

(Un)Rule of Law?: Transfer Pricing Law Around Intra-group Services

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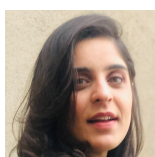
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Introduction: Transfer Pricing Guidelines issued by the OECD:

The arm's length principle is the international transfer pricing standard that has been set and accepted by the Member Countries of the Organisation for Economic Co-operation and Development ("**OECD**"), to govern the transactions amongst associated enterprises ("**AEs**"). This principle requires benchmarking of such related party transactions in order to eliminate the effect on such transactions owing to the relationship between such parties. In other words, the transaction between related parties must be brought on par with a transaction which would be conducted between two independent parties. However, where independent parties do not undertake transactions of the type entered between AEs, this principle inherently fails. While the OECD recognises the difficulties in the application of this principle in such cases, it also cautions tax administrations to not automatically assume that AEs, by entering into such arrangements, have manipulated profits. In fact, the OECD categorically states that the mere fact that a comparable uncontrolled transaction may not be found, does not by itself lead to the conclusion that the transaction between the two AEs is influenced by the relationship. It is in this context, that the OECD also states that transfer pricing is not an exact science and that it requires the exercise of judgment on the part of both the tax administration and the taxpayer.[\[1\]](#)

At the same time, one of the main issues that the OECD itself considers for the application of this principle is **whether intra-group services have been rendered or not?**

This is one of the questions, which has perplexed the Indian tax administration as well as courts for a decade and a half now. While the OECD acknowledges that lack of a similar uncontrolled transaction does not itself render the international transaction between the AEs to not to be at arm's length, it

provides a somewhat inconsistent guidance in answer to the question afore-stated, as follows:[2]

- **Benefit Test:** The OECD states that where an independent enterprise in comparable circumstance would be willing to pay for the activity, if performed by an independent enterprise, or if the independent enterprise would have performed the activity in-house for itself, it could be considered that an intra-group service has been rendered. This is because, in such a case, it could be deemed that the activity in question has provided economic or commercial value to the concerned member of the multinational enterprise (“**MNE**”) group, which enhances or maintains its business position. However, where the activity in question is not one for which an independent enterprise would be willing to pay or perform for itself, the OECD states that such activity “ordinarily should not be considered as an intra-group service under the arm’s length principle”.
- **Shareholder activity:** An activity that a member of an MNE group performs solely because of its ownership interest in one or more other group members, would not qualify as an intra-group service under the arm’s length principle and would therefore, not justify any payment in lieu such shareholder activity.[3]

The judicial approach in India:

While considering these guidelines, the Delhi High Court, in *CIT v. Cushman and Wakefield (India) (P.) Ltd.*[4], observed that:

- The OECD TP Guidelines were not binding and that the OECD TP Guidelines themselves recognised that each case would depend on its own facts and circumstances.
- While the guidance of the OECD on intra-group services was relevant, its strict adherence, bordering on rigidity, would be antithetical.
- The Transfer Pricing Officer (“**TPO**”) is to conduct a transfer pricing analysis to determine the arm’s length price (“**ALP**”) of an international transaction and not to determine whether there is a service or not, from which an assessee benefits. The exercise of determining whether an assessee has benefited from an intra-group service, falls within the domain of the Assessing Officer (“**AO**”) under section 37 of the Income-tax Act, 1961 (“**Act**”).
- The determination of whether an intra-group service exists/ has been rendered, also falls within the domain of an AO under section 37 of the Act and not a TPO.
- However, a TPO, after considering facts, may come to the conclusion that the ALP of the international transaction is “NIL”, given that an independent entity in a comparable transaction would not pay any amount.

This last observation of the Delhi High Court throws the question – “**whether intra-group services have been rendered or not?**”, back in the loop, with added subjectivity. Where a TPO finds a comparable situation, obviously, there would not be any difficulty in determining the ALP of the intra-group service in dispute. However, where no comparable uncontrolled situation is found, could the TPO, based on a subjective judgment, determine the value of the international transaction at “NIL”?

The answer to this question is in the negative. It has been held time and again, for example, by the Income Tax Appellate Tribunal (“**Tribunal**”), in *DCIT v. Flakt (India) Ltd.*,[5] that the ALP of an international transaction has to be determined by a TPO in accordance with section 92C read with Rule 10B of the Income-tax Rules, 1962 (“**Rules**”) alone.[6] Rule 10B of the Rules prescribes the methods for benchmarking the price of an international transaction. An assessee, who has entered into an international transaction, is required to select the most appropriate method (“**MAM**”), out of the methods prescribed in Rule 10B of the Rules.

