Audit of Domestic Transfer Pricing

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Applicability - SDT…

- The Finance Act 2012 extended the scope of Transfer Pricing provision to 'Specified Domestic Transactions ('SDT')

- The SDT would include the following:
  - Expenditure for which payment is made or to be made to domestic related parties-40A 2(b) payment
  - Tax Holiday/ Deductions claimed by the taxpayer, where;
    - Transfer of goods or services between various businesses of same taxpayer
    - More than ordinary profits derived from transactions with closely connected persons

Transfer Pricing provisions to apply to the 'Specified Domestic Transactions' if the aggregate value exceeds five crores

Form 3CEB (Rule 10E)

- Form 3CEB consists of three parts
  - Part A – General Information – Clause 1 to 9
  - Part B – International Transactions – Clause 10 to 20
  - Part C – Specified Domestic Transaction –Clause 21 to 25

Part A – General Information

1. Name of the assessee
2. Address
3. Permanent account number
4. Nature of business or activities of the assessee*
   *Code of Nature of Business to be filled
5. Status
6. Previous year ended
7. Assessment year
8. Aggregate value of international transactions as per books of accounts
9. Aggregate value of specified domestic transactions as per books of accounts

Part C – Clause 21

Associated Enterprises, Relationships and Transactions with AE

- List of associated enterprises with whom the assessee has entered into specified domestic transactions, with the following details:
  - Name, address and PAN of the associated enterprise.
  - Nature of the relationship with the associated enterprise
  - Brief description of the business carried on by the said associated enterprise.

Associated Enterprise for SDT
Rule 10A

- *"associated enterprise" shall,—*
- (i) *have the same meaning as assigned to it in section 92A; and*
- (ii) *in relation to a specified domestic transaction entered into by an assessee, include —*
  - *the persons referred to in 40A(2)(b) in respect of a transaction referred to in 40A(2)(a);*
  - *other units or undertakings or businesses of such assessee in respect of a transaction referred to in section 80A or, (8) of section 80-IA(8);*
  - *any other person referred to in section 80-IA (10) in respect of a transaction referred to therein;*
  - *other units, undertakings, enterprises or business of such assessee, or other person referred to in section 80-IA (10), in respect of a transaction referred to in section 10AA or Chapter VI-A to which the provisions of section 80-IA(8) or (10) are applicable;*
- *"enterprise" shall have the same meaning as assigned to it in section 92F(iii) and shall, for the purposes of a SDT, include a unit, or an enterprise, or an undertaking or a business of a person who undertakes such transaction*

Audit Procedures for Clause 21

- Management Representation
- Test Check of relationships disclosed
- Evaluate Assessee's Procedures to identify SD
- Review of Regulatory Filings like 297/299/301 Registers under Companies Act
- AS 18, AS 21, AS 23, Takeover Code
- Disclosures in Note 3 of Revised Schedule VI
- Stockholders listing of closely held companies
- Review of Investments and whether such investments results in any relationship of AE
- Review of Tax Returns to identify Tax Holiday Status
- Associated only for part of a previous year?
- Multiple Relationships – Report any One

Part C – Clause 22

Reporting of Transactions Covered U/s 40A(2)(b)

- Particulars in respect of transactions in the nature of any expenditure:

  Has the assessee entered into any specified domestic transaction(s) being in respect of which payment has been made or is to be made to any person referred to in section 40A(2)(b)? --- Yes/No

  If 'yes', provide the following details in respect of each of such person and each transaction or class of transaction:

  - (a) Name of person with whom the specified domestic transaction has been entered into.
  - (b) Description of transaction along with quantitative details, if any
  - (c) Total amount paid or payable in the transaction-
    - (i) as per books of account.
    - (ii) as computed by the assessee having regard to the arm's length price.
  - (d) Method used for determining the arm's length price. [See section 92C(1)].

40A(2)(b) - Relatives

Taxpayer (Assessee)	Payee
An Individual	To a relative
A Company	To a director or relative of a director
A Firm	To a partner or relative of a partner
An AOP	To a member of an AOP or a relative of the member
A HUF	To a member of the family or relative of any member
Any Taxpayer	To an Individual who has substantial interest in the business of the Taxpayer or a relative of such Individual
Any Taxpayer	To a Company Any Director of such company Any relative of such director Any other Company in which first mentioned company has substantial interest (from AY 2013 – 14) Has Sub Int. In Taxpayer
Any Taxpayer	To any Firm or its Partners/relative of Partners Any AOP or its members/relative Any HUF or its members/relative Has Sub Int. In Taxpayer

