



## Intra-Group Services ('IGS') - A necessary controversy?

With an aim to increase profitability, Multinational Enterprises (MNEs) or multinational groups strive to achieve economies of scale and efficiencies. MNEs tend to invest excessive man hours due to lack of access to best practices/specialised knowledge that otherwise could be better utilised in discharging their key responsibilities. This is where IGS come to MNEs' aid. Certain functions, inter-alia (administrative, technical, financial, marketing, etc.), are either performed by an in-house entity or outsourced to third-party service providers. This poses a challenge for MNE groups - should the service(s) be procured from a third party? This option would be costly and may not ensure consistency/standardisation between different entities of an MNE. As a result, headquarters/regional headquarters would need to deploy additional resources to monitor/standardise functions within each MNE.

On the other hand, if these activities are undertaken in-house, the potential issues discussed above could be easily addressed.

Services provided by one or more members of an MNE for the benefit of one or more members of the same MNE (commonly referred to as IGS in transfer pricing parlance), are an essential part for an MNE to operate, compete, and survive. IGS can be of various types – core (value-adding services) or non-core (low value-adding) services. Typically, IGS are different, additional, or complementary to the operations of a taxpayer. By centralising certain activities<sup>1</sup>/setting up in-house shared service centres, MNEs can achieve operational efficiencies and ensure optimum resource utilisation.

<sup>1</sup> Examples of centralised IGS duly captured in the OECD Transfer Pricing (TP) Guidelines (OECD Guidelines) include administrative services, (such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, and computer services); financial services (such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing); assistance in the fields of production, buying, distribution and marketing; and services in staff matters (such as recruitment and training).

Considering the very nature of the IGS (being related party transactions), these services need to adhere to the Arm's Length Principle (ALP). There is plenty of literature in the form of Organisation for Economic Co-operation and Development ('OECD') guidelines, United Nations transfer pricing guidance, and judicial precedents on IGS. A few key aspects of these guidance are mentioned below:

### Not all activities are chargeable

Not all services rendered by the group entity(ies) warrant a charge to other members of the MNE. For instance, shareholder activities (undertaken mainly to protect investment in the subsidiary), stewardship and duplicative services, and incidental benefits are classified as services for which an independent enterprise would not be willing to pay for in a typical uncontrolled business scenario.

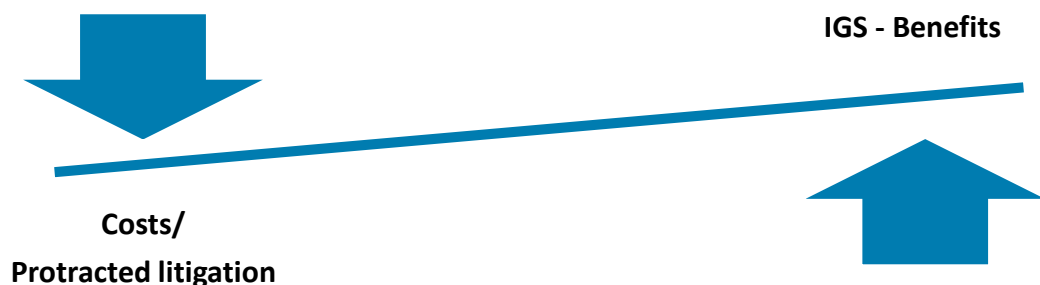
### Determination of IGS charge

To determine the IGS charge, the correct cost base (also referred as an 'allocable cost pool', including determination/classifications of certain costs as pass through costs) is first to be determined. This includes costs that an MNE incurs while performing IGS. Upon determination of the cost pool, costs incurred in connection with activities undertaken for the benefit of specific entity(ies) that are directly identifiable as beneficial to only a specific entity (for example, headquarters' assistance in conducting an ISO audit in a subsidiary's factory) should be charged directly to the said entity(ies). The balance will be allocated across beneficiary entities using a judicious/scientific and consistent allocation key. Depending on the nature of service (direct/indirect), an arm's length mark-up on the identified costs may also be warranted to be charged in compliance with ALP requirements.

