

INDIA

FORMULATING AN INTRAGROUP MANAGEMENT FEE POLICY: AN ANALYSIS
FROM A TRANSFER PRICING AND INTERNATIONAL TAX PERSPECTIVE

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1. INTRODUCTION

One of the important issues that draw the attention of the Indian tax authorities during a transfer pricing audit is the compensation paid for intra-group services to related entities by way of management or intra-group fees. In fact, intra-group services have been one of the important issues world-over for tax authorities while undertaking a taxpayer audits. The reason as to why management fees in the context of transfer pricing receives so much of attention around the world is easy to see. If used properly, management fees are one of the important tax planning tools for effectively lowering taxable income by increasing expenses in a particular tax jurisdiction.

Understandably, tax authorities are concerned that this issue may be open to exploitation by companies that adopt an aggressive tax planning approach. Hence, while a taxpayer's policy regarding intra-group management fees might be looked upon with some measure of scepticism by the tax authorities, such policies can also be a very important tax planning tool, especially if compensation for intra-group services within a multinational enterprise (MNE) can be adequately justified with suitable documentation prepared to fulfil the legislative requirements of the respective tax jurisdictions.

Moreover, group companies of an MNE involved in an intra-group service transaction with each other must consider the tax implications of both sides of the transaction. This means that each group company in its respective tax jurisdiction is obliged to satisfy the local tax authorities that it is paying or receiving an arm's length management fee for the concerned intra-group services. Consequently, taxpayers are well advised to consider a thorough and

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comprehensive approach to identify and evaluate intra-group services, in order to adequately meet the expectations of the tax authorities in their respective jurisdictions.

This article will specify the general principles that must be kept in mind while formulating an intra-group management fee policy. This article will attempt to spell out an organized approach for designing a policy for intra-group services by considering various key factors that would require special attention.

The analysis here is mainly from an Indian perspective (i.e. mainly with reference to a foreign MNE proposing to charge management fees to its Indian group company to which support services are rendered, and also from the perspective of an Indian MNE proposing to charge management fees to its overseas group companies). However, the principles stated in this article would also likewise apply in any other cross-border situation, due regard being had to the nuances that may be found under the domestic tax laws of the relevant jurisdictions. This article will touch upon international and transfer pricing practices followed in different jurisdictions.

While the general transfer pricing provisions are contained in Sec. 92 of the Income Tax Act, 1961 (ITA), there is no specific mention of intra-group services.² The law is still emerging in India and therefore reliance is also placed on, and useful inferences have been drawn from, the international tax practices followed in some other developed countries, along with the OECD Transfer Pricing Guidelines (OECD Guidelines)³ and the applicable Guidance Note of the Indian Institute of Chartered Accountants on transfer pricing.⁴

² While Sec. 92(2) of the ITA deals with cost sharing arrangements, there is no specific provision that specifically deals with intra-group services. Consequently, the general provisions of Sec. 92(1) that requires an arm's length computation of income arising in an international transaction with an associated enterprise, would be applicable in the context of transfer pricing for intra-group services.

³ Although the OECD Guidelines do not by themselves command the force of law in any country, they have been explicitly adopted by the tax authorities in a number of countries and have significant persuasive authority in many other countries (e.g. India). See Guidance Note, Para. 28.3, at 97 ("The guidelines provided by the OECD have a persuasive value").

⁴ Guidance notes are treated as recommendations. A CPA or CPA firm should ordinarily follow recommendations in a guidance note relating to an auditing matter except where the CPA is satisfied that in the circumstances of the case, it may not be necessary to do so. See Compendium of Guidance Notes (4th ed., 1993), vol. 1, at page (x), Para 5.

2. FORMULATING A POLICY FOR CHARGING MANAGEMENT FEES

2.1. Concept of intra-group services and management fees

Before delving into the nuances of formulating a transfer pricing strategy on management fees, it would be helpful to have an understanding of what is meant by management fees and intra-group services.⁵ The discussion below illustrates the OECD approach to describing intra-group services.

An intra-group service is a service performed by one member of a multinational group for the benefit of one or more related members of the same group. In some cases, intra-group services may be performed by a parent company or a sister company for one or more related parties. In a transfer pricing context, such intra-group services become significant when they are rendered to related parties located in different tax jurisdictions.

The OECD **Transfer Pricing** Guidelines (OECD Guidelines) state that nearly every MNE group must arrange for a broad range of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the entire group.⁶ In essence, intra-group services encompass a broad range of services that can potentially be provided by the parent to a subsidiary (or across subsidiaries). In general, the categories of services that could be regarded as intra-group services include the following:

- management services;
- administrative services;

⁵ In the transfer pricing arena, while the term "management fee" is extensively used in common parlance to describe the compensation paid for intra-group services, the term is not defined in the transfer pricing rules found in the OECD Guidelines, nor in the US transfer pricing regulations. Having said that, in general, management fee is often used as a generic term to describe any charge between related parties, in the context of intra-group services.

⁶ OECD Guidelines (1998), Chapter VII, "Special Considerations for Intra-Group Services" Para. 7.2

- coordination, control and administrative services;
- research and development;
- product development;
- technical services;
- purchasing, marketing and distribution;
- engineering services;
- staff-related matters, such as recruitment and training;
- financial services;
- legal services; and
- other commercial services that typically can be provided with regard to the nature of the MNE's business.

Some of the intra-group services rendered in this context could be referred to as routine in nature. In other words, they are basic administrative, financial or support services rendered from one member of an MNE to another. The identification and treatment of those services are generally straightforward and simple. However, the issue of charging for services may become complex as the nature of services moves from routine to more sophisticated.

The OECD Guidelines not only describe services, but also indicate the options available for procuring these services. For example a parent or a specialized group could be the service provider that initially bears the costs of providing the services and then recovers the same from the respective group companies. The OECD Guidelines further broadly categorize the services as those that could be "typically available externally" from independent sources (legal and accounting services) or those that are "ordinarily performed internally" (central auditing, financing advice and training of personnel).

2.2. Concept of group service centre

Not only the nature of services, but also the form of the service provider, may be relevant when formulating a transfer pricing strategy for intra-group services within an MNE. In this

context, the concept of a group service centre⁷ is quite relevant because this type of structure is often used by MNEs to provide services to related parties. A group service centre is defined as a special department within the parent company or other associated enterprise that provides services to associated enterprises. The objectives of establishing group service centres by corporations may vary. Some of the reasons for establishing group service centres may include: accumulating costs (either with or without a mark-up); distributing those accumulated costs to related entities (which receive some benefit from the services rendered); operational synergies; and locational flexibility.

There are primarily three main categories of group service centres that an MNE could generally operate, namely cost centres, profit centres and specialized service centres.

Cost centres normally provide services only to members and associates of the related group. In other words, they are the captive service units. Profit centres normally provide services to group members, but a portion of the activities may consist of rendering similar service to arm's length third parties for which a fee may be charged. Finally, specialized service centres provide exceptional or specialized high-end services to group members, which services cannot ordinarily be purchased from other parties. In other words, these services may be very unique and as such are not ordinarily traded on the open market.

In practice, the most commonly encountered group service centre is the cost centre, mainly seen in corporations with centralized management services.⁸

2.3. Importance of charging management fees on an arm's length basis

Before providing the details of formulating management policy, it is imperative to understand the importance of charging arm's length management fees. As noted above and at the risk of repetition to drive home the point, this is critical not only from an Indian tax perspective, but from an international tax perspective, as well. This is because group companies engaged in

⁷ See also **1984 OECD Report**, at 74.

⁸ While it is not very common to encounter the so-called profit centres and specialized service centres, they do exist in some cases.

cross-border transactions with each other must consider the tax implications of both sides of the transaction, as the group profits could be affected if there were to be adverse tax implications in either jurisdiction. Thus, each group company within each tax jurisdiction must satisfy its local tax authorities that it is paying or receiving an arm's length management fee for the intra-group services concerned. Many tax authorities are sensitive to management fees payments, as this is one area that can tend to be very nebulous. Understandably, tax authorities around the world are concerned that there is potential for exploitation here, especially by companies that adopt an aggressive tax planning approach. Moreover, as is discussed below, the payment / receipt of management fees can attract a number of different taxes depending upon whether the participant is the payer or the payee.

Needless to say, the management fee policy should be designed with the above background in mind, and the policy should be such that it does not result in either overcharging or undercharging of management fees. Any under or overcharging could result in adverse tax implications for the group as a whole. The possible ramifications of undercharging or overcharging are noted below.

2.3.1. Consequences of excessive management fees

Where the tax authorities find that a company has paid excessive management fees to a related company, the consequences thereof may include:

- non-deductibility of some or all of the management fee payment for corporate tax purposes;
- interest and penalties imposed in the host country; and
- the full amount of the management fee income received by the payee remains taxable in the payee's country of residence.

2.3.2. Consequences of undercharging for management services

Potentially adverse consequences of undercharging for management services will generally affect the service provider, and may include (1) increased tax liability on account of an increase in taxable income and (2) interest and penalties imposed in the home country.

2.4. Broad parameters for designing a policy for charging for intra-group services

Considering the importance of charging arm's length management fees from the perspective of both the service provider and the service recipient, the basic principles involved in designing a management fee policy are discussed here. Broadly speaking, the OECD Guidelines outline two main issues that should be addressed when evaluating intra-group services in the context of transfer pricing (including intra-group services),⁹ namely:

- determining whether the activities undertaken by a parent company or group services centre genuinely constitute intra-group services (i.e. whether the payer is receiving a benefit); and
- determining how to determine an arm's length consideration for such services (in accordance with the benefit received).

2.4.1. Determining whether intra-group services have been rendered

The OECD Guidelines provide a basis to determine whether a service has been rendered. Under the arm's length principle, when one group member performs an activity for one or more group members, it will be regarded as a service rendered if and only if the activity provides the respective group member with economic or commercial value that might conceivably enhance the recipient's commercial position.¹⁰ It also provides a simple way to ensure that a legitimate service is being rendered by considering whether an independent enterprise in similar circumstances would be willing to pay for the same service conducted by another independent entity or would have performed that service in-house. **In other words, the OECD Guidelines are based on the principles of willingness to pay for an activity**

⁹ Chapter VII, Para. 7.5 OECD Guidelines (1998).

¹⁰ Id., Para. 7.6 OECD Guidelines.

from an independent enterprise vis-à-vis performing it in-house. Simply stated, if the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be regarded as a chargeable intra-group service under the arm's length principle.

The US regulations under Sec. 482 of the Internal Revenue Code (US regulations) are also based on the line of thinking. Under the US regulations, an important initial examination in transfer pricing analysis for services is determining for whose benefit an expense is incurred. The US regulations then go on to say that it is quite common for one company to incur an expense which benefits itself as well as one or more other affiliates, and that in such cases the expense must be allocated.

In practice, the position of the Australian Tax Office (ATO) with regard to head office activities is that services are chargeable only where the activity has conferred a benefit to an assessee. The ATO also takes the view that where a benefit is provided to an entity by way of a service and there is a real connection between the entity's operations and the associate, the entity would be expected to pay for the services.

This standard involving a willingness to pay or existence of a benefit (benefit rule), as enunciated in the OECD Guidelines and US regulations is, by far, the most important factor that determines whether a related-party service recipient would pay for an intra-group service and, therefore, whether the service provider can justify a charge for the provision of the intra-group services. The objective of the benefit rule is not only to determine the quantum of benefit, but also the relative proximity of the benefit derived to the intra-group services rendered (i.e. using a proximate-and-direct standard. Therefore, one should determine how direct or remote the benefits derived are in relation to the activity performed under the guise of intra-group services. A direct or perceived benefit from the service rendered must be identified. Consequently, allocations are not to be made if the probable benefit to other members is so indirect or remote that unrelated parties would not have charged for similar services.

