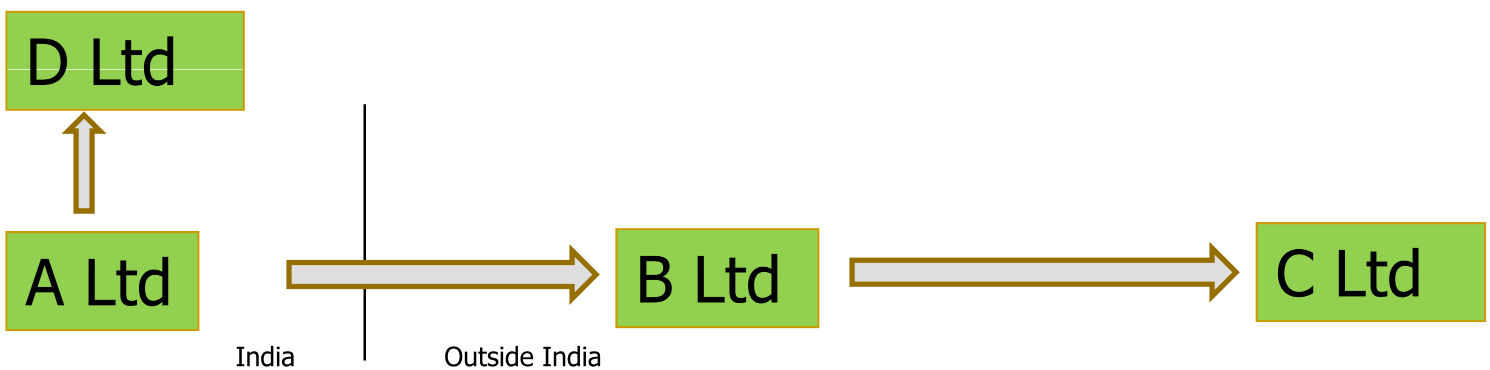
Domestic Transfer Pricing ~ Provisions & Concepts

AE as per International TP

- Enterprise - directly or indirectly or through one or more intermediary participates in the capital, control and management of the other enterprise.

- In the above case both the enterprises i.e. B Ltd and C Ltd are considered as Associated Enterprises of A Ltd.



- In the above case both the enterprises i.e. B Ltd and C Ltd are considered as Associated Enterprises of D Ltd since they have a common parent company

Deemed AE as per International TP

- Holding 26% or more voting rights by one enterprise in another enterprise OR Holding 26% or more voting rights by common person in both the enterprise.
- Loan advanced by one enterprise to another enterprise is 51% or more of the book value of all the assets of the other enterprise.
- One enterprise guarantees 10% or more of the total borrowings of the other enterprise.
- 50% or more of the BOD of one enterprise is appointed by another enterprise OR 50% or more of the BOD of both the enterprises is appointed by a common person.
- Manufacturing of goods or articles by one enterprise depends upon the Drawings/Design/Patent Specification/License/ Trademark/ Copyrights which is owned by the other enterprise.
- 90% or more of raw material required by one enterprise to manufacture or produce any goods or article is provided by another enterprise or by the person specified by the other enterprise.
- Goods and articles produced by one enterprise are purchased by another enterprise or by the person specified by the other enterprise and price and other terms are influenced by such other enterprise.
- Where one enterprise is an individual, the other enterprise is controlled by an individual or his relatives or jointly by an individual and his relatives.
- Where one enterprise is an HUF, the other enterprise is controlled by the member of an HUF or his relatives or jointly by the member and his relatives.
- Where one enterprise is a partnership firm/AOP/BOI, the other enterprise holds 10% or more interest in such firm/AOP/BOI.
- There exist mutual relationship between 2 such enterprises.

Definition of International transaction

- It means transaction between two or more associated enterprises
- The transaction may be in the nature of:

  1) Purchase, sale and lease of tangible or intangible property

  2) Lending and borrowing of money

  3) Rendering of services

  4) any transaction having bearing on the profit, income, losses and assets of the enterprise
- It also includes the mutual agreement or arrangement between two associated enterprises for the allocation or apportionment of the cost incurred or to be incurred in connection with benefit, service or facility provided or to be provided to any one of those enterprises

Position Pre & Post Finance Act, 2012

- Tax Authority empowered to disallow payments to "related parties" which are "excessive" or "unreasonable" – Section 40A(2)(b)
- In cases of entities possessing tax holiday undertakings
  - ✓ AO empowered to <u>*determine profits based on FMV in inter unit transfer*</u> - Also empowered to <u>*re-compute eligible profit in case of arrangements with closely connected persons*</u> or otherwise
  - ✓ No specific methodology prescribed
- Transfer pricing provisions extended to "Specified Domestic Transactions (SDT)" w.e.f A.Y 2013 - 14
  - ✓ Seeks to create legally enforceable obligation on taxpayers to maintain proper documentation increasing compliance and administrative burden for ALL tax payers
  - ✓ Domestic TP provisions exist in other countries such as UK, USA