For example, comparable uncontrolled price (“**CUP**”) method, which is contained in Rule 10B(1)(a) of the Rules, requires the comparison of the price charged in the international transaction between two AEs with the price charged in a comparable uncontrolled transaction. On the other hand, transactional net margin method (“**TNMM**”), which is contained in Rule 10B(1)(e) of the Rules, requires comparison of the

net profit margin on an entity level, derived by an assessee, who has an international transaction with its AE, with the net profit margin of an entity in a comparable uncontrolled situation.

This comparability analysis is therefore, sine qua non, for determining ALP of an international transaction. Without identifying an uncontrolled transaction, the Tribunal in *Flakt (supra)*, held that the TPO could not independently compute the ALP of the international transaction in dispute.

The decision in *Flakt (supra)* was followed by the Tribunal in *Howden Solyvent (India) Pvt. Ltd. v. DCIT*,^[7] wherein the Tribunal reiterated (without referring) the position laid down in *Cushman and Wakefield (supra)*, that the role of a TPO was limited to determining the ALP of the transaction and not to adjudge the same at the threshold of business need/ requirement of the assessee concerned. In *Howden (supra)*, the Tribunal held so while observing that the intra-group services received were general/ routine in nature and that it was mandatory for a TPO to identify comparable uncontrolled situations to apply CUP.

Judicial trend in the favour of assessee:

Therefore, there being no contrary decision from another High Court, the decision in *Cushman and Wakefield (supra)* seems to be the authority, which should be followed by the Coordinate Benches of the Tribunal. In fact, recently, the Tribunal in *DCIT v. Apollo Gleneagles Hospital Limited*,^[8] has followed the said decision and observed that:

1. Where the assessee benchmarked its international transaction using TNMM, such method was not entitled to be discarded by the TPO, without demonstrating that some other method, as prescribed in Rule 10B of the Rules, would be the MAM.^[9]
2. The TPO exceeded his jurisdiction by questioning whether or not services were received and whether or not the assessee derived benefit from the intra-group services in dispute.
3. It is not the domain of a TPO to question the commercial expediency of the expenses and that his role is limited to determining the ALP.^[10]
4. The real question which is to be determined is whether the price for receiving an intra-group service was what an independent enterprise would have paid for.

The decision in *Cushman and Wakefield (supra)* is also extremely relevant, since it approves the decision of the Tribunal in *Dresser-Rand India (P.) Ltd. v. Addl. CIT*,^[11] wherein it has been held that it was wholly irrelevant for the TPO as to whether or not the intra-group service in dispute was received by an assessee free of cost i.e., on a gratuitous basis in preceding years.^[12] Merely because the assessee did not pay for an intra-group service in the preceding year cannot lead to a conclusion that the ALP thereof is NIL. It should also be borne in mind that the transfer pricing provisions contained in Chapter X of the Act, cannot apply where the effect of their application would lead to reduction of taxable profits in India.^[13] Therefore, where an assessee did not pay any amount during any preceding year for the intra-group service received by it, there could not be any upward adjustment under Chapter X of the Act, since the same would lead to an increase in expenditure in the hands of the assessee and consequently, to a decrease in profits chargeable to tax in India.

Judicial trend against assessee:

There have been multiple decisions of the Coordinate Benches, which do not follow the principles laid down in *Cushman and Wakefield (supra)*. The latest one being *International Flavours & Fragrances India Pvt. Ltd. v. DCIT*,^[14] wherein the Tribunal observed and held as follows:

1. Unless the transactions are closely linked to each other and the same belong to a particular class of transactions, aggregation approach (under TNMM) could be discarded, and the transactions could be benchmarked separately.
2. The assessee was availing the intra-group services in the past as well without making any payment.^[15]

3. The email correspondences produced by the assessee to substantiate the receipt of services were very general. Therefore, the assessee failed to prove that it had received specialised services, for which a separate payment was warranted.
4. The complete onus was on the assessee to establish receipt of the intra-group service, which the assessee failed to discharge.
5. Therefore, determination of ALP by the TPO by applying CUP (without identifying any comparably uncontrolled situation) and disregarding TNMM was correct.

The Tribunal, in this decision, followed the decision of the Coordinate Bench in *Akzo Noble India Ltd. v. Add CIT*.^[16] Similar view has been taken in many decisions,^[17] including those mentioned hereinabove, which do not make any reference to the law as laid down in *Cushman and Wakefield* (supra).