The current US regulations provide examples of this rule. In one example an international airline has an affiliate that operates hotels in cities serviced by the airline. The advertising

brochure of the airline mentions the hotel affiliate and includes pictures of its hotels. The regulations indicate that the airline's advertisement is reasonably anticipated to be a substantial benefit to the hotel affiliate and, as a result, an allocation under Sec. 482 is appropriate. If, however, the airline does not directly mention the hotel affiliate's name or includes pictures of its hotels, the situation would have been different. In this context, the regulations go on to indicate that an allocation is not appropriate, even though the hotel affiliate may benefit from advertising. Here the rationale is that the probable benefit is so indirect and remote that an unrelated hotel operator would not have been charged.¹¹

Further, allocations are to be consistent and commensurate with the relevant benefits intended for the services, based on the facts known when the services were rendered, and not based on benefits realized. In other words, the use of hindsight is to be avoided.

Consequently at a practical level, with a view to determining whether intra-group services have been rendered, all relevant intra-group transactions must be aggregated and then segregated to identify and incorporate relevant intra-group services that have been rendered. Then, the services must be evaluated on the basis of whether they provide a group member with economic or commercial value that enhances its commercial position in the market where it operates.

However, not all services are chargeable. The OECD Guidelines also identify certain services or activities that are deemed to be non-beneficial for the recipient thereof. As a result, those activities cannot be regarded as chargeable intra-group services. The main categories of non-beneficial services identified in the OECD Guidelines are:

- shareholder / custodial activities;
- duplicative services;
- services that provide incidental benefits;
- passive association benefits; and
- on-call services.

¹¹ US Treas. Reg. Sec. 1.482-2(b)(2)(i), examples 2 and 3.

2.4.1.1. Shareholder / custodial activities

The 1979 OECD report on transfer pricing (OECD Report),¹² in which the term "stewardship" activities was used for the first time, referred to a wide range of activities performed by shareholders, including the provision of certain services to other group members that are provided by a coordinating centre. However, given the width and the breadth of the definition, the OECD segregated shareholder activities as distinct and separate from the broader definition of "stewardship activity" in its 1984 report. This definition of shareholder activities is narrower in scope and refers to an intra-group activity that one group member might perform for related group members, even though those members do not need the activity and would not be willing to pay for it if it were performed by an independent enterprise. That activity would be one that a group member performs solely because of its ownership interest in one or more of the group members (in its capacity as a shareholder). Under the OECD Guidelines, this type of shareholder activity would not justify a charge to the recipient company.

The OECD Guidelines also list some examples of services that are regarded as shareholder activities,¹³ namely:

- costs of activities relating to the legal structure of the parent company itself (e.g. meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board);
- costs related to reporting requirements of the parent company, including the consolidation of financial reports; and
- costs of raising funds for the acquisition of new companies to be held by the parent company.

In Canada, a Circular (IC 87-2R)¹⁴ deals with this same subject. It contains the position taken by the OECD Guidelines and refers to the relevant section (Para. 7.10) therein. IC 87-2R also specifically identifies costs that should not be charged to other group members, namely:

¹² "Transfer Pricing and Multinational Enterprises – Report of the OECD Committee on Fiscal Affairs" (OECD, 1979), at 100.

¹³ **Id.**, Para. 7.10.

- costs incurred for sole benefit of the shareholders;¹⁵
- costs relating to legal structure of the general financial reporting requirement of a particular group;¹⁶ and
- costs pertaining to functions that are duplicated, except for special cases where an old system backs up the new set up temporarily (reorganizations or system upgrade) or where a second opinion is advisable (legal or accounting functions). According to IC 87-2R, it would be unusual for an entity to pay for a service that has already been performed by one of its own employees or by a third party. However, as the OECD Guidelines also state, under particular circumstances a duplicate charge may be necessary and, hence, regarded as a justified intra-group service.¹⁷

Thus, according to the Circular, costs that are incurred for the sole benefit of shareholders may not be charged to other group members (i.e. should not be regarded as chargeable intra-group services).

In the United States, technical advice memorandum (TAM) 8806002 provides very comprehensive Internal Revenue Service (IRS) guidance on the subject of inter-company services. TAM 8806002 provides that following are deemed to be stewardship activities:

- duplicative review or performance of activities already undertaken by a subsidiary;
- periodic visits and general review of a subsidiary's performance;
- complying with reporting requirements or other legal requirements of the parent shareholder; and
- financing or refinancing the parent's ownership participation in the subsidiary.

Moreover, the current (and even proposed) US regulations emphasize the importance of excluding shareholder activities when evaluating intra-group services.

¹⁴ IC 87-2R (27 September 1999) outlines the CRA's administrative views on transfer pricing. Part 6 deals with treatment of intra-group services (Paras. 152 to 171).

¹⁵ Id. Para. 156.

¹⁶ Id. Para. 157.

¹⁷ Id. Para. 158.

All in all, based on the foregoing discussion, one could conclude that the major categories of expenses that may be regarded as custodial / shareholder activities (so as to be disallowed for tax purposes in the payer country) include:¹⁸

- costs of activities relating to the legal structure of the parent company (e.g. costs of issuing shares, share transfer expenses, meetings of shareholders and costs of the supervisory board). This includes expenses associated with the issuance of stock and maintenance of shareholder relations;
- costs relating to the reporting and legal requirements of the parent company (e.g. consolidation of financial reports, maintenance of shareholder records, filings of prospectuses and income tax returns). This includes expenses for compliance with regulations or policies imposed by the foreign government upon the member rendering the services;
- costs incurred by a parent company to raise funds for acquisition of a new company in its own right.¹⁹ This includes the interest expense on indebtedness not incurred specifically for the benefit of another member of the group;
- costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations;
- costs of visits and reviewing subsidiary performance on a regular basis; and
- costs of financing or refinancing the parent's ownership participation in the subsidiary.

However, merely because an activity has been performed for the benefit of the owner does not per se mean that it is a shareholder activity for which an allocation is not warranted. This is because there may be activities performed for the interest of the owner which conform to the shareholder activity definition provided in Para. 7.6 of the OECD Guidelines, but which could nevertheless be regarded as chargeable based on surrounding facts and circumstances of the case. In such cases, the OECD Guidelines advise that whether the activities fall within the definition of shareholder activities as defined in the OECD Guidelines is to be determined

¹⁸ According to US TAM 8806002, the OECD Guidelines and Canadian IC 87-2R.

¹⁹ In contrast, if the parent company were to raise funds on behalf of another group member which then uses them to acquire a new company, the parent company would generally be regarded as providing an intra-group service to the group member.

based on whether under comparable facts and circumstances, the activity is one that an independent enterprise would have been willing to pay for or to perform for itself.²⁰

In other words, to evaluate services rendered by a parent as a shareholder to its subsidiary for the parent's own interest, but which confers added value on the subsidiary beyond what can be regarded as a routine support, one must exercise some value judgment before eliminating it as a non-chargeable service. Therefore, any service that resembles a shareholder activity or falls within the broad definition of stewardship activities cannot be eliminated outright. As noted above, the underlying test in all cases should be whether an independent enterprise in comparable circumstances would be willing to pay for it or perform it in-house. Once this is determined, inclusion or exclusion as a service rendered can be justified.

2.4.1.2. Duplicative services

Duplicative services or stewardship services are those that a group member offers to any other member which can be regarded as duplicate (i.e. the service is already performed by the recipient or by an arm's length party on its behalf). In that case, no intra-group services should be regarded as being rendered by the group member. The OECD Guidelines, as well as the Canadian and US regulations, all agree that there is no added commercial value provided by such services, and thus they cannot be regarded as being rendered for the benefit of the related party.

Such stewardship or duplicative expenses are illustrated in the US regulations in the context of the financial analysis of a subsidiary's borrowing needs. When the subsidiary does not have personnel qualified to make such an analysis, and does not make the analysis **itself**, the cost of the financial analysis done by the parent must be allocated to the subsidiary. If, however, the subsidiary has a qualified financial staff that performs the analysis, and this analysis is then reviewed by the parent's financial staff, the review by the parent's financial staff is duplicative and an allocation may not be made.

²⁰ Para. 7.10, at VII-4 **OECD Guidelines**.

However, at the same time, the US regulations also recognize that there may be some exceptions, such as a temporary circumstance or an opportunity to eliminate critical business risk. Other instances in which critical business risk is eliminated would come into play when seeking a second legal opinion or performing an external audit to avoid a risky or erroneous business decision. When a valid business reason exists, these duplicate services may be regarded as intra-group services. Such stewardship or duplicative expenses for a valid business reason are illustrated in the Example 6 of the proposed US regulations.²¹

In Example 6, a foreign subsidiary retains outside intellectual property (IP) counsel to assist it in negotiations with an unrelated party in relation to a joint venture, which involves several licenses and cross-licenses of patents and copyrights. Outside counsel reviews the documentation and advises that the transaction terms are advantageous and the contracts are enforceable. The US parent's in-house IP lawyers also review the documentation and concur with the outside counsel's opinion. The example acknowledges that the activities of the US parent substantially duplicate the legal services obtained by the foreign subsidiary. However, the example concludes that the US parent's duplicative activities nevertheless reduce the commercial risk related to the transaction. Consequently, the foreign subsidiary is deemed to derive benefit from those activities and thus an arm's length charge or allocation is required from the foreign subsidiary to the US parent.

Another example could be of an arm's length party willing to continue to operate an existing computer system, for a brief period, concurrently with a new one, in order to deal with unforeseen difficulties that might arise in the implementation of the new system. In this case, there would be a valid business reason for duplicating the function.

The question of whether an expense is for the benefit of the parent (whether as a duplication or as supervision of its investment in a subsidiary) can be a difficult one to resolve in practice. This is because almost any parent activity that relates to a subsidiary can benefit the subsidiary, thereby becoming potentially subject to an allocation between these two categories. Consequently, it may not always be easy to ascertain in practice where the line is

²¹ Prop. Reg. Sec. 1.482-9(1)(4), example 6.

drawn between shareholder / stewardship activities²² for which an allocation is not to be made, and non-shareholder / non-stewardship activities benefiting the subsidiary for which an allocation is to be made. Whether these activities fall within the definition of shareholder / stewardship activities is determined based on all the surrounding facts and circumstances of the case and, more importantly, based on the principle as to whether under comparable facts and circumstances, the activity is one that an independent enterprise would have been willing to pay for or to perform for itself. The proposed US regulations have provided examples that suggest the distinction between genuine stewardship / shareholder activities that do not provide any direct identifiable economic benefit, and those that do. See Appendix 1 for details.

2.4.1.3. Services that provide incidental benefits

The OECD Guidelines highlight another set of services which does not warrant an allocation, namely services that are rendered and result in an incidental benefit. This refers to services performed by one group member (e.g. a shareholder or coordinating centre) for a particular group member or a set of group members, such that it also incidentally provides a benefit to other group members.

The OECD Guidelines provide two examples to explain the situation. The first involves a situation in which a reorganization or acquisition (disinvestment) deal that is carried out by a parent or sister company produces economies of scale or benefits for some other group member not directly involved in the decision. In this case, the service rendered is not an intra-group service because an independent enterprise would not be willing to pay for a service that provides only an incidental benefit.²³

²² Although the OECD proposes a regulatory formalization in terms of the distinctions between stewardship expenses and shareholder activities, the rationale for such a distinction is not very certain, as neither type of expense should precipitate a reallocation. In fact, the examples cited by the OECD Report of shareholder activities are similar in nature to those defined for US tax purposes as Class II and Class IV expenses by TAM 8806002, which the IRS concluded and which may properly be deducted by the parent without reallocation!

²³ Para. 7.12 OECD Guidelines.