SC decision in Glaxo Smithkline – Precursor to Domestic TP provisions

Domestic transfer pricing provisions

Section 40A(2)(b)

Payments for expenses incurred being excessive in nature made to *specified related entities*

Section 80IA(10)

- *Business arrangement* between tax holiday unit & *persons having close connections* results in *more than ordinary profits* to tax payer; and

Section 80IA(8)

- *Inter-business transfer of goods*/ services of the tax payer claiming tax holiday; and
- The *consideration* for such transfer does not correspond to the *market value* of goods/ services transferred

Others

- Transactions specified in chapter VI-A/ section 10AA to which section 80IA(8)/ 80IA(10) applies
- Any other transactions as may be prescribed

Aggregate of above referred transaction to exceed Rs 5 crores

For entities not claiming any tax holiday – only section 40A(2)(b) applicable

Section 40A(2) – Payments to related parties

- Applicable to taxpayers making the payment/incurring expenditure and not to recipients of such income
    - ✓ Can ALP testing of recipient be relied upon to support arm's length nature of expense?
    - ✓ No correlative relief for recipient if payer subject to a TP adjustment
- Expenditure should be towards 'goods', 'services' or 'facilities'

Covered under section 40A(2)

- ✓ Purchases of materials
- ✓ Payment for services
- ✓ Payment of interest on loans/ advances/ debentures
- ✓ Payment for know-how/ brand
- ✓ Fees for financial/ performance guarantee
- ✓ Any other 'expenditure' accounted in profit & loss account

Not covered under section 40A(2)

- ✓ Sales
- ✓ Services fees income
- ✓ Receipt of interest
- ✓ Security deposit
- ✓ Share application money
- ✓ Investments
- ✓ Any income accounted in profit & loss account

Meaning of goods, services, facility

- Goods, services and facility are those which are commercial / marketable in nature
- Goods
  - ✓ Every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale
- Services
  - ✓ Section 28(va) explains the term "services" to mean service of any description which is made available to potential users and includes the provision of services in connection with business of any industrial or commercial nature such as accounting, banking, communication, advertising etc
- Facility
  - ✓ Could include not just physical facility.
  - ✓ The term could also include, extending credit facility

Section 40A(2)(b)
Related entities/ persons (to the extent relevant)…

Payments to :

Clause no	Provisions
(ii)	Directors[1] of the tax payer
(iii)	Individual[1] having substantial interest
(iv)	- A Company having substantial interest in business of the tax payer or Directors[1]/ Partner[1]/ Member[1] of such Company as the case may be - Company having a Common Shareholding Company
(v)	Company, a Director as the case may be of which is having substantial interest in business of the tax payer or any Director[1] of such Company as the case may be
(vi)	Any person in whose business the tax payer Company; or any Directors[1] of such tax payer Company have a Substantial interest

A simplified version of explanation of Section 40A(2)(b) is enclosed as Annexure 1

