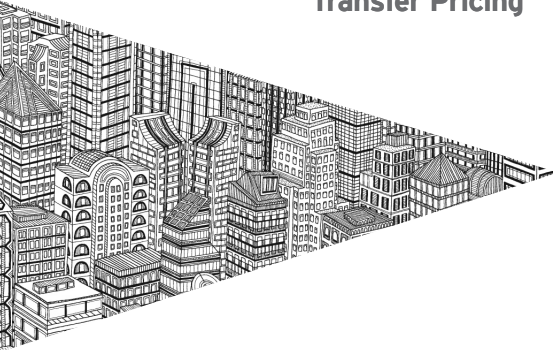


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Recent developments on transfer pricing audits in India: increased focus on transfer pricing aspects of intra group services

Executive summary

In recent years, the appropriate treatment of the intra group provision of services has become a critical transfer pricing (TP) issue in India. These types of transactions are more susceptible to audit by tax authorities.

This tax Alert summarizes recent developments in transfer pricing enforcement and audits in India relating to services transactions between related parties.

Recent TP audit experiences have shown an increased and intense focus by the Indian tax authority on TP aspects of intra group services. The approach of the tax authority has been to make a detailed enquiry into the nature of the services, the organizational structure of the Indian entity, the value of the services, the determination of costs, the benefit received by the Indian affiliate, the allocation key adopted and the methodology chosen to defend the payment. Taxpayers are typically asked to describe the activities undertaken by the foreign affiliates and are also asked to quantify the time spent in India. The nature and extent of enquiry is likely to put an onerous burden on most taxpayers, as documentation of these categories of transactions often lags behind documentation for tangible goods transactions. This is likely to result in making the already challenging Indian transfer pricing audit process even more difficult to manage. Absence of specific TP rules in India dealing with intra group services and the controversial nature of some of the issues is likely to result in complex and monetarily significant transfer pricing disputes and risks of double taxation.

In light of recent developments, taxpayers may need to consider developing or enhancing their existing documentation for these types of transactions, consider customizing their global TP platforms for intra group service transactions to meet local requirements, prepare for audits in advance by building a TP defense file based on the information/data requests made in recent audits and adopt a more proactive approach to TP dispute resolution and controversy management as early as possible in the audit life cycle.

The tax authority's approach: recent developments

In multinational groups, it is common to arrange for a wide scope of services to be made available to members of the group, particularly administrative, technical, financial, and commercial services. Such services may include management, coordination, and control functions for the whole group. If it is determined for transfer pricing purposes, that services have been provided by one member of a group to other members of that group, arm's length pricing for these intra group services must be established. The issues that arise in this context include justifying that a benefit is anticipated to be or has been obtained from the performance of services and determining that the amount charged is arm's length.

The Indian tax authority has become increasingly sophisticated in its management of TP issues. An audit begins by the tax authority reviewing the transfer pricing

documentation prepared by the taxpayer. Even though the Indian regulation has prescribed detailed transfer pricing documentation requirements for some intercompany transactions, no specific guidance has been given for intra-group services. Transfer Pricing Officers (TPOs) scrutinize payment for the intra-group services in great detail. Once in an audit phase, the TPO will gather information, usually by the issue of notices or information requests. While payments for intra-group services have generally been a focus area during a TP audit, recent experiences seem to indicate an even higher degree of scrutiny and enquiry. The information/data request made by the TPOs, are fairly comprehensive as well as quite specific. Some of the information/data that have been requested in recent audits are outlined below:

- ▶ A copy of the inter-company service agreement for providing and receiving the intra group service
- ▶ Information pertaining to the services, including description and uniqueness of services
- ▶ Demonstration of the benefits:
 - Details of the cost-benefit analysis undertaken at the time of entering into the inter-company agreement showing expected benefit from the receipt of such services vis-à-vis payment made for the same
 - Copies of time sheet or cost center reports to evidence the provision of service

