The author considers transfer pricing provisions in Finance Bill 2014, specifically with regard to safe harbours for intra-group services. The treatment of safe harbours for intra-group services in India is also compared with that in several other countries.

1. Introduction

While there were no amendments to the transfer pricing provisions in Finance Bill 2013, India Inc. was fervently expecting progressive transfer pricing amendments in Finance Bill 2014. The maiden budget presented by the Finance Minister, Arun Jaitely, on 10 July 2014 introduced amendments to the transfer pricing provisions in order to align them with internationally accepted practices. The Finance Minister introduced provisions for the rollback of advance pricing agreements, use of multiple year data unconditionally and application of the range concept, in addition to the use of the arithmetical mean. It was also clarified that any transaction with a third-party resident on which the associated enterprise of the taxpayer has an influence, will be treated as a deemed international transaction.

While these amendments are very significant and will eventually pave the way for reduced litigation, it was also anticipated that the safe-harbour margins¹ prescribed by the Central Board of Direct Taxes (CBDT) would be reduced considerably, in line with business realities. However, no amendments have been seen so far on the safe-harbour front. That said, safe-harbour rules are introduced via the Income Tax Rules, 1962, (the Rules), and thus it is entirely plausible for the Rules to be amended at any time to provide for amendments to the safe-harbour rules.

2. Safe-Harbour Mechanism from an OECD Perspective

The 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) discuss the safe-harbour mechanism under section E of chapter IV. The OECD Guidelines state that the primary objective of the safe-harbour mechanism is to simplify transfer pricing compliance for eligible taxpayers in determining arm’s length conditions, to provide certainty to taxpayers that transactions are at arm’s length without much scrutiny from the tax authorities and to enable the tax authorities to shift their focus to complex or high-risk transactions by minimizing their task of scrutinizing low-risk transactions of eligible taxpayers complying with the safe-harbour provisions.

However, the OECD Guidelines seem to take a negative tone towards the safe-harbour mechanism, and the use of a safe harbour was not recommended, basically because it is fundamentally inconsistent with the arm’s length principle. However, the revised section E on safe harbours in chapter IV of the OECD Guidelines, released in May 2013, appears to recommend the use of safe harbours that are properly designed so as to relax the compliance burden and provide taxpayers with greater certainty. The revised OECD Guidelines on the safe-harbour mechanism also encourages the use of a bilateral or multilateral safe harbour in order to avoid issues of double taxation and double non-taxation.

As of 2012, 16 countries had adopted a safe-harbour mechanism as a part of their legislation.² The safe-harbour mechanism was adopted by these countries with the aim of providing an exemption from transfer pricing adjustments and to provide a simplified transfer pricing method for low-risk taxpayers. The transactions typically covered under the safe-harbour mechanism are low-value-added intra-group services, interest on inter-corporate loans and other low-risk transactions.

3. Safe-Harbour Mechanism in India

India is known for its aggressive transfer pricing approach which has resulted in the increase in litigation in tax matters. By number, transfer pricing litigation cases in India constitute 70% of global transfer pricing disputes. During FY 2013-14 (i.e. April 2013 to March 2014), 3,600 transfer pricing cases were audited, with adjustments effected in 1,800 cases, amounting to approximately INR 59,602 crore. This represents a 17% decrease in the amount of transfer pricing adjustments as compared to FY 2012-13, in which adjustments amounting to INR 70,016 crore were made in 1,600 cases against a total audit of 3,200 cases. In terms of the number of cases involving an adjustment relative to those audited, the ratio is still very high at 50%.

The safe-harbour provision specifies the circumstances under which the price declared by the taxpayer will be accepted to be at arm’s length. After a long wait of almost four years since the safe-harbour provision was introduced in the Indian Income Tax Act 1961 (the ITA), the

* BMR & Associates LLP, Mumbai. The author wishes to thank Balaji Ravindran, BMR & Associates LLP, for his assistance with this article.