The other example has been concerning an enterprise that obtains incidental benefits simply by virtue of its affiliation with the parent or the group per se (e.g. in the form of a higher credit rating). This situation generally does not call for the consideration of a service being rendered. However, if the higher credit rating is due to a guarantee provided by a group member or group's reputation derived from global marketing and public relation campaigns, then an intra-group service charge would be appropriate.²⁴

The proposed US regulations provide two examples to illustrate the concept of an indirect or remote benefit. In both the examples, a US parent implements changes to management structure and compensation based on recommendations in an internally performed study. In the first example (Example 2) the study and changes target only the US parent's own management structure and compensation (not the foreign subsidiary's) and any resulting increase in the US parent's competitiveness and efficiency would provide only indirect or remote benefit to its foreign subsidiary. Consequently, the example goes on to conclude that no benefit inures to the foreign subsidiary and therefore no arm's length charge or allocation from the foreign subsidiary is required.²⁵

In the second example (Example 3), the management structure, compensation study and changes target the US parent's foreign subsidiaries and are expected, when implemented, to increase the profitability of both the US parent and its foreign subsidiaries. Example 3 concludes that those changes and results constitute a specific and identifiable benefit for the foreign subsidiary, and an arm's length charge or allocation should therefore be made from the foreign subsidiaries as beneficiaries of US parent as the service provider.

2.4.1.4. Passive association benefit

This is another category of activities that does not justify an allocation under the benefit test. Under the proposed US regulations, which have eloquently dealt with this category, a taxpayer's mere existence as a member of a controlled group generally will not be deemed to

²⁴ Id. Para. 7.13.

²⁵ Prop. Reg. Sec. 1.482-9(1)(4), example 2.

provide a benefit to the taxpayer for which an arm's length charge or allocation will be required.

The proposed regulations provide three examples with a common fact pattern to illustrate this concept. In Examples 15, 16 and 17, Company Y, a newly acquired foreign subsidiary wins a large information technology (IT) system design contract for a local financial institution, without any assistance from its US parent or its affiliates, nor from their marketing intangibles. Although Company Y's winning the contract on favourable terms is said to be due to Company Y's status as a member of the US parent's group, the example concludes that this "passive association" benefit is not regarded as a benefit for purposes of Sec. 482 and that an arm's length charge or allocation is therefore not required.²⁶

In Example 16, the facts are similar except that the US parent executes a performance guarantee regarding the contract, which is said to enable Company Y to win the contract on favourable terms (i.e. winning the contract is not solely due to Company Y's passive association with the US parent group, as in Example 15). The example concludes that the guarantee confers a benefit on Company Y that requires an arm's length charge or allocation.²⁷ Similarly, Example 17,²⁸ where US parent began negotiating the contract before the acquisition of Company Y and then, after the acquisition, simply had Company Y enter into the contract, concludes that more than mere passive association was involved and that turning over the contract provided a benefit to Company Y for which an arm's length charge or allocation is required.²⁹

²⁶ Prop. Reg. Sec. 1.482-9(1)(4), example 15.

²⁷ Prop. Reg. Sec. 1.482-9(1)(4), example 16.

²⁸ Prop. Reg. Sec. 1.482-9(1)(4), example 17.

²⁹ Similar principles were laid down by the Court in the case of *Hospital Corp. of America vs. Commissioner*, 81 TC 520, 597-602 (1983), where an income allocation to a US parent that negotiated Saudi hospital management contracts and then had them performed by a Cayman subsidiary using parent personnel, was upheld. Also Treas. Reg. Sec. 1.482-9(1)(4), example 1, is based on the same line of thinking. In Example 1, the US parent obtained designation as an official sponsor of the Olympics, and thereafter it allowed its subsidiaries along with itself to use the Olympic logo in advertising. The example treats this as a benefit requiring an arm's length charge or allocation from a foreign subsidiary to its US parent.

The predominant consideration here is to be able to distinguish between a passive association that does not warrant an allocation, and an active promotion that does warrant an allocation. Needless to say, such evaluations are dependent on the facts and circumstances and thus cannot be generalized. Rather, a case-by-case analysis is necessary.

2.4.1.5. On-call services

The OECD Guidelines refer to another special category of services in the context of intra-group services, namely services provided on-call.³⁰ The availability of such services generally requires the existence of a support group of some sort and an understanding between the group members about the nature of the assistance being provided in any field of operation whenever required, and on an on-call basis. For example a parent company or a group service centre may be available to provide assistance with regard to legal, finance, technical or tax issues at any time.

The aspect that merits consideration here is whether the availability of that service in itself is regarded as a separate service (for chargeable purpose) over and above the service fee compensation for the actual service rendered. The justification provided in the OECD Guidelines for considering such availability as a separate service rendered is that it is common knowledge that independent enterprises incur so-called stand-by charges to ensure availability of those services when the need for them arises. An example of that service is the appointment of a legal, technical or financial service provider on a retainer basis.

These services are not necessarily a normal requirement and may vary in terms of frequency and importance from year to year. Therefore, one must ascertain the potential need of the stand-by service option for the recipient of the services. In cases where the service requirement is remote or could be easily procured from other sources without an on-call service option, the availability of that option is redundant and, hence, unjustified. Therefore, to evaluate whether an on-call service is rendered, one must consider the benefit that the on-call arrangement offers to the group over a period of several years, given the sporadic nature

³⁰ Para. 7.16, Para. VII-6 OECD Guidelines.

of the occurrence of those service needs (rather than only for the year of taxation under consideration).

2.4.1.6 Ancillary and subsidiary services

It would be inappropriate to regard these services as non-chargeable services. This is because they are otherwise chargeable but are not charged, as they are included in some other consideration. However, for the sake of completeness, this category of service has been included here.

When intangible property is transferred and services are rendered in connection therewith, the IRS generally requires two separate transfer pricing analyses, one for the services and another for the property.³¹ However, when the service rendered is merely "ancillary and subsidiary" to the transfer of the property or the commencement of the effective use of the property, a separate allocation for services is not required.³² However, such services may affect the appropriate transfer price of the property. In effect, consideration may have to be given to the pricing of the services.³³

Whether the services are merely ancillary and subsidiary is a question of fact. Ancillary and subsidiary services can be performed in promoting a transaction by demonstrating and explaining its use, or by assisting in the effective start-up of the property transferred, or by performing under a guarantee relating to such effective start-up.³⁴ When an employee reveals a secret process owned by the employer and at the same time supervises the integration of the process into the manufacturing operations of the related person, the services are deemed to be rendered in connection with the transfer, and do not form the basis for a separate allocation.

³¹ Treas. Reg. Sec. 1.482-4(b)(2)(ii). Transactions involving related products or services may be aggregated under Treas. Reg. Sec. 1.482-4(f)(2)(i).

³² Treas. Reg. Sec. 1.482-2(b)(8).

³³ See e.g. Treas. Reg. Secs. 1.482-3(c)(3)(ii)(C) and 1.482-4(c)(2)(ii)(B)(2).

³⁴ Treas. Reg. Sec. 1.482-2(b)(8).

2.4.2. Conclusion

It is necessary to justify intra-group services from the perspective of an independent enterprise, considering whether that enterprise would be willing to pay for the service in question or perform the same service in-house. Thereafter, a valid segregation or aggregation of the costs should be conducted and the charging or otherwise for those services rendered should be based on the above-mentioned principles.

Also, special attention and close scrutiny generally should be paid to certain non-chargeable categories of services such as shareholder activities, duplicative services, services providing incidental benefits, passive association benefits and on-call services, as the OECD Guidelines (and perhaps even the laws of the foreign countries where the subsidiaries are located), regard such services as non-beneficial activities for the recipient entity, for which a charge is not justified.

2.4.3. Determining the intra-group service charge

2.4.3.1. Arm's length principle

The previous section specified the criteria to determine whether an intra-group service has been rendered by a related entity. Once it has been concluded that a service has been rendered, the second of the two primary issues pertaining to intra-group services needs to be addressed, namely the amount to be charged for the service rendered.³⁵ This is in line with the fundamental concept of transfer pricing (i.e. the arm's length principle). Therefore, similar to the treatment of the other related-party cross-border transactions, intra-group services also must be assessed with reference to third-party comparables dealing at arm's length. In other words, a charge for intra-group services between related parties should reflect the charge that

³⁵ The 1998 OECD Guidelines (Chapter VII, Para. 7.19) state that once it has been determined that an intra-group service has been rendered by a related party, it is necessary to determine whether the amount of the charge, if any, is in accordance with the arm's length principle.

would have been made and accepted between independent enterprises in comparable circumstances.

2.4.3.2. Management fees charged as a percentage of sales of the service recipient

An important issue at this point is whether the management fees may be charged as a percentage of sales of the service recipient, regardless of the cost incurred by the service provider in rendering the services (e.g. 5% of the sales achieved by the service recipients). In other words, based on the above-mentioned principles, could it be said that charging management fees at 5% of sales would also meet the arm's length expectations under the transfer pricing regulations?

In this regard, it would be useful to note the observations made by the OECD Guidelines on the form vs. substance of the international transaction between associated parties. The OECD Guidelines provide that generally tax authorities should examine the transactions between associated enterprises as structured by those parties, using the same methods as are used by the taxpayer, so long as these methods are consistent with the methods prescribed by law. However, in the following two particular cases it is appropriate and legitimate for the tax authorities to look behind the transaction and disregard the structure adopted by the taxpayer:

- when economic substance of a transaction differs from its form. An example of this given by the OECD Guidelines is funding of equity in the form of debt (i.e. thin capitalization). In other words, the apparent form of the transactions should be consistent with the underlying substance thereof; and
- when the form and substance of a transaction are the same, but the arrangements made in relation to the transaction viewed in their entirety differ to those which would have been adopted by independent enterprises operating in a commercially rational manner.

Against the above background, the question of whether management fees could be charged as a percentage of sales is addressed below.

The tax authorities in most countries are wary and not very inclined to accept management fees being charged as a percentage of sales, instead of being based on the cost of services rendered, especially in cases where the net result is overcharging of management fees. If it could be shown (to the tax authorities of the payer country) that the total cost of the management services with or without a reasonable mark-up³⁶ was approximately the same as 5% of all the subsidiaries' sales, it could possibly be argued that the 5% of sales is the most appropriate way of allocating the costs among the subsidiaries. Otherwise (and possibly even with such a documentation), the tax authorities that notice the charges are likely to want to know exactly what services the subsidiary is receiving, and what they cost to provide. In such a case, an argument before the tax authorities that the services were more valuable than their cost might cause the tax authorities (of the payer country) to inquire whether the payments were not really royalties and therefore subject to tax withholding in the host country!³⁷

Moreover, international experience seems to suggest that unless the services are value-added strategic services, the routine support services and low margin services³⁸ are to be charged linked to the cost of rendering these services, either with or without mark-up as the case may be. This is because these services do not generally require the application of know-how or other value-added inputs, which could have a direct bearing on the turnover / profitability of the service recipient. Thus, based on the foregoing discussion, it could be seen from the perspective of the service recipient that routine support and other low-end services should ideally be linked to cost rather than turnover.

Such a method of charging management fees as a percentage of sales, would not only be acceptable to the tax authorities in the country of service recipient, but may also in some

³⁶ Whether or not a mark-up needs to be charged will depend on the facts and circumstances of the case. This **is discussed in more detail, below.**

³⁷ Unlike India, which regards even fees for management services as fees for technical services under its domestic tax law and under most Indian tax treaties, the position is different in the case of many other countries. This is because many overseas countries do not view management fees as taxable services, while they do regard royalties as taxable payments. Consequently, while there may not be any withholding tax incidence on the payment of management fees, the payment of royalties by overseas subsidiaries might in practice trigger withholding tax in the host country.

³⁸ Most back office services (e.g. finance, treasury, accounting, tax and human resource support) are generally regarded as routine, low-margin services.

situations not be acceptable to the tax authorities in the country of service provider (especially where such a methodology does not result in full recovery of the chargeable cost incurred by the service provider). The consequences for under-recovery of management fees have already been noted, above.

All in all (and in general), recovery of management fees as an ad hoc percentage of sales may not be the most appropriate methodology to justify the arm's length nature of the transaction from a transfer pricing perspective.

2.5. Methods prescribed by the OECD Guidelines for intra-group services

The logical question that then arises for consideration is what is the international practice that is followed to benchmark the intra-group support services and what are the views of the OECD Guidelines. The OECD Guidelines indicate that the transfer pricing methods to be used to determine an arm's length transfer price for intra-group services include the comparable uncontrolled (CUP) method and the cost-plus method.³⁹ Sub-classifications of the cost-plus method include the direct charge method and the indirect charge method.

