

Domestic Transfer **Pricing in India**

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After the grand success of International Transfer pricing, through which huge transfer pricing orders slapped on companies with cross-border operations in the financial year 2011-12, Hon'ble Finance Minister has cast his net wider and deeper for the next one by including "Specified Domestic Transactions" in the purview of Transfer Pricing (TP). Out of 100+ amendments in the Finance Act 2012 by overruling 100+ case decisions, the provisions related to Domestic Transfer Pricing seems to be the one which had been brought in the statute after considering instructions / suggestions of the Supreme Court (SC). The other reason for implementing the same may be hidden in the statistics.

Origin of Domestic Transfer Pricing (DTP) law in India:

While dealing with the issue that, whether the assessee company and its service provider are related companies in terms of Section 40A(2), Hon'ble SC in CIT vs. GlaxoSmithKline Asia (p) Ltd. (SLP 18121/2007) had observed ***"The larger issue is whether Transfer Pricing Regulations should be limited to cross-border transactions or whether the Transfer Pricing Regulations to be extended to domestic transactions. In domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances having tax arbitrage such as where one of the related entities is (i) loss making or (ii) liable to pay tax at a lower rate and the profits are shifted to such entity. The CBDT should examine whether Transfer Pricing Regulations can be applied to domestic transactions between related parties u/s 40A(2) by making amendments to the Act. The AO can be empowered to make adjustments to the income declared by the assessee having regard to the fair market value of the transactions between the related parties and can apply any of the generally accepted methods of determination of arm's length price, including the methods provided under Transfer Pricing Regulations."***

SC further mentioned ***"Though the Court normally does not make recommendations or suggestions, in order to reduce litigation occurring in complicated matters, the question of extending Transfer Pricing regulations to domestic transactions require expeditious consideration by the Ministry of Finance and the CBDT may also consider issuing appropriate instructions in that regard."***

These remarks of the SC has laid the foundation for Domestic Transfer Pricing (DTP) law in India. The same is also acknowledged in the memorandum explaining the Finance Bill 2012.

Interesting Statistics of Transfer Pricing (TP) regime in India:

For understanding the magnitude of the topic, it is important to refer interesting statistics of TP regime in India. TP provisions were introduced in India by the Finance Act 2001 (w.e.f. AY 2002-03) and 8 TP assessments i.e. assessment of AY 2002-03 to AY 2009-10 had been concluded. As per the available data, aggregate adjustments of INR 1,70,000 crores (USD 32 billion, approximately) had been made by the TPO's in these eight years, out of which apx adjustments of INR 45,000 crores & INR 70,000 crores had been made in last 2 assessment years i.e. in A.Y. 2008-09 & A.Y. 2009-10. (Source: Business standard/ The Hindu-Business Line/ The Financial Express).

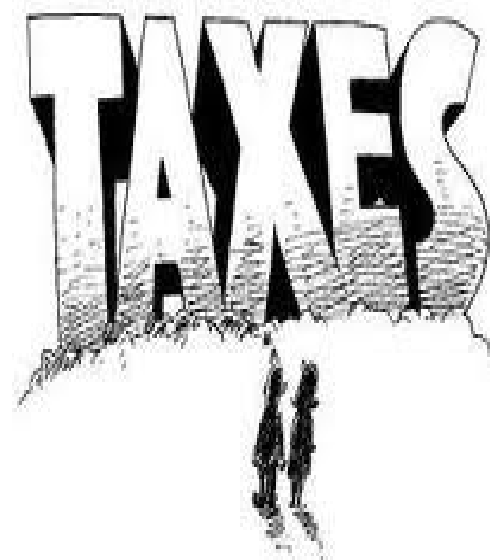
Interestingly AY 2008-09 was one of the best years in terms of outbound Mergers & Acquisition (M & A) deals in India. According to Bloomberg data, Indian companies had acquired assets abroad worth USD 20 billion in 302 deals. When I go through the statistics above, I wonder whether the record Transfer Pricing Adjustments were only an aggressive move on the part of an over enthusiastic department or justified in the wake of global norms? However, various Tribunal / High court orders pronounced in last couple of years have given the answer wherein the magnitude of these adjustments has been significantly reduced.