² OECD, Committee on Fiscal Affairs, Multi-Country Analysis of Existing Transfer Pricing Simplification Measures: 2012 Update (6 June 2012).
safe-harbour rules were notified on 18 September 2013, with a view to minimizing litigation. Taxpayers may enter into a safe-harbour agreement with the tax authorities for a maximum period of five years. The transactions covered under the safe-harbour rules and the safe-harbour margins prescribed by the CBDT are as in Table 1.

While the Indian safe-harbour rules have predominantly covered the core transactions that are often subject to litigation, these rules do not cover transactions in relation to intra-group services.

4. Intra-Group Services

Globalization and the drive to achieve efficiencies within multinational enterprise (MNE) groups have increased the need for sharing resources within the organization to provide support between one or more locations by way of shared services (e.g., financial reporting, technology support, management support services). These intra-group services are generally low value adding routine transactions that are supportive of the MNE’s main business. However, the incidental benefits arising to a taxpayer from being part of the multinational group would not be considered as intra-group services.

5. Overview of Intra-Group Services in India

One of the most prevalent issues litigated by the tax authorities concerns payments to associated enterprises for intra-group services. The Indian tax authorities often view payments for intra-group services as a tax-planning mechanism adopted by taxpayers in effectively lowering their taxable income.

The ITA has not specifically laid down any provisions regarding the determination of the arm’s length price for intra-group services, although there are provisions discussing cost contribution or cost allocation. The absence of specific guidelines has resulted in a significant increase in litigation involving intra-group transactions. The tax authorities and taxpayers reference the OECD Guidelines, UN Practical Manual on Transfer Pricing for Developing Countries and the Guidelines issued by the EU Joint Transfer Pricing Forum in dealing with intra-group services.

The discussion below focuses on the main issues faced by taxpayers in India in justifying the arm’s length price for intra-group services during the course of an audit by the Indian tax authorities.

5.1. Determining the receipt of intra-group services

The tax authorities typically first request that the taxpayer demonstrate the receipt of intra-group services with supporting documentary evidences. If the taxpayer fails to prove the receipt of intra-group services, the tax authorities tend to disallow the entire expense and determine the arm’s length price for the payment of intra-group services at nil.

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Table 1

<table>
<thead>
<tr>
<th>Transactions covered</th>
<th>Prescribed safe-harbour margins</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision of software development services</td>
<td>– Operating profit margin of not less than 20% on operating expense for transaction value of less than INR 500 crore</td>
</tr>
<tr>
<td></td>
<td>– Operating profit margin of not less than 22% on operating expense for transaction value exceeding INR 500 crore</td>
</tr>
<tr>
<td>Provision of information technology enabled services</td>
<td>– Operating profit margin of not less than 20% on operating expense for transaction value of less than INR 500 crore</td>
</tr>
<tr>
<td></td>
<td>– Operating profit margin of not less than 22% on operating expense for transaction value exceeding INR 500 crore</td>
</tr>
<tr>
<td>Provision of knowledge process outsourcing services</td>
<td>– Operating profit margin of not less than 25% on operating expense</td>
</tr>
<tr>
<td>Outbound intra-group loans</td>
<td>– Base rate of State Bank of India (as on 30 June of the relevant previous year) plus 150 basis points for loan amounts exceeding INR 50 crore</td>
</tr>
<tr>
<td></td>
<td>– Base rate of State Bank of India (as on 30 June of the relevant previous year) plus 300 basis points for loan amounts exceeding INR 50 crore</td>
</tr>
<tr>
<td>Provision of corporate guarantee</td>
<td>– Commission of not less than 2% per annum on the amount guaranteed, where the guarantee amount does not exceed INR 100 crore</td>
</tr>
<tr>
<td></td>
<td>– Commission of not less than 1.75% per annum on the amount guaranteed, where the guarantee amount exceeds INR 100 crore and the credit rating of the associated enterprise is of the highest safety</td>
</tr>
<tr>
<td>Provision of contract research and development services relating to software development</td>
<td>– Operating profit margin of not less than 30% on operating expense</td>
</tr>
<tr>
<td>Provision of contract research and development services relating to generic pharmaceutical drugs</td>
<td>– Operating profit margin of not less than 29% on operating expense</td>
</tr>
<tr>
<td>Manufacture and export of core and non-core auto components</td>
<td>– Operating profit margin of not less than 12% on operating expense for core auto components</td>
</tr>
<tr>
<td></td>
<td>– Operating profit margin of not less than 8.5% on operating expense for non-core auto components</td>
</tr>
</tbody>
</table>