The nebulous situation:

Rule of law is a set of principles, describing the way a particular choice ought to be exercised in similar or analogous situations. Effectively therefore, it allows for a degree of precision, away from a state of lawlessness and recklessness. While “discretion” in administration of rule of law is a necessary evil in the pursuit of justice, yet, institutions ought to be structured in a way so as to limit discretion, towards consistency, uniformity and certainty. The question whether rule of law or judicial discipline is observed strikes as an even closer or serious one, when viewed from an investor perspective.

The above set out paragraphs reflect a conventional complacency with respect to the rule of law. The question really is whether it is open to the Tribunal to overlook the binding precedent of the High Court, absent any contrary view being taken by any other High Court?^[18]

In our view, the correct interpretation of the law would be that the assessee should be in a position to provide documentation which is also the mandate of section 92D of the Act, in respect of the international transactions. This would enable the TPO to not only determine the nature of services but would also enable the TPO to correctly apply the Function, Asset and Risk (“FAR”) test and determine the correct comparables for benchmarking the ALP of such international transactions. Whether the service has actually been rendered or not in a particular year is outside the parameters contained in section 92CA(3) of the Act and as such the TPO should desist from encroaching the parameters of section 37 of the Act.

^[1] OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration 2022 (“OECD TP Guidelines”).

^[2] The other instances that OECD Guidelines sets out are Duplication Test, Incidental Benefit Test, Centralised Services scenario etc.

^[3] A shareholder activity is different from a stewardship activity.

^[4] [ITS-150-HC-2014\(DEL\)-TP](#). Appeal against this decision before the Supreme Court was withdrawn (order dated 02.03.2021), on the ground of filing of application under Direct Tax Vivad se Vishwas Act, 2020.

[5] [\[TS-319-ITAT-2016\(CHNY\)-TP\]](#)

[6] CIT v. Lever India Exports Ltd [\[TS-23-HC-2017\(BOM\)-TP\]](#)

[7] Appeal bearing ITA 732/Chny/2015, judgment dated 31.10.2022 (Chennai – Trib.) [\[TS-773-ITAT-2022\(CHNY\)-TP\]](#) See also, M/s Diab Core Materials Pvt. Ltd. v. DCIT, appeal bearing ITA No. 2176/Chny/2017, judgment dated 18.05.2022 (Chennai – Trib.) [\[TS-315-ITAT-2022\(CHNY\)-TP\]](#)

[8] Appeal bearing ITA No. 1501/Kol/2019, judgment dated 27.04.2023 (Kolkata – Trib.) [\[TS-253-ITAT-2023\(Kol\)-TP\]](#)

[9] AWB India (P) Ltd. v. DCIT [\[TS-327-ITAT-2014\(DEL\)-TP\]](#)

[10] CIT v. EKL Appliances Ltd [\[TS-206-HC-2012\(DEL\)-TP\]](#)

[11] [2012] 13 ITR(T) 422 (Mumbai – Trib.).

[12] This aspect has also been held by the Tribunal in DCIT v. Bata India Ltd [\[TS-149-ITAT-2016\(Kol\)-TP\]](#)

[13] Refer in this regard, section 92(3) of the Act.

[14] Appeal bearing ITA No. 58/Chny/2018, judgment dated 27.04.2023 (Chennai - Trib.) [\[TS-251-ITAT-2023\(CHNY\)-TP\]](#)

[15] This observation is directly contrary to Dresser-Rand (Supra) [\[TS-5451-ITAT-2011\(MUMBAI\)-O\]](#)

[16] [\[TS-124-ITAT-2022\(DEL\)-TP\]](#), upheld in [\[TS-774-HC-2022\(DEL\)-TP\]](#). In the facts of this case, it would be seen that even the basic documentation was not available on record which could assist the TPO in determining the nature of services.

[17] For example, Faurecia Automotive Seating India (P.) Ltd. v. DCIT [\[TS-745-ITAT-2022\(PUN\)-TP\]](#) wherein the Tribunal has held that receipt of services is sine qua non for justifying deduction towards payment. However, it must be noted that this principle is relevant for the jurisdiction of an AO under section 37 of the Act, as held Umakant B. Agarwal v. DCIT, [2014] 369 ITR 220 (Bombay High Court).

[18] CIT v. Godavaridevi Saraf [\[TS-5423-HC-1977\(BOMBAY\)-O\]](#)