Category of Transactions covered under Domestic Transfer Pricing net:

As per the newly-inserted section 92BA of the IT Act, "Specified Domestic Transaction" in case of an assessee means any of the following transactions (the aggregate of which exceeds INR 5 crore in previous year and which is not an international transaction), namely:—

- (1) any expenditure incurred between related parties referred to in section 40A(2)(b);
- (2) any transaction referred to in section 80A;
- (3) any transfer of goods or services referred to in section 80-IA(8);
- (4) any business transacted between the assessee and other person as referred to in section 80-IA(10);
- (5) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which section 80-IA(8) or section 80-IA(10) are applicable;
or
- (6) any other transaction as may be prescribed,



If a transaction is an International Transaction, then the same will not be a Specified Domestic Transaction.

Aggregate of Transactions should exceed INR 5 crore:

TP provisions will not be applicable, if aggregate of transactions entered during the year does not exceeds INR 5 crore.

For e.g. - Rent payment of INR 2.5 crore has been made to a sister concern and a remuneration of INR 1.5 crore paid to Managing Director. In this case the aggregate of transaction is below INR 5 crore; hence TP provisions will not be applicable. Suppose Rent of INR 4 crore is paid to sister concern and MD's Remuneration is INR 1.5 crore. Here the aggregate value of transactions will exceed INR 5 crore and both transactions will become Specified Domestic Transaction.

As per Section 92(2A), any allowance for an expenditure or interest or allocation of any cost or expenses or any income in relation to the Specified Domestic Transaction shall be computed having regard to the Arm's Length Price. In the succeeding paras, different categories of transactions have been dealt in detail:

1. Any 'Expenditure' incurred between related parties referred to in section 40A(2)(b)

Section 40A overrides the other provisions of IT Act related to computation of income under "Profit & Gains of Business or Profession". As per sub section (2), any expenditure by way of payment to the persons [mentioned in sub clause (b)], is liable to be disallowed in computing business profit to the extent such expenditure is considered to be excessive or unreasonable having regard to fair market value of goods, services, facilities etc. For e.g. expenditure on purchase of goods, procurement of services, interest payments, purchase of tangible and intangible property, Director's Remuneration, Commission, Sitting fees etc.

However, no disallowance shall be made if the transaction (Specified Domestic Transaction) has been made at arm's length price. Sub clause (b) of sub section (2) covers the various situations mentioned below wherein the two persons are related parties.

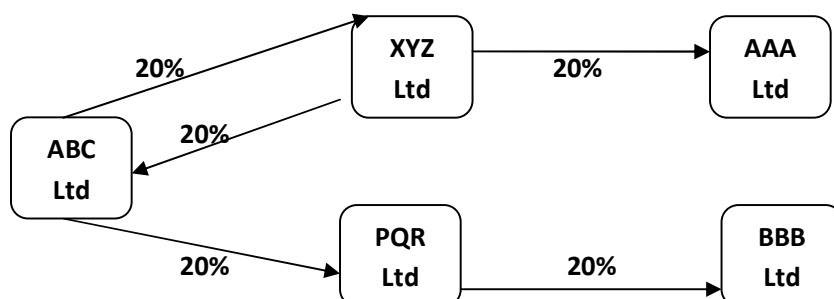
Illustration:

Payments by ABC Ltd to the following persons will be covered under this clause, if the relationship exists at any time during the previous year, where:

- ☞ Any company in which ABC Ltd has 20% or more voting rights,
- ☞ A company, XYZ Ltd, has 20% or more voting power in ABC Ltd,
- ☞ A company in which above-mentioned XYZ Ltd has 20% or more voting power,
- ☞ Any company of which a director has 20% or more voting rights in ABC Ltd,
- ☞ Any company in which a director of ABC Ltd has 20% or more voting rights,
- ☞ Any Director of ABC Ltd or XYZ Ltd and his/her relative,
- ☞ Any Individual having 20% or more voting rights in ABC Ltd or any relative of such individual



Further, related party also includes a company having the same parent company. The following chart will explain the few scenarios:



Now, transactions between (i) ABC Ltd – XYZ Ltd, (ii) ABC Ltd – PQR Ltd & (iii) XYZ Ltd – PQR & (iv) ABC Ltd – AAA Ltd., will fall under the mischief of section 40A (2). However, any transaction between ABC Ltd – BBB Ltd & AAA Ltd – BBB Ltd will not come under 40A(2).

This clause covers only the “Expenditure” and not the income. Hence, it will not cover the cases when any person receives any income which is less than ALP. **For e.g.** - ABC Ltd gives an interest-free loan to its sister concern. The notional interest is not covered in this section and hence no addition can be made in the hands of the ABC Ltd.