2.5.1. Comparable uncontrolled price method

2.5.1.1. General principles

The CUP method compares the price charged for services rendered in a controlled transaction with the price charged for similar services rendered in a comparable uncontrolled transaction under comparable circumstances.⁴⁰ While there are a number of important comparability standards under the CUP method, it is regarded as the most direct way of determining an arm's length price, and even the OECD Guidelines regard the CUP method as preferable to

³⁹ Chapter VII, Para. 7.31 OECD Guidelines (1998).

⁴⁰ Rule 10B (1)(a) **Indian** Income Tax Rules; Chapter II, Para. 2.6 OECD Guidelines

all other methods.⁴¹ A transaction should be regarded as comparable only if both the services and circumstances surrounding the controlled transaction are substantially the same as those of the uncontrolled transaction.

The most important factor in determining comparability under this method is services similarity.⁴² The uncontrolled transactions should reflect services of a similar type, quality and quantity as those between the associated enterprises, and relate to transactions taking place at a similar time and stage in the production or distribution chain, with similar conditions applying. Similarity of contractual terms and economic conditions, such as geographic markets and the level of market, are also important comparability factors of the open market⁴³ under this method. In the event that differences in products or terms exist, the Indian regulations and OECD Guidelines provide that adjustments would be appropriate to eliminate the effect of the differences on price. The OECD Guidelines state that a flexible approach should be adopted when examining the CUP method, and appropriate adjustments should be applied when reasonable.

While the OECD Guidelines provide that where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. However, it may be difficult to apply this method in practice for intra-group services because this method is ideally suited for commodities that are the subject of frequent trade in the open market. However, for intra-group dealings in services, the difficulty that may arise is the absence of an open market price for similar services. Estimation of the price on the hypothetical supposition of the existence of an open market and a willing purchaser and a willing provider may pose a problem. As there could be bona fide differences of opinion about the estimation of an open market price, because reasonable

⁴¹ Chapter II, Para. 2.7 OECD Guidelines.

⁴² Chapter I, Para. 1.19 of the OECD Guidelines provides that in general, similarity in the characteristics of the property or services transferred will matter most when comparing prices of controlled and uncontrolled transactions (and less so when comparing profit margins).

⁴³ According to Guidance Note (point (vii), at 49), the term "open market", although not defined, means a transaction between a knowledgeable and willing purchaser and a knowledgeable and willing seller, where neither of them is influenced or compelled to act in a particular manner.

people acting fairly, reasonably and objectively may arrive at figures which vary considerably from each other. Pricing of services is very subjective and their true value as perceived by the receiver can differ to that perceived by others in the market place. Therefore, the CUP method requires a high degree of comparability in the services provided in the controlled and uncontrolled transactions. This standard of comparability is ordinarily extremely difficult to meet in practice. Even the proposed US regulations echo a similar viewpoint.

2.5.1.2. Applicability in general in practice

In practice, services in the nature of intra-group support services generally may not be rendered by the group service provider to any third parties in India or abroad, nor may similar services under similar circumstances be procured by the group service recipient from any third parties in India or abroad. This is mainly because of the very nature of intra-group services, in that they are in the nature of support services which the group service provider would render only to the entities within the group. Consequently, in general, no internal comparables may be available in practice.

Moreover, regard being had to the nature of intra-group services generally provided, it might also be difficult to procure external comparables from the public domain. Also in the context of intra-group services, as services rendered by the overseas parent are generally in the nature of support services, the CUP method would not be the most appropriate method. Consequently, in the absence of internal or external comparables, the CUP method generally may not be the most appropriate method from a transfer pricing perspective for analysing the arm's length nature of transactions involving intra-group services.

2.5.2. Cost-plus method

2.5.2.1. General principles

The other method prescribed is the cost-plus method. It tests the arm's length nature of a transfer price in a controlled transaction by reference to the gross profit mark-up (e.g. gross profits divided by cost of rendering services) realized in a comparable uncontrolled transaction. The cost-plus method is typically used for evaluating the sale of services by service provider to service recipient, where the service recipient incurs limited economic risk in the transaction. The OECD Guidelines further provide that this method is most useful when semi-finished goods or intermediary services are sold between related parties or where the controlled transaction is the provision of services.⁴⁴

When applying the cost-plus method, the process typically begins with the identification of the costs that the manufacturer incurs in the controlled transactions. An appropriate mark-up is then added to these costs, based on the functions performed and the risks assumed, so that an appropriate profit level is generated.⁴⁵

Under the cost-plus method, comparability is primarily dependent upon the similarity of the functions performed and the risks assumed by the controlled and uncontrolled service providers, and is less dependent on the similarity of the actual services being rendered. In addition to evaluation with external comparable companies, the cost-plus method can be applied in an internal capacity, as well, if such data are available. In this instance, the gross profit mark-up of the service provider in the controlled transaction may be determined by reference to the gross profit margin that the same service provider earns on items produced in comparable uncontrolled transactions.⁴⁶

In order to meet the comparability requirements of the cost-plus method, one of the following two conditions must be satisfied:

- none of the differences (if any) between the transactions being examined can materially affect the gross profit mark-up in the open market; or

⁴⁴ Chapter II, Para. 2.32 OECD Guidelines.

⁴⁵ Rule 10B(1)(c) **Indian** Income Tax Rules; Chapter II, Para. 2.32 OECD Guidelines.

⁴⁶ Rule 10B(1)(b) **Indian** Income Tax Rules; Chapter II, Para. 2.33 OECD Guidelines.

- reasonably accurate adjustments can be made to eliminate the material effects of these differences.⁴⁷

As with other transactional methods such as the resale price method, the comparability requirements under the cost-plus method are less stringent than those under the CUP method.⁴⁸

2.5.2.2. Applicability in practice

Given the facts that details about internal or external transactional may not be available for the application of the CUP method, and given the fact that the costs incurred by the overseas parent in as much as is attributable to its Indian subsidiary may be easily identified or computed, and given the fact that details of margins of comparable companies from transfer pricing databases would generally be available, the total cost-plus method would in practice be the most appropriate method to benchmark intra-group service transactions.

2.5.2.3. Direct charge method and indirect charge method under the cost-plus method

The calculation of any charges for intra-group services under the cost-plus method must be based on a cost accounting system which is developed according to generally accepted accounting principles (GAAP). As noted above, the cost-plus method can be further classified into the direct charge method and the indirect charge method.

2.5.2.3.1. Direct charge method

Under the direct charge method, associated enterprises are charged for specific services. For example the overseas subsidiary may be directly charged for a two-day visit of a software

⁴⁷ Rule 10B(3) **Indian** Income Tax Rules. Even Chapter II, Para. 2.34 of the OECD Guidelines reflects the same line of thinking.

⁴⁸ Chapter II, Para. 2.34 OECD Guidelines.

engineer who is on the rolls of the parent company and who may have visited the overseas subsidiary's site at latter's request to render certain consultancy or advisory services. In such a case, the parent company can charge the specific costs for these consulting services with or without a profit mark-up (as the case may be), directly to the foreign subsidiary. Even a third party would proceed in this way under similar conditions and circumstances.

The direct charge method is applicable primarily when services can be specifically identified for cost attribution. In those circumstances, the expenses of the specific support group responsible for the service rendered can be directly attributed to the services rendered (in terms of hours, travel expenses, etc.). Therefore, the cost could relate to either a specific individual or individuals involved in providing the intra-group service or, in some cases, an entire department responsible for the same, either as a part of the routine, day-to-day functions or on special request from the related affiliate.

The pre-requisite for implementation of the direct charge method is that the services performed and the basis of payment be clearly identifiable. Where the costs are directly related and identifiable to the recipient company, the cost should be allocated directly to that company.

2.5.2.3.2. Indirect charge method

The indirect charge method is appropriate when the services provided and the costs attributable thereto relate to a number of different entities. For example there may be situations when an MNE cannot attribute direct costs either because the associated costs of a service rendered are not easily identifiable or the costs are incorporated into other transactions between the related entities. In those circumstances, a cost allocation or apportionment method is used which often necessitates a degree of estimation or approximation. Even the OECD Guidelines state that the transactional profit method should ideally be applied on a transaction-by-transaction basis, but in appropriate situations transactions may be grouped or aggregated.⁴⁹ Essentially, the relevant controlled transactions

⁴⁹ See Rule 10A(d) **Indian** Income Tax Rules; Paras. 1.42 to 1.44 **OECD Guidelines**.

may be aggregated if it is impractical to analyse the pricing or profits of each individual transaction, or if such transactions are so interrelated that this is the most reliable method of benchmarking the transactions against the arm's length outcome. An appropriate allocation and apportionment of costs incurred by the group member in rendering the service to a specific affiliate should be commensurate with the quantum of the service rendered.

2.5.2.4. Which method is appropriate – direct charge or indirect charge?

From the above, it can be inferred that the direct charge method should be preferred over the indirect charge method in cases where the services rendered by the taxpayer to other group members:

- are the same or similar as those rendered to arm's length parties; or
- can be reasonably identified and quantified.

However, in cases where a particular service has been provided to a number of non-arm's length parties and the portion of the value of the service directly attributable to each of the parties cannot be determined,⁵⁰ it is possible to use the indirect charge method.

Thus, the applicability and acceptance of the direct cost method supersedes that of the indirect cost method and, in cases where the former can be used, the latter is generally not regarded as an acceptable methodology by tax authorities. In general, the direct charge method is of great practical convenience to tax authorities because of the clear correspondence between the resulting charge and the benefit provided to the payer. It is for this very reason that the OECD favours a direct charging method for specific services wherever possible.

However, although the use of a direct method is preferable, it may be that direct charges are impractical or too time consuming in practice. As noted above, even the OECD Guidelines have recognized that in many circumstances, multinational enterprises will have no option but to use indirect cost allocation methods. They clearly state that such methods "should be

⁵⁰ E.g. as noted above, where global market research is intended to benefit all the non-arm's length entities.

allowable provided sufficient regard has been given to the value of the services to recipients and the extent to which comparable services are provided between independent enterprises". In such cases, therefore, intra-group services charged on a global or fixed-key basis (i.e. based on an appropriate allocation key) will be acceptable if the outcome can be justified from an objective perspective. The determining factor with regard to whether a method of charging is acceptable is that the share of benefits received matches the share of costs charged to the payer, and that the benefits justify the fee (based on corresponding documentation).

Wherever an indirect charge method has been used, it should contain safeguards against manipulation, follow sound accounting principles, and be capable of producing charges or allocations of costs that are consistent and in line with the actual or reasonably expected benefits to the recipient of the services. This is important, as charges for services which are structured in such an indirect way that the link between the payment for the services and their value is not established or lost, are more likely to be disallowed in the assessment of the foreign subsidiary and thereby result in double taxation (because of taxation in the parent's country of residence and disallowance of deduction in the subsidiary's country of residence). To satisfy the arm's length principle, any allocation method chosen must also lead to a result that is consistent with what comparable independent enterprises would be prepared to accept in comparable circumstances.

All in all, there is some flexibility as regards the selection of method based on all the surrounding facts and circumstances of the case.⁵¹ In practice, to the extent possible, the use of the direct charge method is recommended. However, where this is not possible, the use of the indirect charge method may be resorted to. Consequently, where it may not be possible to allocate the cost directly to a particular unit, the indirect tax method may be used.

⁵¹ Having said that and as noted above, whichever method has been adopted, the same should be applied consistently within the group. This may be different if sound business and benefit arguments support a different approach. Even the US regulations provide that when the arm's length charge is based on costs and deductions, and a member has allocated and apportioned costs using a consistent method that is reasonable and in keeping with sound accounting practice, the method should not ordinarily be disturbed.