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Taxpayer (Assessee)	Payee
Any Taxpayer	To a Company one of whose Director has Substantial Interest in Taxpayer Any Director of such company Any relative of such director
Any Taxpayer	To any Firm/AOP/HUF where one of partners/members has Substantial Interest in Taxpayer Any partner/member of such Firm/AOP/HUF Any relative of any partner/member of such Firm/AOP/HUF
An Individual	To a person in whose business the taxpayer or any of his relative has substantial interest
A Company	To a person in whose business the taxpayer/any Director of taxpayer/any relative of such director has a substantial interest
A Firm/AOP/HUF	To a person in whose business the taxpayer Any partner/member of taxpayer or Any relative of such partner/member of taxpayer

New Proviso

Sub Interest through more than 1 relative

Decision of Aztec Soft

Indirect Holding Cir 6P of 1968

Disallowance U/s 40A(2) v/s 37(1)

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Audit Procedures for Clause 22

- Transactions in nature of ***Expenditure*** only covered
- Transactions in respect of which ***payment is made or to be made*** are only covered
- Such Transactions have been ***entered with an AE as per Sec. 40A(2)(b)***
- Quantitative Details are also required to be reported – if any
- Reporting U/s 40A(2) in Form 3CD to be taken as base to identify and report all transactions under this Clause 22

Part C – Clause 23A

Reporting of Transactions covered U/s 80A(6), 80IA(8) or 10AA where such Eligible Business has <u>Transferred</u> Goods or Services to Any Other Business

- Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services:
- Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA)]transferred any goods or services to any other business carried on by the assessee? Yes/No

  If 'yes' provide the following details in respect of each unit or enterprise or eligible business:
  - (a) Name and details of business to which goods or services have been transferred.
  - (b) Description of goods or services transferred.
  - (c) Amount received / receivable for transferring of such goods or services –
    - (i) as per books of account.
    - (ii) as computed by the assessee having regard to the arm's length price.
  - (d) Method used for determining the arm's length price [See section 92C(1)]

Part C – Clause 23B

Reporting of Transactions covered U/s 80A(6), 80IA(8) or 10AA where such Eligible Business has Acquired Goods or Services to Any Other Business

- Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services:
- Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA)] acquired any goods or services to any other business carried on by the assessee? Yes/No

  If 'yes' provide the following details in respect of each unit or enterprise or eligible business:
  - (a) Name and details of business to which goods or services have been acquired.
  - (b) Description of goods or services transferred.
  - (c) Amount received / receivable for transferring of such goods or services –
    - (i) as per books of account.
    - (ii) as computed by the assessee having regard to the arm's length price.
  - (d) Method used for determining the arm's length price [See section 92C(1)]

S. 80A(6)/80-IA(8) – Intra Firm Transactions

- Contextually covers intra division transfers not being a transaction
- Influences a case where taxpayer is entitled to deduction u/s. 10A or s.10AA or s.10B or s.10BA or Chapter VI-A in respect of undertaking or unit or Enterprise, where:
  - Goods or services held for the purpose of eligible business are transferred to any other business ,
  - Goods or services held for the purpose of —any other business transferred to eligible business,
  - Consideration recorded in books does not correspond to market value of such goods
- Inter unit transfer between two non-eligible units has no TP implications.
- Section requires —any other business carried on by assessee and dealings between businesses
  - Restricted to goods and services of “marketable” nature
  - Restricted to transfer

S. 80A(6)/80-IA(8) – Intra Firm Transactions - Continued

- Activities which are not carried on as business
  - HO expenses including IT support, accounts, law compliance etc
  - Use of corporate resources, including IPR
  - HO finance out of capital or accumulated profits
  - Temporary use of funds
- Allocation of actual expenses and challenges around allocation keys
  - Research cost, finance cost, HO overheads, sales promotion
- Provides for a —two-way adjustment (both favourable as well as adverse)
- Restricted to core activity
  - Supply of power by captive power unit to the manufacturing unit
  - Supply of intermediate goods to the unit manufacturing final goods
- If SDT, adjustment w.r.t. ALP; if not SDT, adjustment w.r.t FMV

Audit Procedures for Clause 23A/B

- Only Transfer of Goods & Services Covered
  - Property includes Goods .... Intangibles (Rule 10A(b))
  - Services includes Financial Services (Rules 10A(c))
  - Transactions includes a number of closely linked transactions (Rule 10A(d))
- Review of Inter Branch/Unit transactions and HO – Branch Transactions
- Specific Review of Units/Divisions serving for the purpose of Captive Consumption
- Tax Holiday Units are required to maintain separate set of accounts and are required to get a report from an Accountant certifying the correctness of claim of deduction – These set of accounts can be basis of verification of transactions under this Clause 23A