Benefits<sup>2</sup> received from IGS are often imperceptible in nature. Depending on circumstances, actual benefits derived from IGS may outweigh the costs allocated. Thus, taxpayers find it difficult to demonstrate the benefits received in the form of tangible documentary evidence. Sometimes, the services may be available on-call and the value and importance of such services may vary year on year. In such cases, one must look at the extent to which the services have been used over a period of several years rather than solely for the year in which a charge is to be made.

Consider an example of on call medical or psychology support services availed by an organisation during COVID-19. In case the services are not used, the costs incurred would appear to be more than actual receipt of

services. However, in case there is an emergency requirement of medical assistance, services would be available promptly. Thus, the benefits derived from such on-call medical services would be far more valuable than the costs incurred. Similarly, centralised strategic decision-making and policies specifically in the areas of information technology, human resources, procurement, etc., have helped MNEs cope with the unprecedented situations. Such benefits cannot necessarily be quantified; in this regard, tangible evidence is difficult to collate. One may successfully argue that during the pandemic, an organisation may be willing to pay a huge sum for on call medical/psychology support services compared with that actually incurred by the concerned organisation.



<sup>2</sup> Economies of scale, synergy, coordination and control, efficient use of resources and a high degree of specialization, developing own expertise.

Due to the imperceptible nature of IGS, it is often difficult to demonstrate receipt of and benefits derived from IGS by a service recipient. Further, there are instances for taxpayers to consider IGS as a tax planning mechanism and not restricting the use of IGS to its true spirit - to benefit an MNE group via centralisation of services. With the implementation of Base Erosion and Profit Shifting ('BEPS') Action Plans, tax authorities now have access to an MNE's financial data. Thus, tax authorities can closely audit IGS transactions to ensure that the transactions are not "sham" and not entered into with the 'primary intention of avoidance of taxes'. There is a considerable room for disagreement between taxpayers and tax authorities with regards to IGS. As a result, the issue has become one of the key TP controversies across the world, especially in developing countries (such as India).

A recent judgement by the French Administrative Court of Appeal<sup>3</sup> also dealt in detail with core issues surrounding IGS. The court held that (1) the sums paid by the company to one of its group companies constituted pure generosity granted in an interest, other than that of the taxpayer's company; and (2) another group company did not have the material and human resources necessary to carry out its activities of organising trade fairs in Spain. In view of the court, the taxpayer had failed to furnish the evidence that it had received the services and opined that the transaction under consideration constituted profit shifting.

The OECD TP guidelines also recognise that there are two main issues revolving around IGS – whether IGS

have in fact been provided, and if yes, what should be the ALP for that.

Even after simplifying the approach for low value-adding IGS<sup>4</sup> in the 2017 OECD TP Guidelines (as a part of the BEPS process), significant challenges remained for taxpayers. Some of the key suggestions to the OECD on its invitation for public comments on IGS in 2018, included automatic referral of IGS cases into the Mutual Agreement Procedures ('MAP') so that both the service provider and the recipient are considered together, relaxations on evidential requirements, considerations towards indirect benefits arising from IGS, and more guidance/practical examples on exclusions (such as shareholder activities, duplicative services, and incidental benefits).

In India, under the Income-tax Act, 1961 ('the Act'), no direct guidance is available on dealing with IGS from a transfer pricing lens. In addition, no separate guidance is prescribed in connection with the maintenance of documentation for IGS. Tax authorities can allow deduction<sup>5</sup> for IGS charges as long as the expenses are incurred wholly and exclusively for the purposes of the taxpayer's business. However, Transfer Pricing Officers ('TPO') are required to (and restricted to) verify the arm's length nature of the IGS. As no specific guidance is available in the Indian regulations for taxpayers and tax authorities, judicial precedents, OECD, and UN Transfer Pricing Guidelines are usually referred to.