2.5.2.5. Identifying the cost base for the indirect charge method

For application of the indirect charge method, it becomes necessary to ascertain the chargeable cost base. It is necessary in this regard to take all costs directly or indirectly related to the services performed. Direct costs are those costs that are identified specifically with a particular service, including compensation, bonuses, travel expenses, materials and supplies. Indirect costs or deductions to be taken into account are those that are not specifically identified with or attributable to a particular activity, but which nevertheless relate to direct costs. These include utilities, occupancy, supervisory and clerical compensation, and other overhead costs of the department incurring direct costs or deductions. Indirect costs also include an appropriate share of costs or deductions relating to supporting departments and other general and administrative expenses, to the extent reasonably allocable to a particular service. Costs incurred by supporting departments can be apportioned to other departments on the basis of a reasonable overall estimate, or such costs may be reflected by means of application of reasonable departmental overhead rates.

2.5.2.6. Apportioning expenses included in the cost base and selecting the appropriate allocation key

Having identified the cost base, the next issue to be addressed is that of apportioning the cost among various overseas subsidiaries. In general, cost allocations should be made on a reasonable basis, applying a comprehensive review of the centralized expenses incurred for the provision of intra-group services; have a relatively transparent basis of allocation; and result in costs being shared among the service recipients in proportion to the benefits received.

There is no specific method or formula specified for allocating the centralized costs incurred. Therefore, if the portion of the value of the service directly attributable to each of the service recipients cannot be determined (e.g. where global advertisement campaign is intended to benefit all the related entities), an appropriate allocation key is used to allocate the costs. Charges for services rendered are determined by allocating those costs across all potential beneficiaries using an appropriate allocation key.

In fact, with respect to indirect cost allocations, the tax authorities are interested in assessing the arm's length nature of the allocation criterion. This is because, all said and done, the indirect allocation method is open to possible manipulation and is highly dependent on the nature and usage of the intra-group services. Hence, it becomes imperative to select the proper allocation key.

The choice of the allocation key should be made by giving consideration to the nature of the service involved and the use to which it is put. Some of the examples of allocation keys have been noted below.⁵²

- allocation of department costs based on sales of the group;
- time spent by employees performing intra-group services;
- units produced or sold;
- number of employees;
- total expenses;
- space used;
- capital invested;
- asset **quantum**;
- a combination of the above.

When choosing an allocation key, the taxpayer should consider the nature of the services and the use to which the services are put. For example if the services relate to human resource activities, the proportionate number of employees may be the best measure of the benefit to each group member.

In addition, there are situations in which the proportion of services rendered to each beneficiary might not be easily identifiable with reference to the exact quantum of benefit

⁵² As regards the US regulations, there is no real guidance on specific methodologies, but the regulations indicate that the use of one or more bases may be appropriate. Appropriate consideration must be given to all bases and factors, including, for example total expenses, asset size, sales, manufacturing expenses, payroll, space utilized and time spent. In practice, it can be said that IRS has been more inclined to adopt a particular allocation key / method if the activities are in connection with the preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, clients, customers, potential investors or other parties or agencies.

attained or expected (for instance, in cases involving centralized advertisement campaign). In such cases, the allocation key or method would be an approximate value (e.g. proportional net sales of all the beneficiaries to allocate the cost incurred to implement the centralized advertisement campaign mentioned above) must be used for allocation.

There are no specific rules relating to selection of the appropriate allocation key. The New Zealand Transfer Pricing Guidelines have elaborated on the usage of different allocation keys with suitable illustrations. See Appendix 2 for details. In the end, it must be remembered that whichever allocation key is chosen, the allocation key chosen must yield a result that is consistent with what a comparable independent entity would be willing to pay, and the arm's length principle must be satisfied.

2.6. Mark-up on costs

2.6.1. Generally

Having identified the cost base and the basis of allocation to various group companies, the issue of marking up costs is the next issue in any transfer pricing analysis for intra-group services. This is because, depending on the facts and circumstances, the tax authorities in the foreign subsidiary's country of residence may not allow a mark-up on costs unless it is adequately substantiated. Similarly, there may be issues in the home country of service provider, if no mark up is charged on value added services. Therefore, the costs incurred for the provision of intra-group services needs to be properly examined with a view to determine whether a mark-up on the cost base is justifiable.

The rationale for charging the mark-up is based on the premise that in an arm's length transaction, an independent enterprise normally would seek to charge for services in such a way as to generate profit, rather than providing the services merely at cost. However, the economic alternatives available to the recipient of the service also must be taken into account in determining the arm's length charge. Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service supplier. For example in many cases,

the services provided through intra-group arrangements are administrative or ancillary in nature, and the participants would have been prepared only to centralize the activity if they could share in the cost savings. Costs may represent an arm's length charge in such situations. The OECD Guidelines also recognize that there are circumstances in which an independent enterprise may not realize a profit from the performance of service activities alone, for example where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability (by complementing its range of activities). Therefore, it need not always be the case that an arm's length price will result in a profit for an associated enterprise that is performing an intra-group service.⁵³

Indian transfer pricing regulations, as they currently stand, do not shed any light on the issue that there could be situations where no mark-up is charged for transfer pricing purposes. The OECD Guidelines highlight the following such situations:

- services are provided by a third party, and a related party adds no significant value or assumes no major risks with respect to the third-party services (e.g. where the related party is merely an intermediary and the functions are performed by the unrelated third party); and
- the market value of the intra-group service is not greater than the costs incurred by the service provider in rendering that service (especially where the service provided is not part of the main business activity of the service provider, but is offered incidentally as a benefit to the related party group).

The OECD Guidelines suggest that a profit mark-up might not always make sense from the perspective of accumulating the support evidence because establishing the appropriate profit mark-up might be a costly and cumbersome process. Therefore, it may also be desirable to do a cost-benefit analysis before embarking on the process of establishing the need for a profit mark-up.

The position of the Canadian tax authorities on the issue of mark-ups is spelt out in Para. 30 of IC 87-2R, which states "generally there is no profit element in shared costs charged to

⁵³ Para. 7.33 OECD Guidelines

Canadian branches or subsidiaries".⁵⁴ The CRA's position in IC 87-2R, which was laid down in Para. 163 thereof, is noted below:

Arm's length service suppliers would usually expect to recover their costs plus an element of profit. However, in determining an arm's length charge for service, one must also take into account the economic alternatives available to the recipient of the service. Often, the price the recipient is willing to pay for the service does not exceed the cost of supply to the service supplier.⁵⁵

The CRA also specifies factors that must be taken into account before a mark-up can be justified, and the same are noted below:

Determining whether a mark-up is appropriate and, where applicable, the quantum of the mark-up, requires careful consideration of factors such as: the nature of the activity; the significance of the activity to the group; the relative efficiency of the service supplier; and any advantage that the activity creates for the group.⁵⁶

In line with the OECD Guidelines, IC 87-2R also specifies instances in which a mark-up may be explicitly allowed or disallowed, and the same are noted below:

As discussed in paragraph 7.36 of the OECD Guidelines, it is important to distinguish between the situation of: a taxpayer who renders services for the other members of a group; and a taxpayer who acts solely as an agent on behalf of the group to acquire services from an arm's length party. In the latter situation, the arm's length compensation would be limited to rewarding the agency role. In that case, it would not be appropriate to determine an arm's length charge by referring to a mark-up on the cost of the services acquired from an arm's length party. Whether a taxpayer is providing a service or merely acting as an agent on behalf of the group is a question of fact.⁵⁷

With respect to the US law on this subject, it needs to be ascertained at the outset under the current US regulations⁵⁸ whether the relevant services are integral or non-integral. In the case of the inter-company provision of services that have met the criteria of being provided for the

⁵⁴ IC-87.2, "International Transfer Pricing and Other International Transaction" (1987), Para. 30.

⁵⁵ IC 87-2R, "International Transfer Pricing" (27 September 1999), Para. 163.

⁵⁶ Id., Para. 164.

⁵⁷ Id., Para. 165.

⁵⁸ The IRS regulations have proposed to eliminate the cost safe harbour provisions for services. In its place, the IRS has proposed the simplified cost-based method (SCBM) to arrive at an arm's length price. Under the proposed regulations, the IRS would not be able to make a transfer pricing adjustment unless the arm's length mark-up on total costs exceeds the mark-up charged by the taxpayer by a specified number of percentage points.

benefit of a related party, the costs of providing the services will be deemed equal to an arm's length charge for such service (known as safe harbour costs of the provision for services), except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services. The arm's length standard mark-up of costs is normally appropriate where the services are deemed to be an integral part of the business activity of a member of a group of controlled entities.⁵⁹ Accordingly, US Sec. 482 regulations classify the inter-company provision of services into three categories:

- services that are duplicative of or indirect benefit to the recipient. In such case, an arm's length service fee of zero is appropriate;
- non-integral services. In such case, an arm's length service fee equal to a reimbursement of costs is appropriate; and
- integral services. In such case, an arm's length fee is required.

Situations in which services are deemed to be as integral part of the business activity are the following:

- where the renderer or recipient is engaged in the business of rendering similar services to one or more unrelated parties;⁶⁰
- where the renderer renders services to one or more related parties as one of its principal activities. It will be presumed that the provision of services is not one of the principal business activities of the renderer if the costs incurred do not exceed 25% of the total costs of the renderer for the taxable year. If such costs exceed 25% of total costs, one should consider time spent providing the services, the regularity of the services, the amount of capital investment, the risk of loss involved and whether the services are in support of or independent of the other activities of the renderer;

⁵⁹ US Treas. Reg. Sec. 1.482-2(b)(7) and 1482-2(b)(3).

⁶⁰ In this connection, the regulations provide the example (Tres. Reg. Sec. 1.482-2(b)(7)(iv), example 1) of a printing company that is regularly engaged in printing and mailing advertising literature for unrelated persons. The printing company also prints advertising circulars for a related person's products and mails them to potential customers of its affiliates, and **creates** related artwork. The services rendered were viewed as an integral part of the printing company's business activity because similar services were rendered for unrelated persons.

- whether the renderer is "peculiarly capable" of providing such services and whether such services are a principal element in the operations of the recipient. This occurs where the renderer makes use of a particularly advantageous situation (e.g. utilization of special skills and reputation, utilization of an influential relationship with customers or utilization of its intangible property). The renderer will not be regarded as peculiarly capable if the value of the services does not substantially exceed the cost of providing such services;⁶¹ and
- where the recipient has received the benefit of a substantial amount of services from one or more related parties, equal to or exceeding 25% of the total costs of the recipient during the taxable year.

A summary of US case law on whether particular services meet the non-integral safe harbour provisions is found in Appendix 3.

Based on the foregoing discussion and the international tax practice generally followed, it may be concluded that determining whether a mark-up is appropriate and, where appropriate, the quantum of the mark-up, requires careful consideration of factors such as:

- the nature of the activity and the services rendered;

⁶¹ Although the US regulations have given five illustration to explain this concept, two illustrations are explained below.

In one example (Treas. Reg. Sec. 1.482-2(b)(7)(v) example 11), X owns an exclusive patented process by which it detects and removes imperfections in the product of Y, a related party, thereby greatly increasing the marketability of the product. X apparently inspects all of such products. Although the activity is not a principal activity of X, the inspector, it is uniquely capable of rendering the services because it owns the patented process. Furthermore, inspection greatly increases the marketability of the product. Inspection is extremely valuable and the value is substantially in excess of the cost of rendering the inspection service. Because of the impact of the inspection on sales, the services are a principal element of the operations of Y. Thus, the inspection services rendered by X to Y are viewed as integral parts of the business activity.

In another example (Treas. Reg. Sec. 1.482-2(b)(7)(v) example 14), X, a manufacturing company, has an accounting department that maintains financial records of Y, a related distributor of X's products. Although X is able to render the accounting services more efficiently than others due to its familiarity with the operations of Y, X is not uniquely capable of rendering the accounting services. Such familiarity does not, in and of itself, constitute a particularly advantageous circumstance. Furthermore, the services are viewed as supporting in nature, and do not constitute a principal element in the operations of Y. Thus, the integral business activity test is not met.