Part C – Clause 24

Reporting of Business Transactions with AE resulting in extra ordinary profits for a business eligible for Tax Holiday U/s 80IA(10) or 10AA

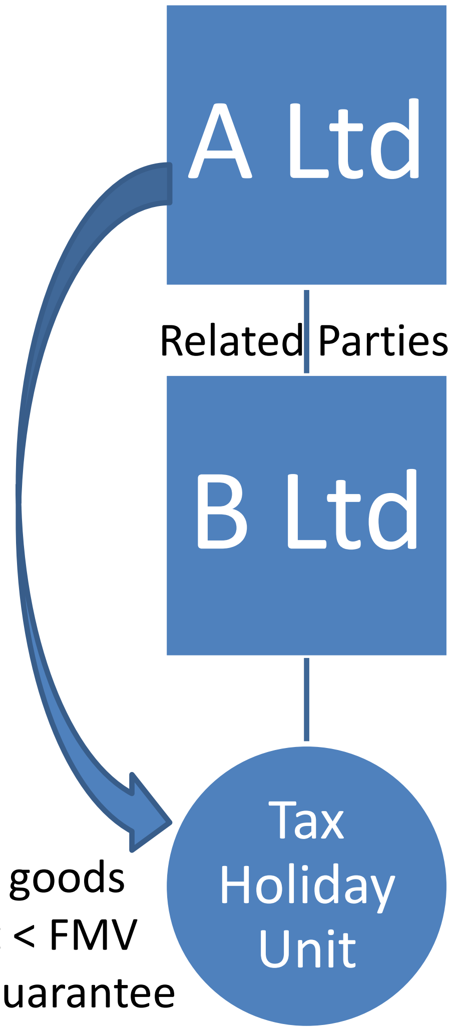
- Particulars in respect of specified domestic transactions in the nature of any business transacted:
- Has the assessee entered into any specified domestic transaction(s) with any associated enterprise which has resulted in more than ordinary profits to an eligible business to which section 80IA(10) or section 10AA applies? Yes/No

  If 'yes' provide the following details:
  - (a) Name of the person with whom the specified domestic transaction has been entered into
  - (b) Description of the transaction including quantitative details, if any
  - (c) Amount received/receivable or paid/payable for transferring of such goods or services –
    - (i) as per books of account.
    - (ii) as computed by the assessee having regard to the arm's length price.
  - (e) Method used for determining the arm's length price [See section 92C(1)]

80IA(10) – Inter Firm Transactions

- Needs to be a —transaction with —other person
- Ingredients which trigger invocation of s. 80-IA(10).
  - Assessee carrying on eligible (tax holiday) business
  - If it appears to AO
  - Owing to close connection or otherwise
  - Course of business arranged
  - Transaction produces more than ordinary profit in tax holiday unit
- No need to report transaction unless conditions for invocation established
  - Scope not restricted to goods or services
  - Scope not restricted to S.40A(2) persons
- Revenue >ALP does not per se imply existence of more than ordinary profits.
- If conditions fulfilled
  - Transaction qualifies as SDT then adopt ALP,
  - Transaction not SDT then AO to impute reasonable profits

Case Study on 80IA(10)



- Sale of goods At Cost < FMV
- Corp Guarantee At Nil Cost
- Free Use of TM or HR Resources

- **For A Co**
  - Domestic TP not applicable – transaction is of income receipt,40A(2) not triggered
- **For B Co**
  - Covered by s. 40A(2)(b) and hence SDT. But, payment is at < FMV, no TP adjustments required.
  - S. 80-IA(10) may still be invoked on the ground that arrangement leads to more than ordinary profits?

Audit Procedures for Clause 24

- Only ***Business Transactions*** need to be reported
- Close Connection not defined but one may take relationships as defined U/s 40A(2)(b) to determine close connection
- Quantitative Details are to be provided – if any
- Tax Holiday Units are required to maintain separate set of accounts and are required to get a report from an Accountant certifying the correctness of claim of deduction – These set of accounts can be basis of verification of transactions under this Clause 24

Part C – Clause 25

Reporting of Transactions with AE not covered in Clause 22 to 24

- Particulars in respect of any other transactions:
- Has the assessee entered into any other specified domestic transactions(s) not specifically referred to above, with an associated enterprise? Yes/No

  If 'yes' provide the following details in respect of each associated enterprise and each transaction:
  - (a) Name of the associated enterprise with whom the specified domestic transaction has been entered into:
  - (b) Description of the transaction.
  - (c) Amount paid/received or payable/receivable in the transaction -
    - (i) as per books of account.
    - (ii) as computed by the assessee having regard to the arm's length price.
  - (d) Method used for determining the arm's length price [See section 92C(1)]

Audit Procedures for Clause 25

- Residuary Clause
- Only Transactions covered within meaning of SDT as defined U/s 92BA need be covered
- As the substance of transactions is determined by standard audit procedures followed – Any such transactions though covered under definition of SDT (92BA) do not get reported Clause 22 – 24 need be reported under this clause.