Certain key issues faced by Indian entities for IGS are summarised as under:

Corporate tax issues	Transfer pricing issues
1) Questions on commercial expediency of IGS	1) Selection of the most appropriate method
2) Denial of deduction under section 37(1) of Income-tax Act, 1961	2) Rejection of a foreign entity as a tested party
	3) Rejection of aggregation approach
	4) Demonstrating receipt of IGS with tangible evidence (need, benefit, and receipt of services test)
	5) Demonstrating economic and commercial benefits derived from IGS
	6) Ad hoc/NIL benchmarking using the comparable uncontrolled price method
	7) Allowance limited only to quantifiable amount of IGS

*Further, sometimes the tax authorities make protective adjustments. These include determining the ALP of the IGS to be NIL. However, if the actual transaction value is accepted as ALP, the Profit Level Indicator ('PLI') of the entity paying the IGS will reduce (by the actual value of the IGS). Considering the TPO would have changed the comparables set of the entity paying the IGS, its reduced PLI will not fit within the new range that the TPO sets (but with IGS as NIL, the PLI may meet the ALP requirements). Thus, first the arm's length value of the IGS is determined to be NIL. However, on a protective basis, if the taxpayer is granted relief and the transaction value is considered to meet the arms' length requirements, at least an adjustment at the entity level is to be sustained.<sup>6</sup>*

<sup>3</sup> France vs. SMAP, March 2021, Administrative Court of Appeal, Case No. 19VE01161

<sup>4</sup> The OECD has laid down parameters that enables one to classify a service as low value-adding IGS

<sup>5</sup> Deductibility under section 37 of the Income-tax Act, 1961

<sup>6</sup> In such cases, the ALP of the IGS is determined using the transaction net margin method after aggregating the transaction with other international transactions.

It is observed that tax authorities propose TP adjustments where (1) the taxpayers fail to produce tangible benefits of services received and (2) charges paid do not correspond to the services received. Initial level tax authorities fail to appreciate the fact that unlike in case of a direct charge, one-to-one correlation of benefits received with charges paid is not always possible in case of indirect charge/cost allocation.

Although the need and benefit tests are not required

Onus is on the taxpayer to demonstrate the receipt of services and ALP of the charge and not the benefits derived.

Voluminous evidence submitted by the taxpayer demonstrating the receipt of services and benefits therefrom should not be held irrelevant without providing cogent reasons.

IGS may be rendered orally.

In today's business environment, business is mostly done through emails and can be considered to demonstrate rendition of services.

There is no obligation on the taxpayer to avail all the services together as some services may be on-call only.

If one peruses the direction of cases disposed of by the final fact finding authority in India i.e., the Income Tax Appellant Tribunal ('ITAT'), one may find about 50 percent of the cases for IGS are remanded back to the initial level tax authorities for fresh determination of ALP (including verifying the evidence provided by the taxpayer). The experience in India demonstrates that the entire crux revolves around collation of appropriate and robust documentary evidence; this is an ongoing challenge for taxpayers. Further, the tax authorities should also consider that periodic and regular manual collation of evidence is time consuming and tedious. However, certain technological advancements have made it possible for MNEs to collate appropriate documentation on a real-time basis and in a more cost-effective manner.

Considering the time involved in reaching the ITAT and then going back to the file of the TPO for fresh

under the Indian regulations (as a taxpayer is considered to be the best judge of its business), these help satisfy the tax authorities' requirements for meeting the arm's length nature of the IGS. It does not mean that taxpayers have to document 100 percent benefits (what constitutes 100 percent is in itself debatable) derived from IGS (especially in case of an indirect charge). Some of the key tax court/tribunal findings that may paint a fair/positive picture include the following:

adjudication significantly affects a taxpayer's morale, patience, and resources. Yet, after the second round of litigation, the fate of IGS remains uncertain. Further, any adjustment to the transaction of payment for IGS leads to double taxation. Thus, exploring options that can guarantee some certainty is needed. These options may include safe harbour; Mutual Agreement Procedure ('MAP'); and/or Advance Pricing Agreements (APA).

Indian Income-tax Rules<sup>7</sup> provide a safe harbour for specified low value-adding IGS transactions with a threshold of up to INR 10 crore (about US\$1.35 million) provided the mark-up on the same does not exceed 5 percent. Moreover, safe harbour rules require that the method of cost pooling; exclusions of shareholder costs and duplicate costs from the cost pool; and the reasonableness of the allocation keys used for allocation of costs are certified by an accountant.