Area of Uncertainty / clarification required:

a) Benchmarking requirement for Remuneration / other payments to Director / Chairman / KMP:

In case of a company, specified person as per sub clause (b) includes directors, key management personnel and their relatives. It will be very difficult for the companies / groups to benchmark the payment made to their directors / chairman. **For e.g.** - It will

be a tough task for Reliance Group to justify the payments made to Mr. Ambani, as it is not possible to find a comparable instance and one cannot compare the above payment with those made by business groups, like the ones owned by the Tatas or Birlas, to their key management personnel.

Delhi High Court in a recent Judgement (CIT vs. India Thermit Corporation – ITA/350/2011) held that when commission paid to the Managing Director/Director was in accordance with the provisions of the Companies Act 1956; AO cannot make any disallowance on this account. In spite of the same, this issue is litigation prone.

b) Payment for Expenditure made to Sister Concern / corresponding adjustments:

For e.g. - ABC Steel Ltd has paid rent of INR 6 crore to sister concern ABC Housing Ltd in F.Y. 2012-13. TPO disallows 50% of the rent payment by stating that it is unreasonable or excessive and accordingly allows a deduction of INR 3 crore only to ABC Steel Ltd. There are no corresponding provisions in the act to adjust the income of ABC Housing Ltd i.e. in spite of disallowance, ABC Housing Ltd will be assessed at an income of INR 6 crore. This will result to double taxation.

c) Whether Depreciation will be covered?

Can depreciation be treated as expenditure for the purpose of this section? **For e.g.** - A Ltd purchases certain fixed assets from its sister concern Z Ltd for INR 1 crore, the ALP of which is INR 50 Lakh. Whether AO can disallow depreciation on INR 50 lakh, as the payment made for purchase of capital asset is not covered under section 40A (2)?

2. Any transaction referred to in section 80A:

Section 80A (6) refers to internal transactions between various units / undertakings of the assessee in respect of goods or services. This clause covers any transactions of goods or services and hence this transaction will be applicable to income as well as expenditure.

3. Transactions of Tax Holiday undertakings

- a) Any transfer of goods or services referred to in section 80-IA(8)
- b) Any business transacted between the assessee and other person as referred to in section 80-IA(10)
- c) Any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which section 80-IA(8) or section 80-IA(10) are applicable;

It is a common practice among corporates, enjoying tax holiday period, to park excess profits in tax-exempt units / businesses. To curb this loophole, given clauses has inserted in the DTP law. Now TPO is empowered to make adjustments if it appears that 'more than ordinary profits' are earned by tax exempt businesses/units owing to its 'close connection' with transacting parties.

Section 80IA (8):

Section 80IA-(8) deals with the internal transactions with more than one undertaking / units of the assessee, out of which one or more undertaking is enjoying the tax holiday. Normally units enjoying tax holiday, charge more than the market value for goods or services used by non-eligible units. Due to this practise, there is no effect on the health of the tax holiday unit as there are no taxes at all and the non-eligible unit gets higher deduction from taxable income. As per Section 80IA-(8), if the internal transfer of goods or services is not at market value, then profits or gains of transacting units shall be computed, as if, transfer, in either case, had been made at market value of such goods or services. Onus is on the taxpayer to prove that the internal transfer is at ALP.

Section 80IA (10):

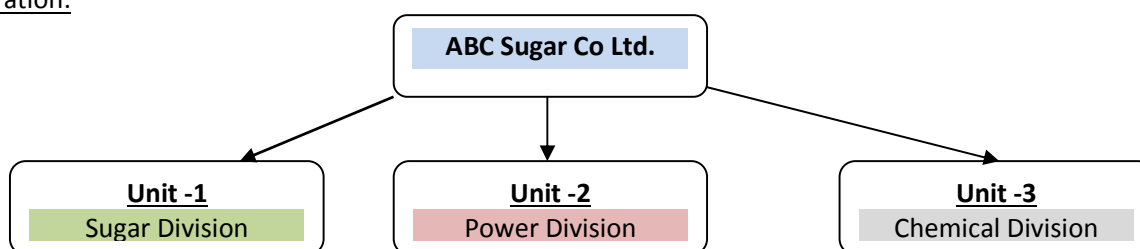
As per this clause, when due to close connection between assessee and 'any other person' or for any other reason, the eligible business of the assessee produces 'more than the ordinary profit', then for the purpose of deduction under this section, profit of the eligible business shall be determined by taking ALP of the transaction. Primary onus is on the taxpayer to prove that the internal transfer is at ALP. However, the department has to prove that the transaction is not at ALP.