Transfer Pricing Process

Identification of Related Parties

Identification of Transactions Subject to Transfer Pricing

Determination of Arm's Length Price (ALP)

Benchmarking Analysis

Documentation and Certification

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Benchmarking Specified Domestic Transactions - Methods

Method 1

- **Comparable Uncontrolled Price Method**
  - **compares the price charged for goods or services transferred** in SDT to the price charged for property or services transferred **in a comparable uncontrolled transaction**

Method 2

- **Resale Price Method**
  - Measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review
  - generally used in case of **distributor/re-seller** model with reference to gross profit earned from such transactions

Method 3

- **Cost Plus Method**
  - Cost plus method tests whether a profit mark-up charged in a SDT is at arm’s length by reference to the mark-up charged in uncontrolled transactions.
  - Transfer pricing is calculated by adding a mark-up, earned in uncontrolled transactions, to a direct and indirect cost of production/ services relating to SDT.

Benchmarking Specified Domestic Transactions - Methods

Method 4

- **Profit Split Method**
  - This method aims to determine what division of total profits independent enterprise would expect in relation to the relevant transactions based on FAR analysis.
  - In order to apply this method, it is necessary to identify the total profit arising from the related party transactions and split that profit between the parties according to their respective contributions.
  - Uses complex context where transaction involves intangibles or transaction is complex. In Indian context, the use of this method is very limited

Method 5

- **Transactional Net Margin Method**
  - Examines **net profit** margin relative to an appropriate base that a taxpayer realizes from a transaction with related party. This method is widely used and most preferred method

Method 6

- **Any other suitable method notified by the Board as per Rule 10AB.**

Transfer Pricing Documentation

Enterprise Wise

Ownership structure of the taxpayer

- Profile of the Group
- Name of Associated Enterprises, address,, legal status, country of tax residence, ownership linkage and business
- Business of the taxpayer, description of industry

Transaction Specific

- Description of transaction
- Functional Asset & Risk Analysis
- Industry / market condition, forecasts/ budget, financial estimates
- Uncontrolled transactions and comparability analysis

Computation Related

- Most appropriate method
- Computation of arm's length price
- Assumptions, policies and price negotiation
- Transfer pricing adjustment

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Case Study

FAR	A Ltd & AB India Ltd	A Ltd. & XY India Ltd.
F.1. Procurement	A Ltd.	A Ltd.
F.2. Packaging	A Ltd.	A Ltd.
F.3. Marketing	AB India Ltd.	XY India Ltd.
F.4. Sales to final Customer	AB India Ltd.	XY India Ltd.
F.5. After sales support	AB India Ltd.	XY India Ltd.
A.1. Warehouse	A Ltd.	A Ltd.
A.2. Logistics	AB India Ltd.	XY India Ltd.
A.3. Brand	A Ltd.	A Ltd.
A.4. Distribution network	AB India Ltd.	XY India Ltd.
A.5. Customer list	AB India Ltd.	XY India Ltd.
R.1. Product risk	A Ltd.	A Ltd.
R.2. Product service risk	AB India Ltd.	XY India Ltd.
R.3. Credit risk	AB India Ltd.	XY India Ltd.
R.4. Product obsolescence risk	AB India Ltd.	XY India Ltd.

Other Information

Transaction Detail	A Ltd & AB India Ltd.	A Ltd. & XY India Ltd.
Product	Cotton Shirts of same fabric and brand	Cotton Shirts of same fabric and brand
Payment terms	30 days	30 days
Delivery terms	FOB	C&F
Market in which A Ltd operates	Wholesale	Wholesale
Market in which AB India & XY India operates	Retail	Retail
Conditions prevailing in the market	Same	Same

Conclusion

- Transaction between A Ltd. & AB Ltd. (‘Controlled transaction’) and A Ltd. & XY India Ltd (‘Uncontrolled transaction’) are comparable.
- However, difference for adjustments in delivery terms need to be carry out.
- Hence, CUP is the most appropriate method.

Thank You