- the significance of the activity to the group;
- the functional profiling and the characterization of the intra-group transactions involved;
- the relative efficiency of the service supplier; and
- any advantage that the activity creates for the group.

In general, the mark-up may not be relevant if the services are very routine and the value-added provided by the services rendered does not exceed the costs of provision. Similarly, if services are provided through a cost centre⁶² the fundamental function of which is providing cost savings or operational synergies to the MNE, a very high percentage of profit element or a mark-up may not be appropriate. If a profit centre is used to provide intra-group services and market prices (including the appropriate mark-up) are charged to other arm's length parties, the service provider may be in a position to charge a similar price with a mark-up included for similar services provided to related parties. If a specialized service centre is used to provide services, a reasonable arm's length mark-up may be charged if the value-added of the services is substantially greater than the costs of provision.

The other issue to consider is whether or not the mark-up makes sense from the recipient's perspective. In the event that the tax jurisdiction of the recipient does not allow a deduction for the mark-up, a mark-up on very routine services with no value added may not be the best idea. This is because it may be treated as earned income and taxed by the recipient's tax jurisdiction and, therefore, subject to double taxation.

Mark-ups on costs should be applied only after taking into account all the facts and circumstances surrounding the provision of intra-group services. Wherever the mark-up is applicable, it must be substantiated as being at arm's length with a thorough analysis of arm's length comparables.⁶³

2.6.2. Benchmarking the mark-up

⁶² See above discussion for an understanding of the concepts of cost centre, profit centre and specialized service centre.

⁶³ The methodology of determining an arm's length mark-up is discussed below.

In the case of certain value-added activities where a mark-up needs to be charged, the question arises as to how to compute the mark-up on such services or how to compute the arm's length price for such services. Determining whether a mark-up is appropriate and, where applicable, the quantum of the mark-up requires careful consideration of factors such as:

- the nature of the activity;
- the significance of the activity to the group;
- the functional profiling and characterization of the intra-group transactions involved;
- the relative efficiency of the service supplier;⁶⁴ and
- any advantage that the activity creates for the group.

Determining the quantum of the mark-up also entails attempting to find comparable independent transactions, determining the extent to which the services are the same or similar, determining the extent to which the surrounding circumstances are the same or similar, adjusting for differences, and considering all other relevant facts. Although the Indian regulations do not give any specific guidance in the context of intra-group services, the regulations do give general guidance on comparability that may be applied to transfer pricing for services.

The Indian regulations provide that the arm's length character of a controlled transaction is tested by comparing the results of the transaction with the results of uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. The regulations indicate that the comparability of transactions and circumstances must be evaluated using mainly in light of five factors:

- functions performed by parties to the transactions;
- risks undertaken by the parties to the transactions;
- contractual terms between the parties;
- economic conditions; and

⁶⁴ For example the Canadian transfer pricing regulations actually recognize that the relative efficiency of arm's length service suppliers may not be comparable to the intra-group services where the intra-group services are offered as a convenience to the group (and not as an ordinary and recurring activity).

- property or services involved.

For two transactions to be regarded as comparable, an uncontrolled transaction need not be identical or exactly comparable, but must be sufficiently similar so that it provides a reasonable and reliable benchmark. If necessary, a reasonable number of adjustments may be made to the results of an uncontrolled transaction to account for material differences between the controlled and uncontrolled transactions if such differences have a definite and reasonably ascertainable effect on prices. Such adjustments should be based on commercial practices, economic principles, or statistical analysis.

Comparison of functions. In the case of analysis of functions, it is desirable to identify and compare economically significant activities by taxpayers in controlled and uncontrolled transactions.

Comparison of risks. A comparison of risks requires a determination of which taxpayer bears the risks under the contractual terms between the parties. The contractual allocation of risks will generally be respected if it is consistent with the economic substance of the underlying transaction.⁶⁵ Relevant risks that may be regarded include market risks (including fluctuations in cost, demand, pricing and inventory levels); risks associated with the success or failure of research and development activities; financial risks (including fluctuations in foreign currency rates of exchange and interest rates); credit and collection risks; product liability risks; and general business risks related to the ownership of property, plant and equipment. In this regard, it is critical to examine whether the pattern of the controlled taxpayer's conduct is consistent with the purported allocation of risk or whether the relevant contractual terms are modified to reflect any inconsistent conduct, whether the controlled taxpayer has the financial capacity to fund the risk and the extent to which the controlled taxpayer exercises control over the activities influencing income or loss.

Contract terms. In applying the contractual terms factor, the regulations require the comparison of significant contractual terms that could affect the prices that would be

⁶⁵ However, in this regard US Treas. Reg. Sec. 1.482-I(d)(3)(iii)(B) provides that an allocation of risks between controlled taxpayers after the outcome of such risks is known, or reasonably knowable, is deemed to lack economic substance.

charged. This can include the form of consideration; payment terms or related financing arrangements; the volume of products; warranties; rights to updates; duration, termination or renegotiation rights; and collateral transactions. The contractual terms of the parties will generally be respected, provided that such terms are consistent with the economic substance of the underlying transaction. Factors given the greatest weight in determining economic substance are the actual conduct and the respective legal rights of the parties.

Economic conditions. The economic conditions factor requires a comparison of significant economic factors that could affect the price, including realistic alternatives; similarity of geographic markets; relative size and extent of economic development in each market; the level of the market; relevant market shares; location-specific costs; other factors of production and distribution; and the extent of competition in each market.

All in all, from transfer pricing perspective, it would be necessary to take into account all of the factors indicated above in determining the mark-up on intra-group services.

To determine the mark-up, one would have to run a search on a transfer pricing database that deals with financial details of potentially comparable companies. The objective of the search is to identify potentially comparable companies that render similar services and to ascertain the margins of such comparable companies. Such comparable margins could then be used to benchmark the margins of the intra-group services within an MNE.

The question that often arises is how does one perform an apple-to-apple (as opposed to apples-to-oranges) comparison, as the comparable companies on the database (even though rendering similar services) are actually in the business of rendering such services in contrast to the tested party that may be only incidentally providing such support services to the MNE group companies. For example would the transfer pricing regulations require a search for legal comparables for benchmarking legal support services rendered by one MNE group company to another group company? This is an interesting question, as for example the services provided by law firms and accounting firms are not comparable to those provided by in-house lawyers and accountants. Outside law and accounting firms have resources not available to in-house lawyers and accountants. In addition, they have attest and other functions that allow them to charge more, and cause them to require malpractice insurance

(which also, in turn, causes them to charge more). The appropriate comparables for any support-type inter-company services should therefore be third parties that offer services with comparable limits on risk, and a comparable lack of their own intangibles.

While only after a detailed search is run on a transfer pricing database (taking into account the specific facts of the case) could the arm's length mark-up that would apply in each case be determined, as a ball park estimate generally it would be reasonable to assume a mark-up in the range of 5% to 20%, depending upon the nature of services provided. Transfer pricing is not an exact science and therefore, more often than not, the application of the most appropriate method or methods and the database search would produce a range of figures, all of which are relatively equally reliable. Therefore, the actual determination of the arm's length price based on arm's length margins would necessarily require exercising good judgment.⁶⁶

3. DOCUMENTATION

3.1. Generally

The obligation to maintain appropriate documentation arises pursuant to Sec. 92D of the Indian Income-tax Act, 1961 read with Rule 10D **of the Indian Income Tax Rules**. The objective is to require the taxpayer to keep and preserve all such records as may be necessary and relevant to understand the taxpayer's inter-company transfer pricing policy. The obligation to maintain documentation therefore rests with every taxpayer that has entered into

⁶⁶ The fact that the mark-up is generally in the range of 5% to 20% could also be evidenced based on the international tax practices followed. For example Swiss laws provide that group service providers should be taxed on net income that an independent enterprise would have earned in the same circumstances and for the performance of the same services, and the applicable method is the cost-plus method. In addition, a circular issued by the Federal tax administration on 17 September 1997 has reduced the minimum amount of taxable income to 5% or from 1/6 of the salary costs to 8.33% on salary costs (from 10% on total costs). In Germany, the mark-up on the management fees accepted by the tax authorities is generally only 5%. In Belgium, with regard to coordination centres an 8% mark-up is generally acceptable for management fees.

cross-border international transaction. As such, every taxpayer in these circumstances needs to perform a thorough review of its documentation to arrive at an acceptable price for intra-group transactions if it is to avoid potential penalties under the Indian Regulations.

The Regulations provide that the documentation requirements are not applicable where the aggregate value of international transactions entered into by the assessee does not exceed INR 10 million. Having stated that, the Regulations go on to add that even in such cases, where the aggregate value of international transactions does not exceed INR 10 million, the assessee should be able to substantiate, based on the available material that international transactions entered into by it are in line with the arm's length standard.

The Guidance Note provides that the information that the assessee may be called upon to furnish, in the absence of which the assessing officer would have power to substitute an arm's length price, should be that which the assessee has in its possession and is capable of being furnished.⁶⁷ The OECD Guidelines also provide that the taxpayer should not be expected to have prepared or obtained documents beyond the minimum needed to make a reasonable assessment of whether it has complied with the arm's length principle.⁶⁸

The OECD Guidelines further provide that the extensiveness of documentation should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers, costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.⁶⁹ The OECD Report emphasized the necessity of preserving an acceptable balance between the need for tax authorities to be able

⁶⁷ Para. 16.3 Guidance Note. The OECD Guidelines also express a similar viewpoint.

⁶⁸ Para. 5.7., OECD Guidelines.

⁶⁹ Id., Para. 5.28.

to secure adequate information and the justifiable concern of taxpayers not to be overburdened by documentation requirements.

The documents and information should be maintained for a period of eight years from the end of the relevant assessment year.

The **Indian Income Tax** Rules provide that the information and documents prescribed should, to the extent possible, be contemporaneous and should exist (at the latest) by due date for filing of transfer pricing report. Requested details must be furnished within 30 days of such request (which may be extended an additional 30 days).⁷⁰ For a detailed discussion on the documentation requirements **in India**, see Appendix 4.

3.2. Intra-group services: the documentation process

The documentation process for intra-group services is very critical to provide tax authorities the necessary evidences to accept the legitimacy of any intra-group service charges, including management fees. In the United States, the legislation⁷¹ does not explicitly comment on what specific documentation is necessary with regard to intra-group services. Even though the Indian regulations have prescribed detailed transfer pricing documentation requirements in general, no specific guidance has been given in the context of intra-group services. Consequently, the general principles laid down under the Indian Income-tax Act, 1961 with regard to maintenance of documentation would need to be kept in mind to substantiate intra-group charges within an MNE.

The majority of taxpayers around the world view recordkeeping as a bureaucratic burden and a financial drag on the business. However, organizations that approach recordkeeping in an organized manner and with the right attitude do eventually tend to benefit. The advantage of maintaining accurate documentation contemporaneously is that organizations can assess their systems effectively and can review each entity accurately. This puts them in a better position

⁷⁰ Sec. 92D of the Indian Income-tax Act, 1961.

⁷¹ Treas. Reg. Sec. 1.482-2.

to effectively answer queries posed by the tax authorities in the course of tax audits. Senior management and in-house tax departments that adopt this practice tend to have fewer problems with tax authorities and are in a better position to establish a mutually respected working relationship with tax authorities.

Moreover, documentation is relevant not only from the perspective of service providers, but also service recipients. As in any situation where the deductibility of expenses will be closely scrutinized by the tax authorities, the importance of adequately documenting the bases for the intra-group service charges cannot be over-emphasized. In many instances, the tax authorities will automatically disallow management fee charges which are not backed up by formal contracts or other key documents, and the burden and the onus will then fall on the taxpayer to demonstrate that its management fee payments should be allowed as a deduction.

To this end, taxpayers will benefit from a comprehensive overview of the documentation that needs to be presented to adequately substantiate intra-group charges. This article will present only an overview of the documentation that generally needs to be maintained in relation to intra-group management fees. The documentation to be maintained in each specific case must be determined based on all the facts and circumstances.

