



India

Intra-group Services under Transfer Pricing

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Background

Intra-group services (“IGS”) including Management services are services rendered by the parent entity or any entity within the Multinational group (“MNE Group”) to other entities. In the current era, IGS are deemed necessary to maintain competitiveness, consistency and collaboration between the entities within an MNE Group. Arms-length Prices for IGS have been highly disputed issues by the tax authorities in India.

IGS can be broadly categorized into two types:

- Common administrative services (e.g., common software, common accounting team, etc.) and
- Value-added services (e.g., strategy setting, treasury, etc.).

Common administrative services

Common administrative services (or Low Value-added services) usually involve sharing of common resources or knowledge. These costs are usually shared among the entities of the group on certain allocable cost base. The primary step is to identify the allocable costs. Then, such identified costs would be allocated using some logical metric based on the nature of the cost. For example, if a software such as Microsoft Office 365 is centrally procured by the Head Office (“HO”) and the cost is shared with other entities, then a logical basis to allocate this cost would be the number of employees in each entity which are using the software in the MNE group. If there is a system admin centrally located, then such costs may also be shared by HO based on the same metric. Depending on the level of involvement, the HO should charge a mark-up on Arm’s Length Basis. Currently, the safe harbor¹ mark-up rate for Low-Value added services in India should not exceed 5%.

Value-added services

Value-added services include technical (i.e. engineering, R&D, etc.) and management services (strategic direction, etc.). The primary challenge is to quantify the value of such services. Since the nature of each value-added service is arguably unique to the MNE group, it is very difficult to find comparable transactions in order to ascertain the arm’s length price. The next challenge is that the receipt of services should be documented. For example, in the case of strategy setting services provided by the service provider, the decisions are usually communicated through informal channels (through meetings or calls) which may not be officially documented most of the time. It is a known fact that tax authorities always have the tendency to request for tangible documentation of evidence during a tax audit. In the absence of complete documentation to support the arm’s length nature of the service fees, the taxpayers would end up in a tax dispute with the tax authorities. On this note, certain tax rulings suggest that not 100% of the evidence are required to be documented, and a structured and logical approach of documentation should be sufficient to defend the MNE Group from litigations.

¹ Safe harbor means circumstances where the Indian tax authorities accept the transfer price declared by the entity.

Guidance's on Documentations

OECD and UN Transfer pricing guidelines provide guidance on documentation and other issues of intra-group services. Though there is no direct guidance under the Indian Income Tax Act ("IITA"), judicial precedents provide guidance on the expectations of the Indian tax authorities. It is important to note under the IITA, the onus is on the taxpayer to prove that the services are received and the amount paid is at an arm's-length price. The widely used method by the Indian tax authorities is "Benefit Test" or "Benefit Purpose Test" where the evidence for rendition of services is to be gathered. Apart from applying the Benefit Test, the other tests include "Need Test" and "Rendition Test" which are applied in certain rulings.

Based on our experience, some of the guidance for taxpayers in complying with the documentation requirements include the following:

- An intercompany service agreement that clearly sets out the nature of services received should be in place. The agreement should contain certain minimum clauses. The pricing methodology in arriving at the transfer price to be mentioned in the agreement, if it's ascertainable. The documentation process should be robust, and the parties should seek to update the agreement with addendums whenever necessary.
- For Common administrative services, the evidence should be relatively easier to document. Backup for cost charge with the logic for allocable cost base should be sufficient. Spreadsheet workings for allocation would also be sufficient.
- For value-added services, the evidence may include emails, number of calls, travel tickets (if meetings happened in-person), etc. The authorities have ruled that in certain cases the evidence need not be correlated one to one, i.e. the evidence can be indirect. For example, if the marketing efforts of a local entity are coordinated by the HO, then the increase in number of customers would indirectly render an evidence for the presence of marketing efforts by the HO.

Takeaways from case laws on IGS

Brief highlights of 3 tax cases on IGS in India:

- The Income Tax Tribunal ("Tribunal") in the case of Adcock Ingram Ltd² explained the "Benefit test" in that the rendition of services should be demonstrated based on actual benefits accruing to the service recipient from the services rendered. The Tribunal stated that Revenue authorities could not decide on what was necessary for a taxpayer. The requirement of services should have been judged from the viewpoint of the taxpayer as an entrepreneur.
- The High Court in the case of EKL appliances Ltd³ held that any legitimate intercompany expenditure for the purposes of carrying on a business cannot be disallowed while computing the Arm's Length Price, merely because the assessee had continuously incurring losses.
- The Appellate Tribunal in case of Henkel Chembond Technologies Ltd⁴ held that regional management services received by the assessee from its AE were intangible in nature. Thus, evidence supporting such services and the benefits received therefrom could only be demonstrated by narrations, descriptions and documentary evidence.

² [2018] 90 taxmann.com 298 (Bengaluru – Trib)

³ [2012] 24 taxmann.com 199 (Delhi)

⁴ [2021] 125 taxmann.com 68 (Mumbai – Trib)

Concluding remarks

In confronting the aggressive approach adopted by the tax authorities, the taxpayers in transactions involving provision of IGS shall need to ensure the process of determination of arm's-length prices and the relevant transfer pricing analysis are documented properly. Paying more attention to structural and consistent documentation would help to defend the MNE Group's transfer pricing position during litigations. It is worth mentioning that in several recent rulings made by the Tax Tribunals, those taxpayers equipped with transfer pricing documentation containing explanations on meeting the Benefit Test stand to gain from the rulings of the higher Tax Tribunals.

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