Section 10AA: As per this section, profits of the units located in SEZ, engaged in the manufacturing of any article or thing or providing any services, is exempt subject to conditions.

Non Allocation of Indirect Costs / Services to Tax Holiday Units:

Many a times indirect expenses / head office expenses / administrative expenses have not been charged to the undertaking enjoying tax holiday, due to which more than ordinary profits arises to the tax-holiday undertaking.

Illustration:



ABC Sugar Co Ltd., engaged in the manufacturing of Sugar, is having three divisions- Sugar, Power & Chemical. Power produced by power division is captively consumed in the sugar and chemical division. In case of any shortfall in power generation, the same is purchased from the State Electricity Board (SEB). By-product of the sugar division is used in chemical division for producing ethanol. Profits of the power division are exempt u/s 80-IA.

INR 5 / unit have been charged by Power Division to sugar & chemical divisions for consumption of electricity. However, SEB rate for industrial undertakings are INR 4/ unit. Due to this pricing, the profit of the power division, which is enjoying a tax holiday, gets inflated by INR 1/ unit. Further, taxable profits of sugar and chemical divisions get reduced due to overcharging by the power division.

There are certain administrative/ indirect expenditure which have been incurred by ABC Sugar Co Ltd. As per prudent accounting norms, entire expenditure should be allocated to the three divisions in a proper ratio. However, ABC Sugar Co Ltd had not allocated the indirect expenditures in the Power division, due to which profits of power division gets inflated and profits of Sugar & chemical division gets reduced. Domestic Transfer Pricing law is introduced to curb similar types of transactions.

4. Any other Transactions as may be prescribed:

Board (CBDT) had been given the power to notify any other transaction, which they feel it necessary, to include in the definition of "Specified Domestic Transaction."

Area of Uncertainty / clarification required:

a) 'Close Connection' not defined

By applying arm's length principle, an imprecise concept of 'more than ordinary profits' has suddenly started appearing. Section 80-IA(10) talks about 'close connection' between the assessee and the other person. However, the term has not been defined, which may lead to litigation.

b) 'Corresponding Adjustments'

Normally DTAA provides that where any upward adjustment has been made in the hands of one entity, say an Indian Company, with respect to transaction with another company, say a British Company, then the corresponding downward adjustments should be made in the hands of the British Company. This eliminates the double taxation. No corresponding provisions are incorporated in DTP law.

c) 'Indian Company having Domestic / International Transaction' :

What happens when an Indian company is having both international transactions as well as domestic transactions? Whether the specified domestic transactions are required to be reported in the following scenarios:

- a) When the value of aggregate of international transactions and specified domestic transactions is less than INR 5 crore.
- b) When the value of aggregate of international transactions and specified domestic transactions is more than INR 5 crore, but value of specified domestic transactions is less than INR 5 crore.



What if, when the value of International transactions as well as value of Specified Domestic Transaction will be INR 3 crore each? Is the assessee required to report the same or to take an accountant's report for the same? As per plain language of the IT Act, if the aggregate value of the Specified Domestic Transaction does not exceed INR 5 crore, then DTP law will not be applicable. A clarification may be required on this issue.

Domestic Transfer Pricing (DTP) law is not applicable, if original tax liability reduces:

Section 92(3) provides that TP provisions will not be applicable when it has the effect of reducing the income chargeable for tax or enhancing the original losses. Hence, for expenditure recorded in the books for 'less than ALP' or income recorded in the books for more than ALP, will be out of purview of DTP. The situation may be reversed when tax holiday unit will come in picture.

For e.g. – If an internal transfer from a tax holiday unit to a non-tax holiday unit has been made at INR 1,00,000 for which ALP is INR 200,000, then the provisions of DTP as well as TP will not be applicable and ALP will not substitute the original recorded transaction. If ALP of INR 200,000 will substitute the original price then it will result into additional exemption to tax holiday unit as well as additional deduction of expenditure to non tax holiday unit, which is not the intention of the statute.

Computation of Arm's Length Price(ALP):

As per Section 92C, the Arm's Length Price in relation to "Specified Domestic Transaction" shall be calculated by the any of the following methods, being the '*most appropriate method*', namely

- a) Comparable uncontrolled price method;
- b) Resale Price Method;
- c) Cost Plus Method;
- d) Profit Split Method;
- e) Transactional Net margin method;
- f) Such other method as prescribed by the board i.e. Any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the facts.

