

Benefit Test in Transfer Pricing

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Introduction

We are living in a globalized world and it is the age of the global Multi-National Enterprise today. Majority of the economies of the world are dominated by the Multi-National Enterprise of various sizes as organisations spread their wings seeking newer markets or cost-saving benefits. One of the features of these MNE's being sharing of resources amongst the various locations to save costs. The sharing of resources results in rendering of Intra-group services. Therefore, Intra-group services are those which are performed by one member of a MNE for the benefit of one or more related members (located in different tax jurisdiction) of the same group.

In general, the categories of services that could be regarded as intra-group services include the following:

- management services;
- administrative services; coordination, budgetary control, financial advice, accounting, auditing;
- research and development;
- product development;
- technical services;
- purchasing, marketing and distribution;
- engineering services;
- staff-related matters, such as recruitment and training; etc.

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;
- incidental benefits received, solely attributable to being part of a group
- passive association benefits; and
- on-call services

India is host to a range of MNE's and the presence of such Intra-group service payments is a common feature in these MNE's. During the Transfer Pricing (TP) assessment it is common for the Transfer Pricing Officer (TPO) to analyse these Intra-group service payments in detail as services being intangible, there is a chance that associated enterprises (AEs) would indulge in payments for fictitious services. In many instances the TPO has arrived at an ALP value of 'Nil' for such Intra-group service payments by applying the 'Benefit Test' to these transactions. In this article we will be

discussing the 'Benefit Test' applied to Intra-group services during the Transfer Pricing assessment in detail.

Benefit Test

For benchmarking arm's length price of an International Transaction many countries adopt the benefit test to ascertain whether intragroup services are actually provided or not. Even the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing guidelines give preference to benefit test which is discussed in subsequent paragraphs in detail.

OECD Transfer Pricing Guidelines on Benefit Test

As per OECD TP guidelines of 2010 Chapter - VII there are two main aspects to be considered while determining the arm's length price of intra group services which are determined as under:

a) Whether intra-group services have been rendered

Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position.

This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise. If the activity or service is not the one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

Further, benefits obtained from an intragroup service purchase or benefits expected from the transaction must be analysed from the perspective of both the parties

b) Whether the amount of the charge, if any is in accordance with the arm's length principle.

Once it is determined that an intra-group service has been rendered, it is necessary to determine whether the amount charged for the transaction is at arm's length.

This means that the charge for Intra-group services should be that which have been made and accepted between independent enterprises in comparable circumstances.

To justify the arm's length nature of intra group services, the next step would be to Identify actual arrangements to charge for intra group services. The 2 types of charging methods are :

- i. Direct charge method – More suitable where it is obvious that a service has been rendered and especially if the MNE rendered the specific services to unrelated third parties at the same time and the MNE has the ability to demonstrate a separate basis for charge;
- ii. Indirect charge method – Applicable only if similar services are not rendered to independent parties; Certain cost allocation and apportionment methods which necessitate some degree of estimation or approximation are adopted which must be sensitive to commercial features of individual case

Benchmarking intragroup services - Transfer Pricing Guidelines – other countries

In considering the arm's length return for intra-group services the benefit to the recipient of the services if any should be taken into consideration. If no benefit is received by the recipient of the service, as per common parlance no remuneration should be actually paid for such transactions as there is no benefit received by the recipient of service. When there is no benefit received by a related party in an International Transaction there is no requirement for consideration to be paid. When any consideration is paid without any benefit being received by the party then such consideration paid will not be considered as at arm's Length as there was no requirement for any consideration to be paid in the absence of benefit element in the transaction. A few countries have specific guidelines on benchmarking of Intra-group services for transfer pricing purposes. Below fig. 1.1 is an extract of Transfer Pricing guidelines on Intra-group services as per Singapore Transfer Pricing law.