- Details of time spent with respect to services rendered to India
- Quantification of the benefits derived to establish that the services rendered are not shareholder activities" or incidental in nature
- Organization chart and job descriptions of the staff at the service provider and the recipient to establish that there is no duplication of services
- Other documents like copies of emails exchanged, minutes of meeting/calls, management reports, periodic activity report, proof of visit, etc., to demonstrate the receipt of services
- ▶ Justification of arm's length price
 - Is a charge justified relative to the benefits?
 - Basis of determination of the service charge - whether it is a direct charge or an indirect charge
 - Detailed invoices from the service provider, which should give full details of services provided during the period of contract and confirmation that fee calculation is in accordance with the agreement
 - Details of service charge paid by other affiliates to the affiliate service provider
 - Whether the service provider is providing similar services to an independent party and if yes, the charge rate to such independent party

- A certificate from an “accountant”, if possible, certifying the charged cost and the method of charge allocation among affiliates

The information/data request also states that the arm’s length price for the intra group service will be treated as nil if the taxpayer fails to furnish the necessary information.

From a review of the information/data requests, it appears the tax authority would expect a taxpayer to have the ability to demonstrate that a service has been rendered by an overseas affiliate and that the Indian taxpayer has received an economic or commercial benefit that has enhanced commercial position of the recipient. This test, known as the benefit test, is critical to determine whether an unrelated party would pay for an intra group service and therefore, whether the service provider can justify a charge for the provision of the intra group service under arm’s length conditions. It also appears that the tax authority expects a taxpayer to demonstrate the benefits received are not remote or incidental or the activities are not shareholder activities or the services are not duplicative in nature. Inherent in the information/data request is the expectation of the tax authority of a functional analysis of the members of the group to establish the relationship between the relevant services and the members’ activities and performance.

Recent Tribunal ruling

The Bangalore Income Tax Appellate Tribunal (Tribunal), in the case of *M/s Gemplus India Pvt. Ltd*¹ (Gemplus India), ruled on transfer pricing aspects of management services fees paid by Gemplus India to its regional headquarter company (HQ). The Tribunal held that Gemplus India had not proved the commensurate benefits received for the service fees paid to the HQ and, hence, ruled the payment of the management services was not justified under arm’s length principles. The Tribunal, in this case, relied on the underlying documentation of Gemplus India before concluding there were no details available on record with respect to the nature of services rendered by the HQ to Gemplus India.

Implications for taxpayers

Taxpayers may experience more intense audit activity on intra group services and more TP disputes. In the absence of adequate underlying documentation, the tax authorities may contend that the services rendered by the foreign affiliate are either shareholder activities or do not provide a specific benefit to the Indian affiliate, and therefore under arm’s length conditions, do not justify a charge. Furthermore, because of the information/data requests, compiling the necessary information is likely to be an onerous and time consuming task for taxpayers, which may be further compounded by the short time frame in which the tax authority would typically expect the taxpayer to respond.


¹ 2010-TII-55-ITAT-BANG-TP

Absence of specific TP rules in India dealing with intra group services and the controversial nature of some of the issues is likely to result in complex and monetarily significant transfer pricing disputes and risks of double taxation.

What should taxpayers do?

Taxpayers may need to consider the following for managing the likely challenge:

- ▶ Develop or enhance documentation for these types of transactions. As identified in Ernst & Young’s 2010 Global Transfer Pricing Survey, documentation of service transactions (along with IP and financing transactions) often lags behind documentation for tangible goods.
- ▶ Taxpayers may need to tailor their global TP platform for analysis of intra group service transactions to local requirements in view of the higher risk of scrutiny. Taxpayers should look at developing an integrated global and local approach to documentation.
- ▶ Prepare for an intensive TP audit on these types of transactions in advance by building a TP defense file based on the information/documents that may be requested during an audit.
- ▶ Consider a more proactive approach to controversy management and dispute resolution early in the life cycle of an audit.



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