As per Rule 10C of the Income Tax Rules, most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction and provides the most reasonable measure of the transaction. Following factors should be taken into account while choosing the most appropriate method namely:

- I. the nature and class of the international transaction;
- II. the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- III. the availability, coverage and reliability of data necessary for application of the method;
- IV. the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- V. the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- VI. the nature, extent and reliability of assumptions required to be made in application of a method.

If more than 1 price is determined by the most appropriate method, the ALP shall be taken to be arithmetical mean of such prices.

Further as per notification no 30/2013 dated 15.04.2013, Actual transaction price of Specified Domestic Transaction shall be deemed to be at Arm's Length, if the variation between the ALP so determined and the actual transaction price *does not exceed 3% of the actual transaction price (1% in case of whole sale trade)*

Documentation / Compliances:

As per section 92D, every person who has entered into *Specified Domestic Transaction* shall keep and maintain such information and documents in respect thereof, as prescribed in Rule 10D of the Income Tax Rules.

As per Section 92E, the assessee has to take an accountant's report, in Form 3CEB, duly signed and verified as per the provisions of the Act. The Transfer Pricing Audit Report is **required to file electronically** on or before the due date of filing of Income Tax Return i.e. on or before 30th November of the respective assessment year.

Penalty Provisions for Non- compliances:

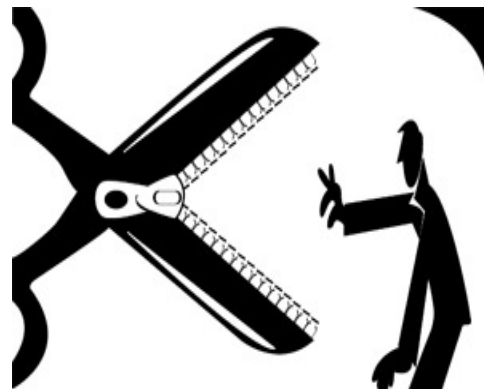
Penal provisions for non compliance are now made very harsh by the Board. Earlier there was no penalty when any transaction escapes from the Auditor's Report in Form 3CEB. Section 271AA has been amended w.e.f. 01-07-2012 to give the power to the AO to impose penalty @ 2% of the value of transaction, if assessee fails to report any transaction or fails to maintain required information or furnishes incorrect information. Thus, even if one forgets to disclose a transaction of INR 5 crore, which is the minimum threshold for reporting, the penalty is INR 10 lakh.

This penalty is in addition to penalty of INR 1 lakh prescribed u/s 271BA for non- furnishing of Auditors report u/s 92E.



Preventive Measures:

TPO will apply all lessons learnt from the assessments of international transaction over the past 10 years, while finalising assessments of Specified Domestic Transactions. Now they know the exact issues which require special attention. Questions will be raised on routing of transactions through multiple entities, and adjustment entries. Companies, who have the specified domestic transitions exceeding INR 5 crore, should be advised to validate their present business model and pricing methodology from a transfer pricing perspective, which will enable them to take corrective action, if any. A good understanding of the business of the assessee is a must for every consultant dealing with the Transfer Pricing issues.



Conclusion:

Domestic Transfer pricing will not be limited to large groups. Many mid-sized groups, partnership firms, HUFs and even individuals in smaller cities will now have to adhere to the TP laws. This will lead to an increase in the administrative and compliance burden for the taxpayer in respect of such transactions. Certain expenses, transfer of goods and services between related parties, extraordinary profits and profits earned by SEZs / tax holiday units will now be liable for scrutiny by TPO's. While the Advance Pricing Agreement (APA) regime has been introduced with respect to international transactions, the same benefit has not been extended for domestic transactions.

One can pray that the extension of transfer pricing provisions to Specified Domestic Transactions will not create the same level of havoc as prevalent in current Transfer Pricing assessments. It would be pertinent for the Government to bring out a clarification on all such issues so that domestic transfer pricing provisions can achieve the purpose for which they were introduced.

Glossary of Terms

AO : Assessing Officer
AY : Assessment Year
APA : Advance Pricing Agreement.
BOARD : Central Board of Direct taxes
CIT : Commissioner of Income Tax
DTAA : Double Taxation Avoidance Agreements
DTP : Domestic Transfer Pricing.
e.g. : Example

FY : Financial Year
ITAT : Income Tax Appellate Tribunal.
IT Act : Income Tax Act, 1961
INR : Indian Rupees
TPO : Transfer Pricing Officer.
TP : Transfer Pricing
SC : Supreme Court
SEZ : Special Economic Zone
W.E.F : With effect from

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