<sup>7</sup> Rule 10TA to Rule 10THD of the Income-tax Rules, 1962. The safe harbours can be opted for a few specific years that are prescribed on a periodic basis.

A few examples of safe harbour provisions from other countries are summarised here under:

Country	Safe harbour conditions on low value-added intra-group services
Australia <sup>8</sup>	Mark-up up to 7.5 percent for services received; and Mark-up of 7.5 percent or more for services rendered
New Zealand	Mark-up of 5 percent on qualifying services
Israel	Mark-up of 5 percent on qualifying services
Korea <sup>9</sup>	Mark-up of 5 percent on qualifying services

MAP helps resolve litigation for past years between the competent authorities of two countries and ensures elimination of double taxation. Moreover, depending on the memorandum of understanding signed between two competent authorities, collection of taxes during pendency of the MAP may be suspended, subject to issuance of bank guarantees in most cases.

APAs can help resolve conflicts for the past as well as future years. Unlike a unilateral APA, bilateral/multilateral APA involves negotiations between competent authorities that ensure the elimination of double taxation.

In late 2017, India issued a clarification on the acceptance of MAP and bilateral APA applications regardless of the presence or otherwise of Paragraph 2 of Article 9 (or its relevant equivalent Article) in the Double Taxation Avoidance Agreements ('DTAAs') that provides for corresponding/correlative adjustments. This relaxation opened the doors for bilateral negotiation between India and its major treaty partners – France, Germany, Finland, and Belgium – under bilateral or multilateral APAs.

As rightly captured in the UN TP Manual (2021), the Indian APA programme has been well-received by taxpayers with about 1,300 applications been filed so far. More than 350 APAs have been entered into by the Central Board of Direct Taxation ('CBDT'). This demonstrates that many MNEs are making the most of this alternate dispute resolution programme. According to the latest APA annual report published by the CBDT,<sup>10</sup> IGS featured at the top of the list for which APAs have been applied for by the MNEs. Of the 164 international transactions covered under 41 APAs entered into in financial year 2018-19, 19 transactions are in the nature of payment of royalty and receipt of various kinds of support services (i.e., IGS).

Depending on the facts of the case, Indian APA authorities may put a cap on the value of IGS (via a percentage of IGS to sales) that would be considered as

an arm's length charge. Based on the specific business circumstances, one may:

- negotiate a graded cap based on the profitability for various years i.e., a cap subject to minimum profitability (which may vary year on year);
- even in case of losses – agree on the arm's length nature of the IGS
- consider the service provider (foreign entity) as the tested party (subject to a profitability threshold for service provider and/or service recipient); and
- maintain/provide the least amount of documentation (minimum requirements on maintaining evidence demonstrating receipt and benefits of IGS, subject to group or independent professional certification).

Further, once the charge of IGS is covered under an APA, it carries persuasive value for years not covered by the APA as well as for allowance of the charge as an expenditure under Section 37(1) of the Act.

In case the taxpayer is not satisfied with the outcome, a withdrawal option is available both under MAP as well as APA; in which case, the normal litigation process continues. Thus, depending on the facts, MAP or unilateral/bilateral/multilateral APAs present themselves as the best options available with MNEs to deal with the IGS controversy.

The Indian government has taken many initiatives to curb litigation and make India a taxpayer friendly country. Detailed guidance on IGS under the Indian TP regulations, the type of acceptable documentation, relooking at the safe harbour rules and making it easier to adopt the same, can go a long way in getting the required certainty and curbing litigation on the ever-challenging controversy on IGS. While the Indian government pays heed to this controversy, MNEs should prepare well-articulated facts supported by thorough documentation to dodge protracted litigation (in addition to exploring the MAP/APA routes, wherever feasible).

<sup>8</sup> For IGS less than AUD 1 million or less than 15 percent of the total expenses or revenue

<sup>9</sup> Provided the charge does not exceed 5% of the taxpayer's sales or 15% of the taxpayer's operating expenses

<sup>10</sup> Advance Pricing Agreement (APA) Programme of India – Annual Report (2018-19) Central Board of Direct Taxes November 2019



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