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3. IN: Direct Tax Notification 73/2013, supra n. 1.
The taxpayer in *Quintiles Research (India)* had submitted voluminous evidence in the form of invoices to the tax authorities evidencing the receipt of intra-group services. Although the Bangalore bench of the Income Tax Appellate Tribunal (the Tribunal) agreed to the existence of evidence on records as regards the allocation of cost and the basis of such allocation, the Tribunal observed that invoices per se did not demonstrate the nature of services received, and directed the taxpayer to link the invoices to the emails describing the nature of the intra-group services.

However, a different view was taken by the Hyderabad Bench of the Tribunal in *TNS India*. The Tribunal accepted the evidence submitted by the taxpayer and held that providing concrete evidence with reference to services in the nature of specific activities is difficult. The Tribunal further opined that until the tax authorities step into the business premises of the taxpayer and observe the role of the taxpayer’s business transactions, it will be difficult to place on record the sort of intra-group services in its day-to-day operations.

Further, the Delhi High Court in *Cashman and Wakefield (India)* held that although the taxpayer had reimbursed only the actual costs incurred by the associated enterprise in receiving intra-group services, it was necessary to test whether the cost which the taxpayer claimed to be the actual cost of services incurred by the associated enterprise, is not inflated and is at arm’s length.

### 5.2. Determining benefits from the receipt of intra-group services

The tax authorities in India also require that the taxpayer determine the quantum of benefit derived from intra-group services received from its associated enterprises. The mere existence of service agreements would not justify the benefits received by the taxpayer for the payment towards intra-group services.

The Bangalore Bench of the Tribunal in *Gemplus India* observed that the payment made by the taxpayer for intra-group services was independent of the nature and volume of intra-group services received from its associated enterprises. The Tribunal held that the taxpayer defeated the primary examination itself, and also noted that the details as regards intra-group services received by the taxpayer were not made available in the records. The Tribunal further held that the taxpayer has not received any commensurate benefits from the intra-group payments made to the associated enterprise.

The Mumbai Bench of the Tribunal in *Dresser Rand India* held that it was irrelevant for the tax authorities to determine whether the intra-group service was beneficial to the taxpayer. The Tribunal held that the tax authorities cannot question the commercial necessity of the taxpayer, and that the tax authorities must restrict themselves to determine the arm’s length price for intra-group services.

In a few other rulings, the Tribunal held that payments for intra-group services were at arm’s length where the taxpayer had demonstrated the benefits received from the intra-group services and the tax authorities cannot examine the commercial necessity of the services to the taxpayer.

### 5.3. Documentation requirements

Documenting intra-group services received by the taxpayer is extremely significant in establishing the legitimacy of intra-group service charges before the tax authorities. Although section 92D of the ITA and Rule 10D of the Rules prescribe general requirements for transfer pricing documentation, no specific guidance is provided in the context of intra-group services. The taxpayer should provide documentary evidence such as copies of reports, email correspondence and other relevant records as may be required during the course of assessment to the tax authorities.

The Bangalore Bench of the Tribunal in *Festo Controls* observed that the taxpayer had not determined the arm’s length price for intra-group services in its transfer pricing documentation under any of the methods prescribed in section 92C of the ITA. The Tribunal directed the taxpayer to establish various aspects such as the nature of services, the details of the associated enterprise rendering such services, other group entities that are recipients of such services and the costs incurred by the associated enterprise in rendering the intra-group services in the transfer pricing documentation maintained by the taxpayer, so as to determine the arm’s length price.

The Delhi Bench of Tribunal in *Atotech India* acknowledged the fact that the taxpayer had maintained detailed documentation and other relevant agreements, contracts, arrangements and invoices in substantiating the arm’s length nature of the transaction, and directed the tax authorities to consider the documentation submitted by the taxpayer and to determine the arm’s length price for the intra-group services.

### 6. Intra-Group Services: Treatment in Other Countries

A global overview on the practices followed in a few developed and developing countries is presented below.

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5. IN: ITAT (Bangalore), 21 Feb. 2014, Quintiles Research (India) Pvt. Ltd., IT(TP)A 1605/Bang/2012.
7. IN: HC (Delhi), 23 May 2014, Cashman and Wakefield (India) Pvt. Ltd. v. ACIT, TS-150-HC-2014.
9. IN: ITAT (Mumbai), 7 September 2011, Dresser Rand India Pvt. Ltd. v. DCIT, ITA 8753/Mum/2010, Tax Treaty Case Law IBFD.
10. IN: ITAT (Delhi), 8 June 2012, McCann Erickson India Pvt. Ltd. v. ACIT, TS-391-ITAT-2012, Tax Treaty Case Law IBFD;
12. IN: ITAT (Delhi), 10 Jan. 2014, Atotech India Ltd., ITA 104/Del/2012.
6.1. China

The tax authorities in China determine the arm's length price for the intra-group services by applying six tests, namely the benefit test, the necessity test, the duplication test, the value creation test, the remuneration test and the authenticity test.

While intra-group service fees are allowed as deduction for taxpayers, the current tax laws and regulations in China do not allow taxpayers to claim a deduction for management fees. Management fees, as defined in article 49 of the Corporate Income Tax Law of the People's Republic of China, refer to general shareholder activities that are charged on account of the associated relationship between “investors and investees”.

Based on recent public reports, the major controversy surrounding intra-group services in China concerns the cost allocation keys used and the consistency in the cost allocation carried out under the intercompany agreements. Another practical difficulty faced by the tax authorities is that they are not provided with the details regarding the group entities providing such intra-group services, which in turn makes it difficult for the tax authorities to validate the authenticity of the services received and the reasonableness of the allocation mechanisms.

6.2. Canada

In Canada, intra-group services for transfer pricing purposes are primarily governed by Canadian legislation and the OECD Guidelines. The charge for the intra-group services is determined under either the direct charge method or indirect charge method. The direct charge method is applied where the actual cost for the intra-group services is identifiable. Where the expenses are allocated using common keys, the indirect charge method is applied. The Canadian tax authorities adopt an increasingly proactive and sophisticated approach, and prefer the direct charge method in determining the arm's length price for intra-group services.

Under Canadian law, a taxpayer is first required to determine whether the activity performed by its group member constitutes a service for which a charge is justified, and subsequently determine the arm's length price for such services. Similar to the practices adopted in other countries, the Canadian tax authorities do not provide for any markup to be charged on the cost of intra-group services that are ancillary in nature.

The Canadian Tax Court in Safety Boss Limited held that the management service fees received by the taxpayer were at arm’s length after analysing in detail the amount of expertise, experience, know-how, reputation and managerial skills in rendering such services. The Canadian Tax Court observed that the taxpayer had received enormous benefits from the receipt of management services, and that the payment made towards such services was reasonable. The Tax Court also noted that the provider of such services could have earned more income if it had operated independently and provided such management services to unrelated third parties.

6.3. United States

US Treasury Regulation section 1.482-9 provides certain guidance on controlled service transactions. In 2006, the Treasury issued temporary regulations whereby the simplified cost based method was replaced with the services cost method, which permits certain “non-integral” services to be priced at cost. Section 1.482-9T(b)(4) of the temporary regulations specifies the category of covered services that are eligible for the services cost method. The first category consists of specified covered services such as payroll services; general administration services; accounts payable and receivable services; meeting coordination and travel planning services; and staffing and reporting services. The second category of services consists of low-margin covered services that have a median comparable arm's length markup on total services costs of not more than 7%.

As prescribed in the OECD Guidelines, the US Regulations also exclude shareholder activities from the scope of intra-group services. The US tax authorities do not accept the general benefit test, as they are of the view that it is inconsistent with the arm's length principle.

7. Should the Safe-Harbour Rules in India Be Extended to Intra-Group Services?

In the domain of transfer pricing, payments for intra-group services pose serious challenges to the taxpayer. One of the major reasons for controversy is the lack of a proper mechanism in identifying, evaluating and documenting payments for intra-group services. In this regard, the Indian tax authorities may consider extending the safe-harbour rules for intra-group service transactions entered into by the taxpayer. The safe-harbour rules, if proposed to be extended to intra-group services, should be formulated such that they do not result in under-payment or over-payment to the associated enterprises and also factor in the other tax and regulatory aspects.

A significant point for consideration in determining the arm’s length nature of a transaction is that the Indian taxpayer should request the intra-group services and such services should not be thrust upon the Indian taxpayer by the associated enterprise.

Indian taxpayers are both recipients of intra-group services and providers of such services. Therefore, as regards the receipt of intra-group services, the CBDT could consider fixing a threshold on the payment of intra-group services for the purpose of safe-harbour rules. A similar reciprocal arrangement could also apply to the provision of intra-group services that are of a non-integral nature, and reasonably low margins, if any, required to be paid for such services could be determined.


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8. Safe Harbour for Intra-Group Services: A Global Overview

Countries such as Australia, Austria, New Zealand and Singapore have adopted the safe harbour for intra-group services to simplify transfer pricing compliance and reduce the administrative burden. A broad overview of the services covered, safe-harbour margins and the prescribed transfer pricing methodology is presented in Table 2.

<table>
<thead>
<tr>
<th>Table 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Australia</strong></td>
</tr>
<tr>
<td>Year of introduction</td>
</tr>
<tr>
<td>Nature of amendment</td>
</tr>
<tr>
<td>Transactions covered</td>
</tr>
<tr>
<td>Transfer pricing methodology prescribed</td>
</tr>
</tbody>
</table>
| Safe-harbour margins prescribed | – Receipt of intra-group services: actual charge and cost-plus 7.5-10%
– Provision of intra-group services: actual charge and cost-plus 5-7.5%
| |
| **Austria** |
| Year of introduction | 2010 |
| Nature of amendment | Introduced by way of administrative guidance (paras. 77-80 of Austrian Transfer Pricing Guidelines) |
| Transactions covered | Routine functions where assets are involved only on a small scale and where risk involved is only small. The intra-group ancillary services should not form part of the ordinary business of the enterprise |
| Transfer pricing methodology prescribed | Cost-plus method |
| Safe-harbour margins prescribed | – Profit markup for routine services should be approximately 5-15%.
– Intra-group ancillary services may be charged without any markup. However, where only direct costs (instead of also indirect costs) of the intra-group routine service are available, a markup of 5% should be charged without further evidence in considering indirect costs, as well |
| **New Zealand** |
| Year of introduction | 2000 |
| Nature of amendment | Introduced by way of administrative guidance: (paras. 557 to 567 of the Inland Revenue Transfer Pricing Guidelines) |
| Transactions covered | – Non-core services that are not integral to the profit-earning or economically significant activities of the group
– Threshold for the cost of intra-group services is determined at NZD 600,000 |
| Transfer pricing methodology prescribed | Cost-plus method |
| Safe-harbour margins prescribed | – Receipt of intra-group services: actual charge and cost-plus 7.5-10%
– Provision of intra-group services: actual charge and cost-plus 5-7.5%
| |
| **Singapore** |
| Year of introduction | 2009 |
| Nature of amendment | Introduced by way of administrative guidance: transfer pricing guidelines for related-party loans and related-party services |
| Transactions covered | Routine services as listed in Annex A¹ of “Transfer Pricing Guidelines for Related Party Loans and Related Party Services”. These routine support activities that the service provider offers to its related party should not be provided to an unrelated party |
| Transfer pricing methodology prescribed | Cost-plus method |
| Safe-harbour margins prescribed | Cost of providing services plus 5% for routine services listed in Annex A of “Transfer Pricing Guidelines for Related Party Loans and Related Party Services” |

¹. Services covered under Annex A of Transfer Pricing Guidelines for Related Party Loans and Related Party Services include accounting and auditing; accounts receivable and payable; budgeting; computer support; database administration; employee benefits; general administrative and legal services; payroll; and corporate communications.

9. Other Simplification Measures for Intra-Group Services

Further, countries such as Hungary, Japan, the Netherlands and the United States have simplified their transfer pricing measures for intra-group services, as discussed in Table 3.
<table>
<thead>
<tr>
<th>Country</th>
<th>Year of introduction</th>
<th>Nature of amendment</th>
<th>Transactions covered</th>
<th>Transfer pricing methodology prescribed</th>
<th>Simplification measure</th>
</tr>
</thead>
</table>
| Hungary | 2012                | Introduced by way of Regulation: Article 6 of Decree of Minister of Finance 22/2009 X.16 | Low-value-adding intra-group services and routine services the value of which does not exceed HUF 150 million at arm’s length (excluding VAT), 5% of the service provider’s net income and 10% of the recipient’s operating costs during a given tax year | Cost-plus method | – Simplified documentation and no benchmarking required  
– Simplification measure may be used if taxpayer accepts application of the cost-plus method; if application of the cost-plus method leads to a result other than the arm’s length price, this simplification measure may not be used |
| Japan   | 2001                | Introduced by way of administrative guidance: articles 2-7 and 2-10 of the Commissioner’s Directive on the operation of transfer pricing | Low-value-adding intra-group services accompanying the original business activities of the enterprises, for which no comparable transactions (neither internal or external) can be found | Cost-plus method | – Simplified transfer pricing method  
– Actual cost of providing the services is deemed to be the arm’s length price |
– At the taxpayer’s advance request, all relevant actual costs (instead of arm’s length consideration) may be charged for support services |
| United States | Established in 1968; revised materially in 2006 | Provision of low-value-adding intra-group services that:  
– have a median comparable markup of 7% or less or are listed in Rev. Proc. 2007-13;  
– are not listed as excluded activities;  
– do not contribute significantly to key competitive advantages or core capabilities, or fundamental risks of success or failure; and  
– services for which certain documentation requirements are met | Services cost method and associated shared services arrangement for services cost method transactions | – Simplified transfer pricing method  
– Services cost method: Taxpayer may choose to price the services at cost rather than the actual arm’s length price. Cost reimbursement is deemed to be the arm’s length price if the taxpayer properly chooses to apply this method  
– Shared services agreement: If a taxpayer elects to use the services cost method, it may further elect to use a shared services agreement. Such an agreement permits cost allocation on the basis of reasonably anticipated benefits under a relaxed standard. Specifically, the Commissioner must respect the allocation basis if the taxpayer only “reasonably concluded” that its chosen cost allocation basis most reliably reflects the respective shares of reasonably anticipated benefits. In contrast, absent the rule for shared services agreements, the Commissioner must respect an allocation basis only if it most reliably reflects the respective shares of reasonably anticipated benefits |
10. Conclusion

The Indian 2014 Budget has brought about positive changes in transfer pricing with a view to reducing protracted litigation. In addition to the amendments made to the transfer pricing provisions, the government should also consider extending the safe-harbour rules for intra-group services and formulating comprehensive rules for determining the arm’s length price for intra-group transactions. Globally, countries have adopted a sophisticated approach in framing their transfer pricing policies for intra-group services. The CBDT could take cue from the countries that have covered intra-group services under the safe-harbour mechanism, and must ensure that the purposes for which the safe-harbour rules were introduced for intra-group services are achieved.

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