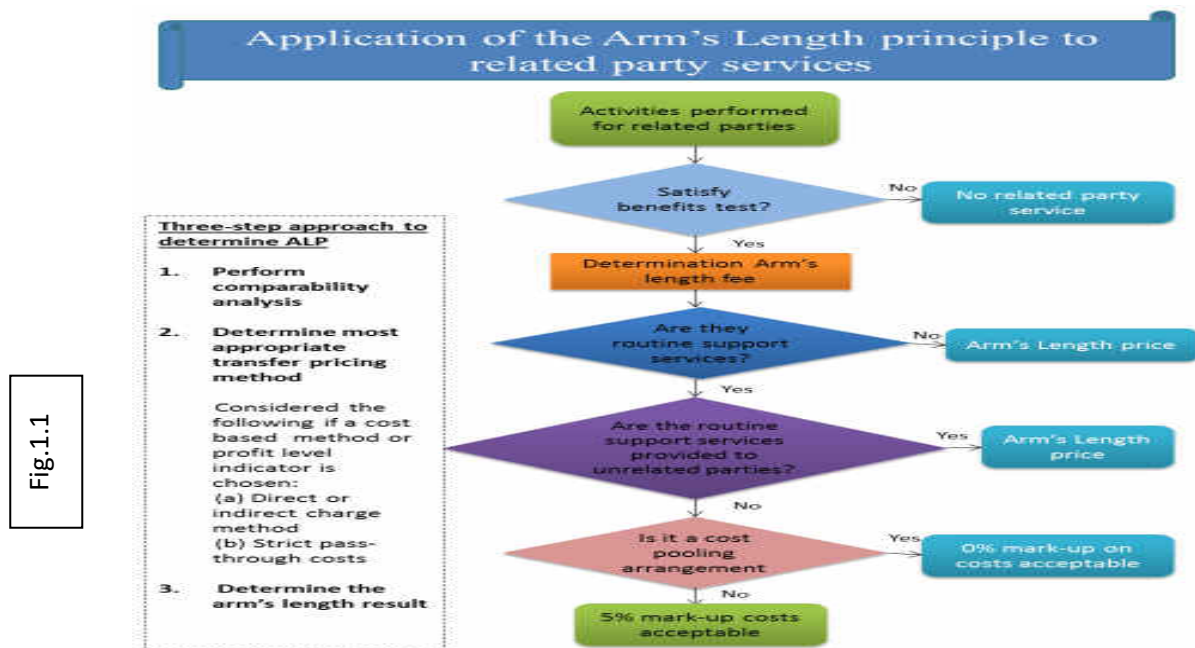


Fig. 1.1

Intra-group services – Indian TP Landscape

Unlike the Singapore TP guidelines as mentioned above, the Indian TP provisions do not contain any specific guidelines on Intra-group service payments. In many cases the TPO has arrived at an ALP value of 'Nil' arriving at a conclusion that no benefit has been obtained by the assessee from such intra-group service payments. These orders of the revenue authorities have been challenged before the judiciary to a degree of varying success.

Decisions in favour of the Assessee

Dresser Rand ⁽¹⁾

- TPO/AO cannot question the commercial wisdom of the taxpayer
- Disapproved that since the taxpayer has qualified staff on its roll, there was no need to obtain such services from its AE
- Services availed by the taxpayer is legitimate – furtherance of its business interests entails such costs

- Allocation of cost on the basis of headcount and turnover is reasonable

McCann India Pvt Ltd. ⁽²⁾

- Substantial evidence placed on record of benefits of services provided by AE
- Entity level benchmarking using Transaction Net Margin Method was accepted
- Assessing Officer (AO) cannot dictate the business needs. The term 'benefit' has wide connotations.

