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Intra-Group Service Payments

Tax Risk Mitigation Approach vs. Tax Litigation Approach

In the globalised world, every multinational enterprise ('MNE') would like to work on their strengths to enable efficient and successful supply chain management. In the current scenario, business is not only provision of goods and services to the ultimate external customer, but also provision of such goods and services to the internal customer. In a modern organisation, while the department of sales interacts with the final customers, every department in the supply chain of the MNE is working towards delivering the product and services to the next leg in the supply chain, where such next leg is considered as an internal customer in the group.

Now, let us take in to consideration that the various functions in the value chain are located in different countries and different companies. While it wouldn't have been a necessity to invoice pertaining to inter department transfers if the products or services pass from one supply chain department in the same company in the same country, the structure assumes an importance when such supply chain is rooted in various countries. Such an importance is placed due to the fact that every country has separate profit centres to pay taxes and the respective governments have a right to tax the profits generated out of functions undertaken, assets employed and the risks assumed being a part of the supply chain. Such profits should be fair and at arm's length price, what other independent organisations would have earned from performing similar functions.

While the issue is complicated enough when one considers transfer of goods, the issue assumes the next level of complexity when the transfer between the MNE corporation involves provision of service. Such a service provided from one company to another, forming a part of same group, is considered as an intra-group service and it is necessary that such services are provided at an arm's length transaction. Such services may include Management Services / Charges, Back office ITeS and IT Support services, Accounting and Administration Services, Technology Services etc. The Shareholder Services, Incidental services, Duplication Services which does not carry charge a remuneration are not a part of this write up, yet certain principles could be adopted to represent the services in their respective transfer pricing documentation.

Further, this snippet is written from a perspective of the issues involved during payments made for intra-group services rather than income received from intra-group services. Considering transfer pricing risks on booking of expenditure for intra group services, possibly the MNEs would consider it as one of the top priorities. With plethora of cases and additions made on the topic of intra group service payments, the issue remains common and in search of possible solution to mitigate this risk of litigation around the topic.

Let us understand the genesis of the issue itself. An inherent difference between intra-group transfer of goods and services is tangibility. While transfer of goods could be traced back to the origin, the transfer of services is very fluid and without tangible existence. For example – A discussion on a telephone call made by a customer of a local company to the subsidiary of the local company in a different tax jurisdiction is difficult to be traced and valued, therefore the payment made by parent company to the subsidiary company would come under the scanner of the Income-tax authorities. Moreover, shifting of profits from one jurisdiction to another, intra-group services were considered as one of the tax effective measures of tax avoidance.

There are two main aspects of a transaction that needs to be justified by the taxpayer:

Aspect 1: To prove that the service is indeed provided;

Aspect 2: Valuation of service.

While you may have seen numerous transfer pricing documentations on Aspect 2 mentioned about 'Valuation of service' with all the complex methodologies and formulas, often such strategies fail to answer Aspect 1 of the Intra Group service arrangement. The result is an ad-hoc addition by the Revenue due to non-maintenance of documentation around Aspect 1 mentioned above. Once Aspect 1 with regard to the provision of service is proven, Aspect 2 is an easier element to prove to the Revenue.

Often the taxpayer has used time sheets and attendance records as a tool to prove the service provision, however such records being internal to the company are not relied upon by the tax authorities. A simpler methodology could be to use third party audit services and certifications with simpler techniques to prove a service provision that could be effective with the transfer pricing authorities. Although such an approach may seem complex, yet in practice it is simple to implement with a bit of meticulousness and perseverance on the topic of transfer pricing throughout the year. A successful planning and organising of an international transition could go a long way in mitigating the tax risks by providing satisfactory and on the target documentation to the taxation authorities.