First, however, taxpayers would benefit from an understanding of the approach of the tax authorities around the world with regard to assessing intra-group services under transfer pricing regulations. In general, the arm's length nature of an intra-group service is assessed internationally by the various tax authorities on the basis of the following criteria:

- Is the price of the service arm's length?
- Does the recipient benefit from the service?
- Are the so-called shareholder's costs eliminated?
- Has a service contract been drawn up? If so, are the services defined accurately and has the basis for the service fee been specified in the contract?
- Have the services clearly been supplied?
- Do valid commercial reasons exist for concluding a service contract?
- Have the service costs already been incorporated in the internal pricing of the products?
- Did the contract for the services exist from the outset?

Against the above background and considering the general approach of the tax authorities when assessing the arm's length nature of intra-group transactions, the necessary steps and the detailed documentation that should be maintained are discussed below.

The first step in the documentation process would be to document an analysis of the business and industry in which the MNE operates. This documentation is like the introduction to the transfer pricing documentation that could help educate the tax authorities on the relevant company and the industry in which the company operates. The industry analysis, if well documented, should provide the tax authorities with an excellent overview of the demand and value drivers within the industry, as well as the company's position within the industry. This can also provide an overview of the company's growth objectives, given the evolution of the industry sector and the competitive dynamics within the industry in which the company operates. It can be an effective tool to highlight industry-wide or company-specific conditions that may make it imperative to provide intra-group services to related parties.

The next step would be to clearly delineate the members of the multinational corporate group and the nature of their association with each other (i.e. the parent company vs. the subsidiaries and group companies). In this context, it is also prudent to present an organizational chart to clearly identify the related parties that are involved in the intra-group service transactions. A description of the corporate history may also be useful to highlight the evolution of the company and some of the assumptions underlying the provision of services.

The next step would be to identify all the relevant intra-group service transactions. At this juncture, it is also necessary to understand and document the organizational structure and the functions performed by different shareholders within the MNE. The entities involved in performing intra-group services within the MNE can be any members of an integrated MNE group. The specific relationships in this context might include (1) service transactions between a parent and a subsidiary and (2) service transactions between two affiliated (sister) corporations (i.e. subsidiaries **with a common parent**).

The next step is the documentation of the intra-group services performed by the service provider and the benefits received by the service recipient. The documentation of the precise

functions performed by various associated entities and the economic characterization of the relevant associated entities would be relevant here. A detailed functional and risk analysis, corroborated with a comprehensive economic characterization of inter-company transactions aids in gaining an insight into the relative functions performed, assets employed and risks assumed by the associated enterprises.

At a minimum, it is generally advisable that the following documentation be maintained on file with respect to all intra-group management service arrangements:

- a detailed business overview (specifying the related parties involved in the transaction) and an industry analysis;
- a detailed and comprehensive functional and risk analysis. As with any other transfer pricing issues, it is extremely important in determining transfer pricing for services to first describe the relevant transactions. All aspects of a transaction must be analysed, and the basic questions that must be asked and documented include:
 - who is doing what and for whom;
 - where are they doing it;
 - why are they doing it;
 - how are they doing it; and
 - what property is being used or transferred in connection therewith.
- a written, binding service contract between the payer and payee companies, i.e. the charter of the company which illustrates what policies have been adopted, what services are to be provided, what costs are to be included and what is to be excluded etc.⁷² The contract should at a minimum set out:
 - details of the group companies which will be providing and receiving management services under the contract;
 - full details of the nature and extent of services to be provided;
 - the basis for determining the fees to be charged;
 - the basis for periodic rate increases (if applicable);

⁷² The description of the services in the service contract assumes significance. Based on practices followed in other developed countries, it appears that based on the contract, the tax authorities can sometimes quickly question the arm's length nature of the services. This occurs most frequently when the description of the services to be provided appears incomplete, unclear and disjointed in the contract or (in the worst case scenario) the description or even the agreement is entirely missing.

- the times at which invoices will be issued;
 - the time for payment of fee invoices; and
 - the charges for late payment of invoices and outstanding accounts.
- documents (e.g. meeting notes and draft agreements) to show that the contract was concluded only after bona fide (bilateral) negotiations regarding its terms;
 - proof beyond a reasonable doubt of the provision of the intra-group service⁷³ (in order to demonstrate that the service recipient benefited therefrom). A comprehensive and complete description of those benefits may consist of the following:
 - a detailed description of the benefits provided by each business unit the costs of which are being allocated;
 - examples to illustrate those benefits, both qualitative and incidental; and
 - some of the following, in order to establish the existence of a benefit:
 - documentation (e.g. correspondence, memoranda, manuals and directives) indicating a benefit to the recipient of the intra-group services;
 - job descriptions of staff at the service provider and the recipient to identify services and to prove that there is no duplication of services; and
 - documentation to demonstrate that the recipient's operations have not been required to absorb a disproportionate share of the total global costs of administration and management; and
 - documentation of each of the functions, such as marketing, legal, technical functions, as the case may be;
 - the documentation that the service provider undertakes to supply in support of justification of the fee for the services rendered, e.g. copies of time sheets or cost centre reports. Documentation could also include letters, manuals, instructions, proof of visits, written advice, periodic activity reports and any other documents or data

⁷³ Intra-group services may be rendered for the joint benefit of several members of the related group. When services have been rendered for the exclusive purpose of a single recipient, it is relatively easy to determine whether the service recipient has received a benefit from the provision of the service. However, when the services rendered result in a joint benefit (i.e. benefit a number of members of the same related group), it becomes quite critical to establish the actual or perceived benefit for each individual recipient.

- which tend to confirm that the services were rendered for the benefit of the recipient and are justifiable on an arm's length basis;
- detailed fee accounts or invoices from the payee which include (1) full details of services rendered over the period covered by the charge, (2) confirmation that the fee calculation agrees with the service contract and (3) any other documents supplied by the payee, which support the amount of the charge. In particular, any substantiating documentation which must be tendered in accordance with the contract of services;
 - a certificate from a CPA, if possible, certifying (1) the viability of the method for allocation and apportionment of costs among subsidiaries and (2) the authenticity of the cost apportioned to each entity; and
 - as noted above, where a fixed key is used under the indirect charge method, the tax authorities may require that the justification for the method adopted be demonstrated, as they may be concerned that fixed-key methods do not produce the required correspondence between costs and benefits. In this respect, it is important to substantiate the cost basis and to have details on file to show which costs have been included / excluded with a fixed-key method. In other words, all shareholder costs that are incurred must be adequately documented, whether included or excluded in the actual charge-outs, along with the respective supporting analyses.

4. OTHER ISSUES IMPACTING MANAGEMENT FEE POLICIES IN AN INTERNATIONAL CONTEXT

4.1. Service tax

There may be an issue surrounding the levy of service tax under Indian tax laws on management fees. This depends on certain factors such as whether there is an importation of services into India or exportation of services from India; where the services are consumed; where the services are rendered; and the nature of services rendered. While a detailed examination of service tax provisions is beyond the scope of this article, this is an important levy which should be kept in mind. Unlike the withholding tax credit, the credit for service tax is generally not available under Indian tax treaties.

4.2. VAT

Similarly, one must also consider whether there could be a VAT issue under the domestic tax laws of the foreign country. While this would also depend on a host of factors, VAT is another an important levy which should be kept in mind. Unlike the withholding tax credit, the credit for VAT is also generally not available under Indian tax treaties.

4.3. Service permanent establishment

Some Indian treaties (including those with Australia, Singapore and the United States) contain a service permanent establishment (PE) clause. Such a clause generally provides that if the service provider renders services to its affiliates in the other country through its employees and if the duration of the stay of the employees in the other country exceed a particular threshold,⁷⁴ then a service PE is deemed to exist in the host country. The implication of a the existence of a service PE is that the company rendering services through its employees would be taxable in the host country to the extent of the profits attributable to the service PE in the host country. Hence, it would be desirable to take proper precautions to ensure that service PE exposure is minimized.

4.4. Withholding tax and payments of management fees

While the domestic laws of many overseas countries does not provide for withholding tax at the time of remittance of fees for technical services, Indian law does provide for just such a withholding tax. Under Indian tax law (and also many Indian treaties), the definition of fees for technical services is very comprehensive and includes any payments for managerial, consultancy or technical services. In other words, Indian tax law and most Indian treaties, any

⁷⁴ Some Indian treaties provide for no threshold when services are rendered to an affiliated party. In such a case, even if services were rendered for a day, a service PE would be deemed to exist.

payments to an overseas service provider for intra-group management fees could trigger withholding tax. However, some Indian treaties (e.g. with the United Kingdom and the United States) contain a very restricted definition for fees for technical services, under which "managerial services" are excluded from the purview of fees for technical services. Consequently, in such a case it may be possible to argue that **managerial services** are not covered under such a restricted definition of fees for technical services and therefore in absence of a service PE of a service provider in India, such payments are not taxable in India.⁷⁵ Similarly, some Indian treaties (e.g. the treaty with Mauritius) do not contain an article regarding fees for technical services. In such a case, in absence of a service PE of a service provider in India, payments for management fees are not taxable in India.

5. CONCLUSION

Globally, tax authorities have adopted an increasingly proactive and more sophisticated approach to examining transfer pricing policies in respect of intra-group support services. It is only matter of time before the Indian tax authorities will take a cue from them and follow a similar approach. Accordingly, Indian MNEs with subsidiaries abroad, as well as foreign MNEs operating in India, are well advised to contemporaneously document their intra-group arrangements and practices in respect of support services, so as to prepare in advance for an otherwise inevitable transfer pricing examination. Because intra-group services are regarded by many as one of the most likely areas to be examined by the transfer pricing authorities, taxpayers that have not performed the necessary analysis and maintained adequate documentation run the definite risk of being audited (with the possible result that their income will be reassessed by those same authorities). Undoubtedly, the best defence for a multinational with intra-group service transactions is a thorough evaluation process (with the

⁷⁵ In an Indian ruling (242 ITR 208 (AAR)), the Authority for Advance Ruling (AAR) in India held that fees fore managerial services rendered in India by a US-based company are not taxable in India under the India-United States treaty. The ruling found favour with the AAR due to the restricted definition of fees for included services under the India-United States treaty, (which did not include managerial services within the definition of fees for included services). The ratio of this ruling should also apply under other Indian treaties that have a similarly narrow definition.

help of transfer pricing experts) that results in adequate documentation presenting the most persuasive case before tax and transfer pricing authorities.

Experience shows that many companies fail to develop a coordinated and centrally managed intra-group support strategy. Moreover, it has been observed that while formulating an intra-group transfer pricing strategy, many MNEs fail to work out the overall business strategy in tandem with various other pertinent international tax planning considerations. Formulating a comprehensive transfer pricing strategy for intra-group service transactions also requires a well-founded understanding of various international tax planning principles. This, in turn, requires detailed knowledge of applicable tax treaties, as well as a thorough understanding of the laws and practices in the home and host countries. For example there is no point in formulating a pricing policy that satisfies the tax authorities of the home jurisdiction but which is not acceptable to the authorities in the foreign jurisdiction; which does not achieve the overall management objectives; or which does not optimize the after-tax cash flows for the group on the whole. In fact, there are various permutations, combinations and considerations that need to be borne in mind and balanced when formulating a comprehensive transfer pricing strategy. The overall message is that it is imperative to consider all of these factors in the course of designing a proper intra-group management policy.

APPENDIX 1

EXAMPLES OF STEWARDSHIP / SHAREHOLDER ACTIVITIES UNDER PROPOSED US REGULATIONS

Under the proposed US regulations, shareholder activities undertaken mainly to (1) protect the service provider's capital investment in the recipient or other group members or (2) ensure the compliance of the controlling service provider with local reporting, legal and regulatory requirements when the control by the shareholder-service provide of the other group members is not deemed to provide a benefit to the recipient. Consequently, no arm's length charge or allocation is required for those activities. In this connection, the proposed

regulations provide eight examples, several of which illustrate the problem (as indicated, below).