Safran Aerospace India Private Limited ⁽³⁾

- Not necessary for the assessee to show that any legitimate expenditure incurred by him was incurred out of necessity
- Not necessary to establish that it has resulted in any profit or income either in the same year or in any of the subsequent years
- Expenditure should have been incurred wholly and exclusively for the purpose of business

Decisions in favour of the Revenue

Gemplus India Pvt Ltd. ⁽⁴⁾

- The charge for management must be commensurate with the nature, volume and quality of services
- There were no evidence/details available on record to demonstrate the nature of services rendered
- The tribunal held that the expenses incurred should ideally be apportioned on the basis of actual services rendered to the individual units

In **Knorr-Bremse India Pvt Ltd.** ⁽⁵⁾ the tribunal had decided the case in favour of the revenue on the grounds that the perusal of the documents reveal that the activities are in the nature of shareholder activities and the intra-group services provide only incidental and passive association benefit has been provided by the AE. However, this was challenged before the High Court by the assessee, on the grounds that the revenue cannot question business expediency of a transaction and also as the assessee had adopted Transaction Net Margin (TNM) Method to benchmark transaction and Intra-group services need not be benchmarked separately since the revenue had not questioned the TNM Method. The P&H High Court in its November – 2015 order remanded the matter back to the tribunal arriving at its conclusion that, *“on a reading of the orders of the TPO, the DRP and of the Tribunal makes it clear that one of the main reasons for not accepting the assessee’s case was that the assessee had not been able to substantiate that the payment for the services had actually increased its profits. As we noted earlier, the TPO, in fact, further held that the assessee should have been able to show the level of increase in profit post the said transactions. We are unable to agree with this finding. The answer to the issue whether a transaction is at an arm’s length price or not is not dependent on whether the transaction results in an increase in the assessee’s profit. This would be contrary to the established manner in which business is conducted by people and by enterprises. Business decisions are at times good and profitable and at times bad and unprofitable. Business decisions may and, in fact, often do result in a loss. The question whether the decision was commercially sound or not is not relevant. The only question is whether the transaction was entered into bona fide or not or whether it was sham and only for the purpose of diverting the profits.”*

Conclusion

Benchmarking of Intra-group services has always been a challenge. Though the judiciary in many cases such as Knorr-Bremse case law which followed the precedent laid down by the decision of the Delhi High Court in **CIT vs. EKL Appliance Ltd.** ⁽⁶⁾ have consistently ruled that question of business expediency/benefit test cannot be a ground for making an adjustment to the transfer price for Intra-group service, nevertheless it is advisable for assesseees to maintain substantial documents evidencing receipt of intra-group services (Eg: Written Contracts, Letters, Manuals, Proof of Visits, Time sheets, etc.,) for a smooth transfer pricing assessment process. Further, it is pertinent to note that under the Indian tax regulations, the primary onus to prove that the international transactions are at arm's length is on the taxpayer and the tax authorities have powers to make appropriate adjustments where such onus is not adequately discharged by the taxpayer.

The Base Erosion and Profit Shifting (BEPS) Action Plan 8-10 of the OECD also have focused on the benchmarking of Intra-group service where Chapter – VII of the Action Plan defines a wide category of low-value adding Intra-group services and a simplified approach to benchmark the same. India has been a frontrunner in adoption of the BEPS recommendations and we may be soon witness to a change in the Transfer Pricing provisions of the Income-tax Act, 1961, incorporating the recommendations of the BEPS Action Plan 8-10.

References:

- (1) Dresser-Rand India Private Limited v. ACIT [(ITA no. 8753 / Mum / 10) dated 7 September 2011]
- (2) McCann Erickson India Pvt. Ltd. v. ACIT (ITA No. 5871/Del/2011)
- (3) Safran Aerospace India Private Limited v. DCIT (ITA No. 1261/Bang/2010)
- (4) Gemplus India Private Limited. V. ACIT (ITA No.352/Bang/2009) Asst. Year – 2003 -04
- (5) Knorr Bremse India Pvt. Ltd. V. ACIT (ITA No. 5097/Del/2011),
Knorr Bremse India Pvt. Ltd. V. ACIT (ITA Nos.182 & 172 of 2013) (Punjab & Haryana HC)
- (6) CIT vs EKL Appliances (ITA No 1068/2011 &.1070/2011) (Delhi High Court)