS.

Singapore taxpayers can choose to apply 5% cost mark-up for a list of routine support services as an alternative to performing detailed transfer pricing analysis. Taxpayers are exempt from preparing TP documentation for these transactions. In addition, in the case of any services carried out by taxpayers which do not fall under the list of routine support services, Singapore taxpayers

can opt for the OECD simplified approach provided the required conditions are met. Further, in the case of cost-pooling contracts where the costs of routine support services are shared among Group members, 0% mark-up on costs is acceptable.

Similarly, in the US, the IRS has prescribed the Services Cost Method ('SCM') which is a specified transfer pricing method under which certain LVAS can be charged out at cost at the election of the taxpayer in certain circumstances.

In countries like China, regulatory requirements may restrict deductibility of IGS

charge. For fees paid by subsidiaries that receive IGS, the following six tests should be used to determine the arm's length nature of services: benefit test, necessity test, duplication test, value creation test, remuneration test and authenticity test.

Issues under assessment/Local jurisprudence

Considering the very terminology of IGS, it becomes an easy target for tax authorities to impose transfer pricing adjustments. Tax authorities generally adopt an aggressive approach and the issues raised include:

- Disregarding the evidence submitted by taxpayers and imposing adjustments on the ground that need-benefit test not satisfied
- Determining Arm's Length Price ('ALP') as Nil under CUP method stating no independent party would pay for such services
- Not permitting aggregation of services under TNMM

There are multiple cases of the Tribunal both in favour of taxpayers and Revenue. Majority of cases pertaining to IGS at the ITAT level are remanded back to the lower authorities for verifying

the need-benefit test documentation. Some of the principles which emanate from judicial precedents in favour of taxpayers are:

- TPO cannot question commercial expediency and does not have the authority to disallow an expenditure based on whether benefit received
- TPO can only determine the ALP by selecting comparables in accordance with the 6 prescribed methods and not on an ad-hoc basis
- Receiving the same services on gratuitous basis

in the earlier years does not mean that ALP of these services is 'nil'.

One of the important judgements was in the case of Cushman and Wakefield (India) (P.) Ltd. (Delhi High Court - ITA No. 475 of 2012) wherein it was held TPO's authority is to conduct a transfer pricing analysis to determine ALP and not to determine whether there is a service or not from which assessee benefits. Therefore, TPO cannot determine ALP of payments made to related parties as nil taking a view that assessee did not derive any benefit from services received.

In the case of Frigoglass India (ITA 1906/(DEL)/2015), the TPO preferred to apply CUP as against TNMM adopted by the Assessee. The Hon'ble Delhi ITAT held that where no comparable transactions had been brought on record by the Assessing Officer or even by the DRP or Revenue during the ITAT appeal, the approach of the Revenue could not be accepted.

In the matter of Avery Dennison (ITA nos. 4869 & 4934/(DEL)/2014), the ITAT rejected Nil ALP determined by TPO / CIT(A) in respect of some of the services on the contention that no benefit was derived by assessee. ITAT

accepted ALP determined by assessee by aggregating transactions under TNMM, observing that assessee was predominantly a manufacturer and that services received by assessee from its related parties were intrinsically linked to core business operations.

Options available

The Indian Safe Harbour rules cover payments towards LVAS received, with a threshold of INR 10 crores and where the mark-up on cost does not exceed 5%. Indian taxpayers may resort to Safe harbour rules to ring-fence transactions from tax litigation where certificate of

cost pool workings is required and the process of a need benefit test documentation is eliminated. In the Union Budget for 2024-25, the Finance Minister had mentioned that the scope of safe harbour rules would be expanded and revised to make it more attractive. One would need to wait to see whether there would be any increase in the threshold or whether the threshold could be revised to a financial ratio like percentage of IGS costs to total costs of the service recipient.

Considering the protracted litigation process in India, many taxpayers also opt for alternate

dispute mechanisms like Advance Pricing Agreement or Mutual Agreement Procedure.

Global jurisprudence

Global case laws also emphasise the importance of robust documentation in defending IGS charges. In one of the cases adjudicated by the French Administrative Court of Appeal (France vs. SMAP, March 2021, Administrative Court of Appeal, Case No. 19VE01161), the court had ruled that the sums paid by the taxpayer to its Group company termed as IGS constituted pure generosity granted in an interest other than that of the taxpayer's company.

Further no documents had been produced to establish the reality of services rendered by the Group company.

In a judgement by Supreme Administrative Court of the Czech Republic (Czech Republic vs STOCK Plzeň-Božkov, s. r. o., May 2023, Supreme Administrative Court, Case No 10 Afs 93/2021 - 69), the taxpayer (STOCK) had deducted costs for production consultancy services and internal support services allegedly received from related parties. The tax authorities disallowed deduction of the costs for tax purposes on the

basis that the evidence provided regarding the nature and pricing of the services was insufficient. The Court ruled in favour of STOCK in relation to the production consultancy services stating that the tax authority's requirement that the company document each individual 'piece of advice' and quantify the benefits in minute detail was unreasonable. According to the Court, it was sufficient to explain how the production services were provided and what benefits the company derived from them. However, in the same case, the court also agreed with the tax authorities on the internal

support services. The documents, witness statements and e-mails provided by STOCK were not sufficient to prove that the services had been received.

Conclusion

IGS of all types are routinely undertaken by MNEs. Hence, a proactive approach of pricing the IGS as per the arm's length principle and maintaining strong documentation will contribute greatly to justifying these transactions before the tax authorities. In recent times, technology tools also play an important role in efficient

collation and maintenance of supporting documentation (emails, contracts etc.) on a contemporaneous basis. Further, they can aid in automation of the cost pool allocation process to ensure costs are allocated among Group members accurately.

(The authors are part of VSTN Consultancy Private Limited, Transfer Pricing boutique firm and can be reached at snithya@vstnconsultancy.com and nityajoseph@vstnconsultancy.com)