Example 1 involves the case of a public US parent's preparation and filing of periodic reports required by US securities laws that include financial data on foreign subsidiaries (including Company *Y*). The example concludes that the US parent's activities in this respect are shareholder activities, in as much as Company *Y* does not obtain a benefit from those activities. Thus, no arm's length charge or allocation is required from US parent to Company *Y*.

Example 2 is similar to Example 1, except that the reports prepared by US parent are used by Company *Y* (the foreign subsidiary) to comply with similar reporting requirements imposed under the domestic law of its own jurisdiction. The example concludes that Company *Y* derives a benefit from US parent's compilation and analysis of financial data, and therefore an arm's length charge or allocation should be made.

Example 3 deals with a situation where the US parent's internal audit staff periodically reviews the foreign subsidiary's compliance with internal operating procedures and US anti-bribery laws. Consequently these are classified as shareholder activities for which no charge is required.

Example 4 concerns the US parent that hires an investment banking firm and a law firm to analyse changes in the laws of Country *B* (where its foreign subsidiary, Company *Y*, is resident) and to propose a possible restructuring of Company *Y* in response to those changes. These are deemed to be shareholder activities for which no charge or allocation should be made to Company *Y*, as the restructuring was designed to enable the US parent to receive dividends and other payments from Company *Y* (payments for which Company *Y* would accrue no benefit).

A contrast is seen in Example 5, where the changes in foreign law relate to corporate governance, and the stated purposes for the restructuring is to reduce the number of Country *B* legal entities and accelerate the introduction of new products. Here, the consulting activities and costs related to the restructuring are intended to enhance Company *Y*'s

operational efficiency and profitability and thus are not shareholder activities. Rather, those activities and costs provide a specific and valuable benefit to Company Y for which an arm's length charges or allocation should be made to the US parent.

Examples 6 and 7 both involve management or headquarters functions. In Example 6, the US parent performs a variety of personnel / human resources functions regarding its foreign subsidiaries, including approving performance appraisals, monitoring compensation levels and participating in senior level hiring and firing decisions. Here, the activity is characterized as involving day-to-day management that does not qualify as mere shareholder activity. Rather, the activity provides a benefit to Company Y for which an arm's length charge or allocation to the US parent is required.

Example 7 involves the US parent's conduct of a retreat for senior executives to develop business strategy for the US parent and its subsidiaries, including Company Y, together with preparation and circulation to the foreign subsidiaries of a strategy statement to collate the results of the retreat, including potential growth initiatives and methods to increase profitability. Preparation of the strategy statement (and presumably the retreat) is not deemed to be shareholder activities.

APPENDIX 2

SELECTING AN APPROPRIATE ALLOCATION KEY⁷⁶

There are number of allocation keys that might be applied to allocate costs between members of a group. The strengths and weaknesses of various allocation keys that might be applied are analysed below.⁷⁷

GLOBAL FORMULA APPROACH

⁷⁶ As explained in the New Zealand Transfer Pricing Guidelines (New Zealand Transfer Pricing Circular, Paras. 533 to 555).

⁷⁷ Whether or not one of the keys, in the form discussed below or in an adapted form, might be appropriate will depend on the facts and circumstances of the case.

One approach is to apportion costs on the basis of gross turnover of the worldwide group as follows:

Affiliate's gross sales
----- X costs to be allocated
Worldwide group's gross sales

The global formula approach does not always arrive at a reasonable or realistic result.

Deficiencies in the approach include the inappropriate allocation across all subsidiaries of:

- start-up costs of new subsidiaries;
- costs relating to specific functions performed for, or product lines carried by, only certain group members; and
- charges for services available to the group but not taken advantage of by all its members.

Another issue to be aware of concerns the level of costs associated with certain activities. For example an affiliate of an MNE may derive its income from a number of sources, such as diverse product sales, providing services and leasing assets. However, the ratio of income to expenditure may not be uniform across all these income streams, with some types of income having higher inputs per dollar of output.

Therefore, it may be appropriate to improve the above formula and associate the income and expenditure with the relevant functions. Then, once the specific functions of the concerned overseas affiliate have been identified, the costs relating to functions that the concerned overseas affiliate performs could be allocated as follows:

Gross turnover for relevant
functions of the overseas
affiliate
----- X net central expenditure on relevant functions
Gross worldwide turnover for
relevant functions of the concerned
group

TIME EXPENDED

When dealing with the service industry, it is common to speak of units of time expended to perform a task. When a central service provider performs functions for the group as a whole, it may be appropriate to allocate costs based on the amount of time expended on providing spaces to each member of the group.

Again, if services are provided that have varying degrees of value (e.g. the provision of both specialized technical assistance and general clerical activities), an allocation based only on time spent may not be appropriate. Instead, the costs should be determined for each category of service provided by the central service provider. Costs associated with each category might then be allocated among group members based on time spent providing each of those services.

The purpose of dividing costs between various categories of service is to ascertain an allocation of costs between group members that better reflects the benefits they derive. In undertaking this division, however, it may be neither worthwhile nor desirable to attempt to over-refine service categorization. In many cases, the gains in accuracy from further refining the service categorization will not be sufficient to justify the additional cost of performing the additional analysis. Having said that, the tax authorities would expect taxpayers to record the basis for any cut-off decision.

INCOME-PRODUCING UNITS

Corporations in the business of leasing plant and equipment are generally able to identify the generation of income from the utilization of specific units. Expenditure incurred in producing the income can also be more readily identified. Once it is determined what assets the concerned overseas affiliate is leasing out (as compared to the leasing of assets by the worldwide group), centralized costs in connection therewith might be allocated based on the number of units being utilized.

This principle is seen in Illustration 12 in the New Zealand Transfer Pricing Circular, as follows. A New Zealand shipping company charters ships that it owns. In allocating head office costs incurred by a foreign parent, it is likely to be appropriate to make an allocation of head office costs relating to chartered vessels over the number of chartered vessels worldwide. However, it is not likely to be appropriate to allocate head office charges of the group's entire shipping operations over the number of ships operated and leased. These types of allocations do not recognize that different types of ships have different costs, for example support vessels for oil exploration and production platforms as contrasted with roll-on-roll-off freighters.

If only support vessels are present in New Zealand, it is appropriate only to identify the **worldwide** costs applicable to support vessels. It is also necessary to distinguish between those vessels leased fully manned and bareboat charters. Once the relevant costs have been identified, they could be allocated as follows:

Support vessels in New Zealand

----- X allocation expenditure

Support vessels worldwide

(whether working or not)

GROSS PROFIT ALLOCATION BASIS

There will be situations where allocating costs on the basis of gross revenue will not be appropriate. This may be through an inability to make like comparison of the turnover of the various members of a group, because the mix of activities is not consistent throughout the group and some activities may require greater support than others. For example one member's gross turnover may be distorted by a high turnover activity, conducted only by that member and which generates little, if any, profit and requires relatively less assistance to administer (e.g. a lease that is sub-leased or a contract that is sub-contracted).

In this situation, it may be worthwhile to explore the possibility of allocating costs on the basis of relative gross profits instead. Income from non-active business sources would have to be excluded.

OTHER METHODS

There are various other keys that might be employed to allocate central expenditures. These include units produced, material used and number of employees. However, as with any other key, use of alternative keys would have to provide a cost allocation that is consistent with the benefit derived by the New Zealand entity.

CONCLUSION

It may be stated that any indirect charge method should be sensitive to the commercial facts of the individual case (i.e. the allocation key should make sense under the circumstances); contain safeguards against manipulation; follow sound accounting principles; and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the services.

In performing cost allocations, it is important not to lose sight of the overall picture. Tax authorities will seek a realistic allocation of costs, not accounting perfection. Taxpayers should attempt to determine a fair charge for services provided to a subsidiary, while at the same time making a reasonable effort to establish a coherent basis for determining the price for future services.

APPENDIX 3

US CASE LAW ON NON-INTEGRAL SAFE HARBOUR PROVISIONS

In *Hospital Corporation of America v. Commissioner*,⁷⁸ the taxpayer was able to show that a foreign affiliate was entitled to a profit for what it did. The Court held that the domestic parent had earned a profit for a variety of services it performed on the foreign affiliate's behalf, including negotiating a contract, providing a guarantee,⁷⁹ formulating a staffing plan,

⁷⁸ 81 TC 520 (1983).

⁷⁹ While the Court in *HCA* (supra, note 29) appeared to treat a guarantee as a service, in *Service in Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982) the Court of Claims

ordering supplies and equipment, and performing other services. Accordingly, US parent services performed for its subsidiary were not stewardship, but integral services. Thus, a profit mark-up plus compensation for know-how and other intangibles was required.

In *Diefenthal v. United States*,⁸⁰ the foreign corporation was able to justify a profit by showing that it had assumed a significant risk when it time-chartered vessels in and voyage-chartered vessels out. At the same time, the company minimized the value of ancillary services performed by its domestic affiliate.

In *InverWorld, Inc. v. Commissioner*,⁸¹ the Tax Court addressed the issue of whether a foreign corporation's allocation of income to its US subsidiary was an appropriate arm's length charge. The foreign parent, a financial services corporation that relied on its domestic subsidiary to provide virtually all its investment management services to clients, allocated a cost-plus profit amount which it claimed was comparable to the charges it had previously incurred for similar services rendered by an independent service provider. The IRS, having determined that the domestic subsidiary effectively provided all of the services rendered by the parent to its clients, argued that the appropriate arm's length charge for services rendered by the subsidiary to its foreign parent was the net amount of revenues the parent derived from servicing its clients.

Although the petitioner had not relied on the safe harbour use of cost as a measure of the arm's length charge, the Court went through a painstaking, but instructive, analysis of the reasons why the safe harbour did not apply. The Court concluded that the subsidiary's services were an integral part of its business under the 25% test **and** that such services were rendered to a related party as one of the subsidiary's principal activities under the facts and circumstances test.

The Court, lacking information on the relative cost of the services rendered by the subsidiary to its parent, extrapolated its conclusion from the percentage of revenues earned by the

sourced income from a guarantee-like transaction by analogy to the sourcing of interest income (rather than as service income).

⁸⁰ 367 F. Supp. 506 (E.D.La. 1973).

⁸¹ 71 TCM 3231; TC Memo 1996, 301.

subsidiary from its parent over its total revenues to conclude that the 25% threshold had been exceeded.

APPENDIX 4

NATURE OF REQUIRED DOCUMENTATION IN INDIA

Sec. 92D, read with Rule 10D of the **Indian Income Tax Rules**, has prescribed comprehensive documentation requirement; these are set out below for ready reference.

Primary documentation includes the following:

- a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held by another enterprise;
- a profile of the multinational group of which the assessee enterprise is a part, along with the name, address, legal status and country of tax residence of each of the group members with whom international transactions have been entered into by the assessee, and ownership linkages among them;
- a general description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with which the assessee has entered into transactions;
- the nature and terms (including prices) of international transactions entered into with each associated enterprise; details of property transferred or services provided; and the quantum and value of each such transaction or class of such transactions;
- a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction;
- a record of the economic and market analysis, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;
- a record of uncontrolled transactions taken into account in analysing their comparability with the international transactions entered into, including a record of

- the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;
- a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;
 - a description of the methods considered for determining the arm's length price in relation to each international transaction or class of transactions, the method selected as the most appropriate method (along with explanations as to why such method was selected), and how such method was applied in each case;
 - a record of the actual work carried out in determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;
 - the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;
 - details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules, and any consequent adjustment made to the total income for tax purposes; and
 - any other information, data or document (including information or data relating to the associated enterprise) which may be relevant for the determination of the arm's length price.

Secondary documentation includes the following:

- official publications, reports, studies and databases from the Government of the associated enterprise's country of residence, or of any other country;
- reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
- price publications including stock exchange and commodity market quotations;
- published accounts and financial statements relating to the business affairs of the associated enterprises;
- agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions; and

- letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise.