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Intra-group services and shareholder activities

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Tax authorities and taxpayers have experienced numerous disputes over the definition of intra-grou services and the applicability of the arm's length principle to such services. The following article discusses the issues involved.

I. General overview

A multinational group is a conglomerate of multiple entities working in various geographic regions at different sizes and scale of operations. The group is regarded as a collective unit that functions by mutual cooperation and assistance, focusing on increasing its efficiency and wealth. In its endeavour to improve synergies and its market position, it is common for the ultimate parent company to render a range of services for all its group entities on a centralized basis.

Usually, a range of services is provided by the ultimate parent company or through another company of the group whose primary purpose is to render such services. This is done for a number of reasons, ranging from cheaper labor and capital being available in various jurisdictions, to improving the efficiency or productivity of a group as whole by avoiding the duplication of resources for each entity on a standalone basis. These services are commonly referred to as *intra-group services*.

Out of several widely disputed issues between the tax authorities and the taxpayers, arm's length pricing for intra-group services is one of the most common issues. Arm's length pricing for intra-group services remains one of the global transfer pricing challenges for taxpayers and tax authorities alike.

The main feature of a service is its *intangible character*. In the case of the sale/purchase of goods/property, what has been purchased or sold can be easily identified. However, due to the intangible character of services, it is very difficult to identify the services actually received/rendered. In the case of goods, one is not required to substantiate the occurrence of the transaction and only one question needs to be addressed: whether the sale/purchase of goods/property is at arm's length. However, in the case of provision of services the question of *whether the service transaction has actually occurred* also needs to be addressed.

There are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group chargeable services have in fact been provided. The other issue is what the intra-group charge for such services should be in accordance with the arm's length principle.[1]

With respect to the second issue, in general, the taxpayers have experienced lesser disputes with the tax officers. The reason for this is that taxpayers are able to provide a comprehensive set of documents, including the cost charge mechanism (whether direct or indirect), details of cost components, constituents of total cost pool, identification and segregation of non-chargeable costs, allocation drivers, share of Indian taxpayers etc., to the satisfaction of the tax authorities.

It is primarily with respect to the first issue that the tax authorities aggressively scrutinize the available documentation with the taxpayers and require them to substantiate the receipt of services and the consequent benefits accrued to the Indian taxpayer.

The first issue has another two components attached. The first is whether the services have been rendered, i.e. occurrence, and the second is the subsequent benefits accruing from it. One can still substantiate the occurrence of an event with the aid of subsequent documents generated in the course of providing services, i.e. emails correspondences, reports,

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presentations, memos, circulars etc. Addressing the second component, i.e. benefits accruing to the recipient of the services, remains a challenge.

It is, in general, an accepted principle that shareholder services should not bear a charge, as the benefits from shareholding activities ought to be received by the provider of the services rather than the recipient.

Hence, the greater question that arises is what constitutes a shareholder activity. The current OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 (amended since 1995), lists the following as shareholder activities:

- costs of activities relating to the juridical structure of the parent company itself, such as parent company shareholder meetings, issuing shares in the parent company and supervisory board costs;
- costs relating to reporting requirements of the parent company, including the consolidation of reports; and
- costs of raising funds for acquisition by its participants[2]

The current definition given by the OECD Guidelines on what constitutes a shareholder activity was reached after a couple of deliberations in past decades. It is interesting to analyse the evolution in the definition of shareholder activity. Historically, the OECD has been entrusted with the responsibility to provide guidelines on core tax issues which have a global impact. The first guidelines issued by the OECD in relation to the treatment of intra-group services were issued in 1979 and provided, among other things, the concept of central coordination and managerial activities. However, the guidelines did not provide a clear methodology on how to treat the costs of such activities.

Since the 1979 guidelines provided no clear methodology on this, and the member countries had different views on the treatment of such centralized activities, the OECD came up with the 1984 Report on 'The allocation of central management and service costs'. Although the report provided a broader definition of benefits, it failed to bring a consensus on the treatment of central coordination and managerial costs, because it provided two extreme approaches on how to deal with them.

Considering the non-consensus between the member countries and at the same time keeping itself with the pace of economic evolution taking place, the 1995 Guidelines shifted from an 'activity-centric' approach to a 'comparable circumstances' approach. They did not focus on whether a particular centralized activity would classify as a chargeable/non-chargeable service. Instead, they looked at testing the service recipient's 'willingness to pay' a third party under comparable circumstances.

Like the OECD, for decades the US Regulations have witnessed significant deliberations on how to deal with central coordination and managerial services. With the US as the largest economy in the world, their regulations should be examined for guidance on the treatment of centralized managerial services, which has remained a controversial issue worldwide.

We have therefore discussed the developments taken place in the OECD Guidelines and US Regulations in the subsequent paragraphs to ascertain what constitutes a 'service' and what consequent 'benefit' can accrue from it.

II. What constitutes an intra-group chargeableservice?

Before contemplating what constitutes a shareholder activity, it is necessary to understand what constitutes a service under currently enforced OECD Guidelines and US Regulations.

The OECD Guidelines, 1995 (now 2010), in paragraph 7.6, define a service as follows:

Under the arm's length principle, the question of 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.

The U.S. Regulations, in Regs 1.482-9(I)(1), include the following definition of a service:

A controlled services transaction includes any activity (as defined in paragraph (l)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (1)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

According to the above definitions, a service would mean an activity performed by an enterprise which provides an associated enterprise with a benefit. Therefore, activities which do not provide an associated enterprise with a benefit would not be considered as intra-group chargeable services.

III. What constitutes a shareholder activity?

It is natural to understand that services other than intra-group chargeable services are characterized as shareholder services. However, it is also pertinent to directly identify what classifies as a shareholder service.

A. OECD Guidelines

Paragraph 7.9 of the OCED Guidelines, 1995 states that an activity performed by a group member (usually the parent company or a regional holding company) solely for its ownership interests in one or more other group members, i.e. in its capacity as a shareholder, would be referred to as "shareholder activity" and would not justify a charge. It also provides that a shareholder activity should be distinguished from the broader term "stewardship activity" used in the 1979 Report. The 1995 guidelines also state that the costs of managerial and control (monitoring) activities, as mentioned in the 1984 Report, whether falling within the definition of shareholder activities or not, should be determined according to the facts and circumstances of the activity and whether an independent enterprise would be willing to pay to perform for itself.

It is therefore of great importance to understand the guidelines of the 1979 and 1984 Reports to gain a

clearer understanding of the evolution of the definition of shareholder activities.

1. The OECD Report of 1979

According to the 1979 OECD Report, activities of a servicing nature provided within a group of associated enterprises fall into the following three categories.

1. Activities of the parent company acting in its capacity as a shareholder (shareholder activities)
   Activities in the nature of managing and protecting the investment interests were considered as shareholder services. Parent companies' activities relating to the audit of subsidiaries, arranging shareholder meetings, and consolidating financial results were also categorized as shareholder services and as non-chargeable in nature.[3]
2. Activities performed for the benefit of one or more associates (service activities)
   The concept of benefit in the 1979 OECD report was narrowly defined as it only allowed service charges for tax purposes if a direct/real benefit accrued to the recipient entity.[4]
3. Activities which may benefit to varying degrees the parent, the group as a whole and one or more of the associated enterprises in particular (central coordination and control activities)
   The report stated that there are grey areas regarding the treatment of costs relating to central coordination and managerial activities, and provided a case-to-case analysis on whether the charge should be allocated to service recipients or providers. According to the report, the benefit to the subsidiaries was only of an indirect or remote nature, and a subsidiary would not be willing to pay an unrelated third party to perform central coordination and control activities. On the other hand, the long-term effects of the activities on the recipients could be considered, and they could levy a charge.

The tax jurisdictions of Argentina, France, Switzerland, the United Kingdom, and the United States stated that coordination costs should be allocated between the group companies. In contrast, the tax jurisdictions of Germany and the Netherlands stated that central coordination and managerial activities only qualified as a service if they provided a direct or real benefit for a particular subsidiary.

Thus, the analysis of the 1979 OECD Report reflected a fundamental lack of consensus among the member countries on the definition of shareholder activities for transfer pricing purposes.

2. The OECD Report of 1984

Thereafter, the OECD issued its 1984 report on 'The allocation of central management and service costs' after receiving input from member countries on the need to define shareholder costs more precisely. A general benefit approach was suggested to qualify the benefit tests rather a direct benefit approach as provided in 1979 Report.

The 1984 Report stated that shareholder costs could be distinguished from the general benefit costs incurred to make the sum of the group's individual parts more profitable than they would be if they were not related.[5]

The report also brought about how to distinguish and treat central coordination and control activities' related costs in decentralized and centralized organisation structures.

Decentralized structures – In certain Multinational Enterprises (MNEs) the structure of the group was so loose, the mandate of the board of the parent company so limited, and the degree of decentralisation so high that in fact, all the parent company's activities related solely to monitoring the participants, and all the costs of those activities qualified as shareholder costs.

Centralized structures – In certain MNEs, the management was highly centralized, the board of the parent company made all the investment decisions above a certain value and many services (marketing, training, consultancy) were provided centrally (centralized MNEs). In relation to centralized MNEs, the question was whether the costs of the additional activities (activities above the level of typical shareholder activities) should be borne by the parent company or by the subsidiaries.[6]

The report further stated two approaches on how to deal with costs relating to central coordination and managerial services in the case of centralized MNEs.

Under the first approach, any extra profits arising from the said services of the parent company are seen as accruing primarily to the subsidiaries and only indirectly to the parent company. The underlying justification for this approach is the view that it is characteristic of MNEs that the subsidiaries' profit-making capacity is enhanced as a result of managerial and central coordinating activities. These considerations lead to the conclusion that a considerable part of the costs of central management, coordinating and control activities should not be borne by the parent company, but should be allocated to the various parts of the MNE.[7] It was stated under the first approach that central coordination and managerial activities in relation to protecting the investments of the parent company should be considered as shareholder costs. However, if the same central coordination and managerial activities are performed to improve the subsidiaries' operations, they should be considered as intra-group chargeable services. The problem that might arise in practice is distinguishing central coordination and managerial activities for protecting the investment interest from improving the operations of the subsidiaries.

A practical solution might be to split the total costs of the central coordination and managerial activities according to an estimate of the proportion of time and effort of the persons and departments concerned with rendering managerial services.

The second approach was based on the view that it was not appropriate to require a charge to be made during any particular accounting period for tax purposes, except to the extent that it was possible to identify and quantify, with a reasonable degree of certainty, services which had been rendered during that period and which provided a real or expected benefit to the recipient and reduced its costs. Under this approach, costs incurred by the parent company

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were regarded appropriately to be borne by them unless there was a positive case of charging them out.[8] Thus, the treatment under the second approach reconciles with the treatment of central coordination and control costs for the decentralized MNEs.

It was highly unlikely that the two diverging approaches could be easily reconciled within the non-binding recommendatory framework of the OECD, so that bilateral solutions would be necessary. Hence, the issue remained unresolved.

3. The OECD Guidelines, 1995

After lot of deliberation, and more than a decade later, the OECD Guidelines, 1995 came up with a much clearer vision of what constitutes a shareholder service. It states that an intra-group activity performed solely because of its ownership interest in one or more other group members, i.e. in capacity as shareholder would not justify a charge to the recipient companies.[9]

The following examples will constitute shareholder activities:

- costs of activities relating to the juridical structure of the parent company itself, such as shareholders' meetings, issuing shares in the parent company, and costs of the supervisory board;
- costs relating to the parent company's reporting requirements, including the consolidation of reports;
- costs of raising funds for the acquisition of its participants[10].

The OECD Guidelines, 2010,[11] define benefit as follows:

> Under the arm's length principle, the question of 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 or would have performed the activity in-house for itself. 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 considered as an intra-group service under the arm's length principle.

One can observe that the OECD shifted its approach to testing the 'willingness to pay' for an activity under comparable circumstances. It implies that, contrary to the 1979 OECD Report, a central coordination and managerial activity will not qualify as a shareholder activity *if* the activity is one that an independent enterprise would have been willing to pay for or to perform for itself.

Therefore, central coordination and managerial activities which may qualify as services include quality control, cost control, and efficiency control, since such activities may provide subsidiaries with a direct and proximate benefit. Coordination activities, in particular, are not directly mentioned in the OECD Guidelines, even though such activities were a central point of dispute in the 1979 and 1984 reports.

Furthermore, in relation to activities which concern more than one enterprise of an MNE, the OECD Guidelines state that shareholder activities should be distinguished from the broader concept of stewardship activities which include the following:[12]

> Stewardship activities cover a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by acoordination centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (troubleshooting), or in some cases assistance in day-to-day management.

Thus, in the case of central coordination and control activities, the focus has changed from the nature of the activity to the willingness to pay in an independent scenario. It follows implicitly from the OECD Guidelines that coordination activities (stewardship activities) qualify as services, *unless* a particular subsidiary does not need the activity and would not be willing to pay an unrelated party to perform it.

The OECD Guidelines, 1995, also provided that activities which provide indirect and incidental benefits or are duplicative in nature are generally categorized as non-chargeable services. Benefits by virtue of passive association generally do not require a charge, however the current OECD Guidelines, 1995, provided an exception to these activities and warrants to perform a 'willingness to pay' test, to appropriately determine whether a particular activity warrants a charge or not on the facts and the circumstances of the case.

B. US Regulations

As highlighted earlier, as the largest economy in the world the US could also be thought to understand the concept of shareholder activity. In fact, the US Regulations have seen a turnaround in the definition of shareholder activities.

Shareholder activities do not qualify as chargeable services under the US Regulations. The concept of shareholder activities was previously developed on the basis of US Tax Court's decisions concerning sections 482, 861, and 862. While section 482 provided for the arm's length principle to be considered for inter-company transactions, sections 861 and 862 covered the calculation of US and foreign net income and provided for an allocation and apportionment of costs between US and foreign sources. The close link between the provisions is evident from the fact that section 482 and section 861 regulations were proposed together in 1966. The final section 482 regulations were issued in 1968, whereas the final section 861 regulations were issued in 1977.

Section 482 from 1968 did not apply the concept of shareholder activities, though it provided that 'duplicative activities' and 'activities with an indirect and remote benefit' did not qualify as services for transfer pricing purposes.

In relation to foreign dividends, the old section 861 regulations made use of the concept of 'stewardship expenses' regarding the following duplicative activities:

> **Stewardship expenses attributable to dividends received** – if a corporation renders services for the benefit of a related corporation and the corporation

> charges the related corporation for such services (see section 482 and the regulations thereunder which provide for an allocation where the charge is not on an arm's length basis as determined therein), the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (§ I .482-2(b)(2)(ii)) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute 'stewardship' or 'overseeing' functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. . . The deductions resulting from stewardship or overseeing functions are incurred as a result of, or incident to, the ownership of the related corporation and, thus, shall be considered definitely related and allocable to dividends received or to be received from the related corporation.[13]

Judicial pronouncements in the US also broadened the concept of 'stewardship functions', which have included control activities or 'supervisory activities' within its meaning. This is evident from the decisions in *Columbian Rope Co. v. Commissioner, 42 TC 800 (1964) and Young and Rubicam v. United States, 410 F.2d 1233 (Ct.CI.1969)*. It was in these cases that the concept of *'proximate and direct benefit'* was put forward. If the direct and proximate benefit arose to the service provider, then the recipient was considered to be only an indirect beneficiary.

This concept of proximate and direct benefit was further elucidated in a Tax Advisory Memorandum issued in 1987 (TAM 8806002), which stated that the definition of 'stewardship functions' in cases where both a U.S. parent company and a foreign subsidiary obtained benefits from a particular activity must be made on the basis of the 'proximate and direct benefit' test established in *Young & Rubicam v. United States.* Activities which provided a proximate and direct benefit for the parent company were considered to provide only an indirect or remote benefit for the subsidiaries.

Specifically, the IRS has noted under TAM, 1987 that stewardship expenses would include, but are not necessarily limited to, the following costs:

- duplicative review or performance of activities already undertaken by the subsidiary;
- periodic visits and general review of the subsidiary's performance;
- meeting reporting requirements or other legal requirements of the parent shareholder that the subsidiary would not incur, but for being part of the affiliated group; and
- financing or refinancing the parent's ownership participation in the subsidiary.

In the TAM, the IRS emphasized that stewardship services are those activities that *do not benefit the related subsidiary in the conduct of its day-to-day business operations*. They added, however, that there may be instances in which the benefits derived from a single, indivisible activity are *"proximate and direct" to both the businesses of the parent and the subsidiary*. Consequently, the IRS has acknowledged that in certain circumstances, the line between stewardship services and other supportive activities is blurred.

TAM 8806002 also described four separate classes of expenses, resulting in differing tax treatment:

Class I. Expenses for the direct benefit of one or more of the subsidiary corporations, even though the parent corporation may receive an indirect benefit from some of these expenditures.

Class II. Stewardship expenses allocable to the parent, such as expenses in connection with the U.S. tax return, information report filings with the IRS and Securities and Exchange Commission, periodic reviews of the subsidiary, and financing the parent's ownership in the subsidiary.

Class III. Expenses for the operating members of the group as a whole, allocated on a facts-and circumstances test by an end-result analysis.

Class IV. Expenses of the parent those are not properly included as stewardship expenses, such as expenses for investigating new business activities using employees of existing entities that would not participate in the business opportunity if it came to fruition.

Expenses that clearly fall within a specific class may be easily allocated between the parent and affiliate. The "proximate and direct" test is applied to those expenses that are difficult to classify because both the parent and affiliate receive benefits in varying degrees from the same expenditures which would dedicate shares of such expenditures between the parent and affiliate.

Thus, TAM, 1987 provided useful guidance on various aspects of identifying the parts for which the benefit of an expense is incurred. This test is factual, and it is unclear whether or not the TAM is entirely consistent with *Young and Rubicam*, which seemed to contemplate a very broad scope of supervisory or stewardship services. The TAM also suggested that more attention would be paid by the IRS than appeared to be the case in *Young and Rubicam* to whether the expense benefits both a parent and a subsidiary and should thus be allocated between them.

In the case of *Merck & Co. v. United States, 24 Cl.Ct. 73 (tow), 1991*, it was decided that services provided by the US parent company like (1) diligent efforts to provide the subsidiary with the highest feasible sales revenues, including shutting down a U.S. plant in order to keep the subsidiary in production; (2) the establishment of artificial and unreasonably high prices to help subsidiary in production; and (3) the provision of personnel who served as members of the board of directors and officers of the subsidiary, did not constitute the type of managerial services which the foreign subsidiary would have hired an unrelated company to perform.

The Court of Claims held that the first category of activities did not qualify as services, partly because the vertical integration of the group meant that the marketing companies had no other sources of supply than the related manufacturing companies. In addition, the closure of the U.S. plant was a rational business decision caused by excess capacity. The high prices were due to economic forces and the absence of government price controls. Finally, the Court held that the management of subsidiaries through teams of executives that hold multiple titles of director or officer was a frequently used control mechanism. To summa-

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rize, it was held that the activities were not the type of managerial services which the subsidiary would have hired an unrelated company to perform.

In the case of *H. Group Holding Inc. v. Commissioner, TCM 1999-334 (1999)*, the Tax Court found that the following activities did not qualify as services:

> We find that items such as HIC's audits, reporting requirements, reviewing contracts, and providing for consistency of accounting systems are supervisory functions that benefited the parent company and are not management services . . . Likewise, business development activities, financial guaranties, and owner relations are to the benefit of the parent company and not subject to allocation.

The following activities constitute services under section 482:

> However, we are, likewise, not persuaded by petitioners' argument that chain and design services should not be subject to section 482 allocation because they were provided to unrelated parties. . .However, the services were provided as part of the Hyatt International group's hotel management business . . . Accordingly, the remaining arm's-length issues for our consideration involve: The services HIC performed with respect to worldwide marketing, chain and design services, and coordination of human resources, insurance, and employee benefits.

In conclusion, the US courts have applied a broad definition to the concept of 'stewardship functions' so as to include control activities, duplicative activities, reporting activities of a parent company, and financing activities of a parent company. The TAM issued in 1987 tried to categorize the activities under four broad headings which were, to some extent, not in consensus with the US Court's decision.

The lack of clear guidance on what types of services constitute stewardship activities triggered the need for the IRS to come up with specific provisions on how to treat inter-company service transactions. The Section of Taxation – Transfer Pricing Committee at the American Bar Association provided IRS with a detailed report on the status of service regulations in the US and the need to revise them in light of the significant changes that had occurred in how MNEs conduct business.

The committee specifically stated that the transfer pricing regulations governing intercompany services were over 30 years old. Structural and business changes in the global economy and new issues involved in the transfer of services have increased the need to reconsider the service regulations and for up-to-date guidance from the IRS.[14]

Thus, on the recommendations of the Committee, the US revised its service regulations in 2009 with due consultation of stakeholders. One major change that the US brought in its regulations was to analyse the transaction from the service recipient's perspectives rather than the service provider's perspective, which was provided in earlier regulations.

It provided for shareholder activities to be restricted to activities for the sole purpose of protecting the service provider's capital investment or to comply with its reporting requirements. If an activity involves both services and shareholder elements, the costs should be allocated between the two elements if the arm's length test is made on a cost based method. Day-to-day management activities are deemed not to constitute shareholder activities, which conforms to the courts' decisions.

Standing today the definition of shareholder activity in the US Regs is as follows:

> Shareholder activities–An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganisation may be considered to provide a benefit to one or more controlled taxpayers.[15]

The US regulations also provided that activities might be categorized to provide indirect, incidental or passive benefits, and certain activities might also be in the nature of duplicative activities. However, a 'willingness to pay' test should be performed from the service recipient's perspective to appropriately determine whether a particular activity warrants a charge or not on the facts and the circumstances of the case.

US regulations also came up with a clearer definition of stewardship activities to include only shareholder activities and duplicative activities under revised regulations 1.861-8(e)(4)(ii). They state that shareholder's activities include activities either to protect the investor's capital investment or to facilitate compliance by the corporation with reporting legal or regulatory requirements applicable specifically for the corporation. It also provided that in the case of a department of the parent company engaging in rendering stewardship services among other services, acceptable methods of apportionment should be considered to segregate chargeable and non-chargeable costs. These may include comparisons of time spent by employees or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, etc.

The definition of stewardship activities is as follows:

> (ii) Stewardship expenses attributable to dividends received. Stewardship expenses, which result from "overseeing" functions undertaken for a corporation's own benefit as an investor in a related corporation, shall be considered definitely related and allocable to dividends received, or to be received, from the related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from "duplicative activities" (as defined in § 1.482–9(l)(3)(iii)) or "shareholder activities" (as defined in § 1.482–9(l)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign-source royalties, and gross income of foreign branches), some part of the deductions with respect to that department are considered

definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate United States source income (such as fees for services performed in the United States). Permissible methods of apportionment with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors.[16]

The US regulations also provided that the benefit should be reasonably identifiable and there should be a link between the activity and the benefit. The benefit test is generally held to be met if, under comparable circumstances, an uncontrolled taxpayer would be *willing to pay an uncontrolled party to perform the same or a similar activity or if the recipient would otherwise have performed the same activity or a similar activity for itself*.

Furthermore, depending on the circumstances, it may be more reliable to measure incremental value on a functional aggregate-activity basis rather than on a component activity-by-activity basis.

The definition of 'benefit' under US Regulations has been provided below:

> An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonable identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity.[17]

IV. Where does the world stand today on this issue?

On perusal of the above historical developments, both in the case of OECD Guidelines and US Regulations, it is clear that the concepts of shareholders and stewardships have evolved with the changes in economic circumstances. With greater focus on achieving cost efficiencies, cost reduction, synergies, operation integration etc., MNEs across the world are moving more towards centralising common services and costs. The benefits emanating from centralisation are shared by all the members of MNE, and sharing centralized costs has an economic rationale.

Providing clearer definitions of shareholder costs and bringing in distinction the treatment of shareholder costs and stewardship costs are all evidence of the fact that tax jurisdictions worldwide are keeping pace with the economic evolution taking place in the globalized world.

It is clear that a taxpayer should 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.

The US Regulations and the OECD Guidelines, in order to answer the question of what constitutes a benefit, have emphasized that it is an activity performed by one or more group members for another group member that provides the recipient 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 an independent enterprise to perform the activity or would have performed the activity in-house for itself. In other words, as a simple check, both the US Regulations and the OECD Guidelines prescribe the principle of willingness to pay for an activity performed by an independent enterprise or performing it in-house.

Moreover, the European Union's Joint Transfer Pricing Forum (EU JTPF), February, 2010, classified costs of central coordination and managerial activities generally to be in the nature of shareholder costs. However, it also stated that such activities should be related to the management and protection of the investments in participants and no independent party should be willing to pay or perform for itself.[18]

The transaction related to the provision of services would be at arm's length only where a benefit is provided to an entity by way of provision of services, and there should be a real connection between the operation of the enterprise which is providing services and the enterprise which is expected to pay for the same. The concept of willingness to pay can be summed up as a 'benefit test'.

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NOTES

[1] Paragraph 7.5 of OECD Guidelines.
[2] Paragraph 7.10 of the OECD Guidelines
[3] Paragraph 154 of OECD TP Guidelines, 1979
[4] Paragraph 151 of OECD TP Guidelines, 1979
[5] Paragraph 35 of the OECD Report, 1984
[6] Paragraph 36 of the OECD Report, 1984
[7] Paragraph 37 of the OECD Report, 1984
[8] Paragraph 41 of the OECD Report, 1984
[9] Paragraph 7.9 of the OECD Guidelines
[10] Paragraph 7.10 of the OECD Guidelines
[11] Paragraph 7.6 of the OECD Guidelines
[12] Paragraph 7.9 of the OECD Guidelines
[13] US Regs (1977) – 1.861-8(e)(4)
[14] Comments Concerning Transfer Pricing "Services" Regulations – American Bar Association
[15] US Regs – 1.482-9(I)(3)(iv)
[16] US Regs – 1.861-8(e)(4)(ii)
[17] US Regs 1.482-9(I)(3)(i)
[18] Annex II; point 12 of EU JTPF Report: Guidelines on low value adding intra-group services, 2010

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