[1] Includes reference to relatives

Tax holiday eligible business

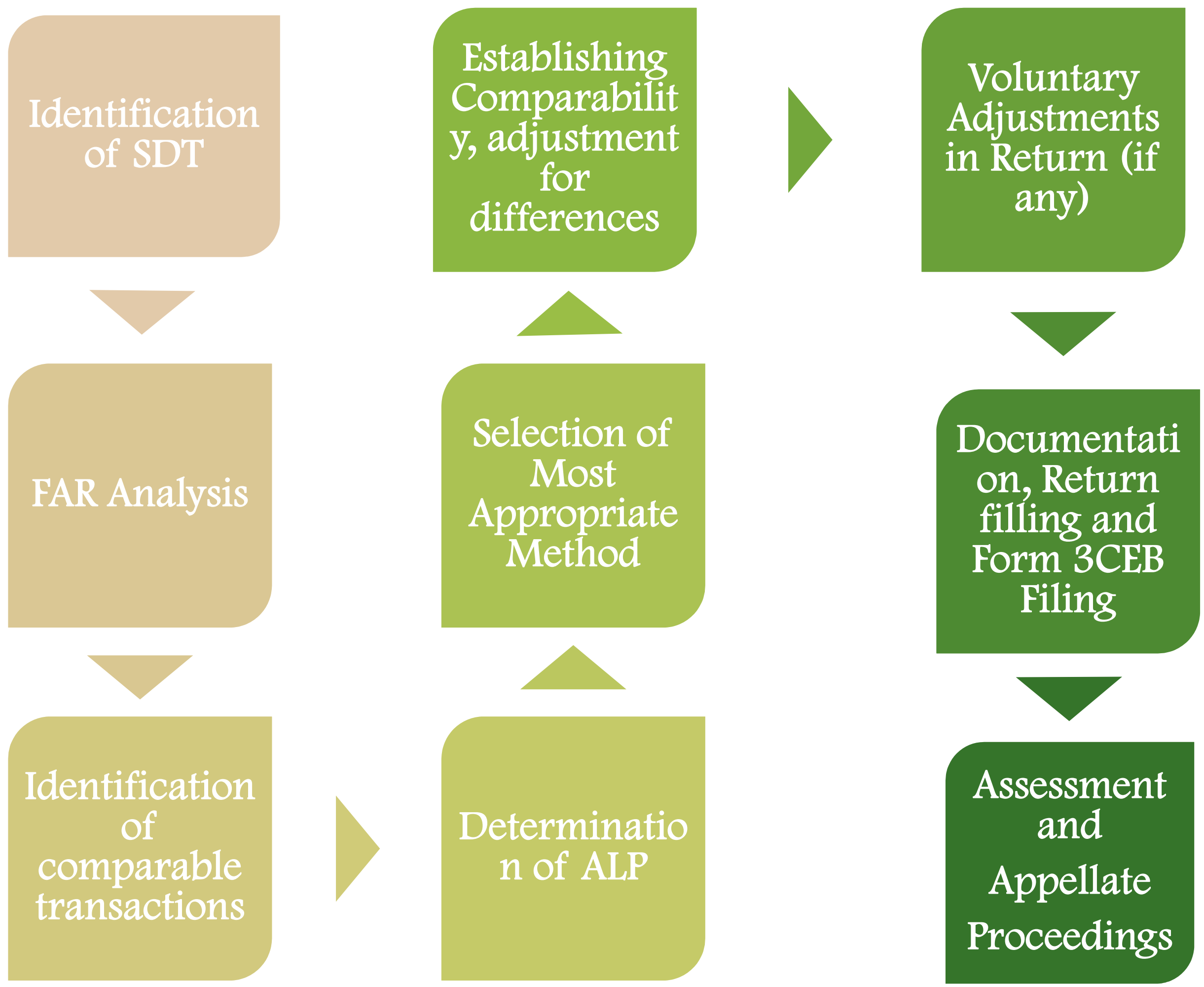
- SDT provisions apply to business transactions/transfers referred to in section 80A, 80IA(8), 80IA(10), 10AA, Chapter VI-A provisions
- General Scope of Section 80A(6) and Section 80IA(8) require adjustment to tax holiday profits where
  - ✓ Existence of two or more separate businesses of the same taxpayer - Goods and services of eligible business are transferred to other business and vice versa
  - ✓ Consideration for such transfer as recorded in the accounts of eligible business does not correspond to market value of such goods/services
  - ✓ In such cases, tax authorities/ taxpayer required to recompute tax holiday claim by reference to ALP of such goods/services
- General scope of Section 80IA(10)
  - ✓ Tax officer empowered to re-compute tax holiday profits if more than "ordinary profits" have arisen in the eligible business due to transactions between closely connected persons or for other reasons
  - ✓ Onus still on tax officer to establish that the course of business was arranged to produce more than ordinary profits?

Applicability to investment-linked tax incentives under Section 35AD?

Domestic TP ~ Applicability

- Application of Domestic TP can not reduce total income that is subject to tax
- Tax holiday denial to adjusted income, if Domestic TP adjustment results in enhancement of total income
- TP provisions applicable to international transactions applicable to SDT as well, with the exception of Advance Pricing Agreement (APA) provisions
- Concept of Arms Length Price (ALP) applicable for determining taxable income arising from international transactions introduced in 2001, now extended to SDT
- ALP defined to mean a price which is applied or proposed to be applied in a transaction between persons other than Associated Enterprises (AEs), in uncontrolled conditions

Domestic Transfer Pricing Process Flow



Various methods for domestic Transfer Pricing

Method	Applicability	PLI to be compared
CUP	CUP method can be applied where reliable data of similar uncontrolled transaction between two unrelated parties or between related party and third party is available	Prices
RPM	Where an enterprise purchases goods or services from a related party and sells them to unrelated parties without adding any substantial value to the product or services	Gross Profit Margin
CPM	Where there is transfer of semi finished goods between related parties or in case of services	Gross Profit Margin/ Direct and indirect cost of production/service
PSM	In case of transfer of unique intangibles or in multiple inter-related transactions which cannot be evaluated separately for determining the arm's length price	Generally, operating Profit margins
TNMM	When all other methods for determining ALP fails and reliable comparable data with broad functional similarity is available	Generally, operating Profit margins
Other Method as per Rule 10AB	Where the price which would be charged for similar transaction between unrelated parties is available (based on the valuation reports, genuine quotes available from independent parties, etc)	Such "would be price"

Compliance Required

- Maintenance of prescribed documentation to prove that transactions are at arm's length - Section 92D read with Rule 10D
  - ✓ The prescribed information & documentation should be contemporaneous and must be in existence by the specified date – November 30th of the following financial year

Entity related	Price related	Transaction related	Supporting documents
• Profile of industry/group • Profile of eligible unit • Profile of related parties	• Transaction terms • Functional analysis & Economic Analysis • Forecasts, budgets	• Agreements • Invoices • Pricing related correspondence (letters, emails etc)	• Official publications, reports by Government, institutions of repute, Stock exchanges • Financial statements

- Obtaining of Accountant's report (Form 3CEB) and the same to be filled by the due date – Section 92E
  - ✓ Requirement to file electronically
  - ✓ If an inter-company transaction has effect in more than one financial year, a fresh documentation need not be maintained separately , unless there is significant change in the Nature or terms or Assumptions made

Domestic TP – Penal provisions

Section	Trigger	Quantum of penalty
271(1)(c)	In case of an adjustment post assessment, if regarded as concealment of income	100-300% of the tax leviable on the amount of adjustments
271AA	Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information/document	2% of the value of the transactions
271BA	Failure to furnish Form 3CEB	INR 100,000
271G	Failure to furnish TP documentation with the tax officer	2% of the value of the transactions

- Adjustment related penalty not leviable where taxpayer has acted in 'good faith' and exercised 'due diligence'
- TP documentation serves as a good basis to demonstrate good faith and due diligence

What taxpayers need to do

- Analyze SDT provisions and applicability thereof well in advance
- Analyze and document technical positions relating to scope/ coverage/ applicability of SDT
- Undertake impact assessment on current practices and policies
- Take corrective action as may be necessary
  - ✓ Reset inter company/inter unit pricing policies, wherever required
  - ✓ Properly document inter-company/ intra-company pricing policies
- Initiate steps for preparing SDT TP documentation

Four Step action plan

1 Identifying SDTs

- Identify inter company Transactions/ arrangements that would be covered within the ambit of Domestic TP provisions
- Map the transactions and document the current policy of pricing/allocation

2 Understand implications

- Review the agreements/documents for current inter company pricing/allocations
- Analyze whether the current pricing policy of the group are in line with the ALP
- Technical assessment of the arrangements to evaluate applicability of SDT provisions and approach for establishing ALP for the SDT arrangements

3 Impact assessment

- Undertake Functional analysis of the identified transactions
- Undertake a bench marking analysis

4 Compliance requirements

- Maintain prescribed TP documentation as stipulated under Rule 10D of the ITL within the prescribed due date (Nov 30, 2013 for FY 2012-13 transactions)
- Obtain and file Form 3CEB with the tax authorities (Nov 30, 2013 for FY 2012-13 transactions)

Complete Steps 1 - 3 by March 31, 2013 and Step 4 by Nov 30, 2013 (mandatory)

Tax Burden, if transaction not at ALP

X Ltd. (non-tax holiday) → Sale at 120 v/s ALP i.e. 100 → Y Ltd. (non-tax holiday)

Disallowance of Rs. 20 to Y Ltd
[40A(2)(b)]

X Ltd. (tax holiday) → Sale at 120 v/s ALP i.e. 100 → Y Ltd. (non-tax holiday)

Double Adjustment
Tax holiday on 20 not allowed to X Ltd –
[80IA(10)] (more than ordinary profits) .
Disallowance of 20 to Y Ltd. – [40A(2)(b)]

X Ltd. (tax holiday) → Sale at 80 v/s ALP i.e. 100 → Y Ltd. (non-tax holiday)

Inefficient pricing structure - reduced tax holiday benefit since sale price is lower than ALP

Position post – budget 2012 for SDT

FMV	ALP
No method prescribed for computing FMV	Six methods prescribed for computing FMV
No documentation required to be maintained	Contemporaneous documentation required to be maintained
Other than reporting in tax audit report, Form 56F and 10CCB no statutory compliance	Accountant's report signed by a CA to be filed
Assessment done by the AO	Assessment done by the TPO

Implications of the position

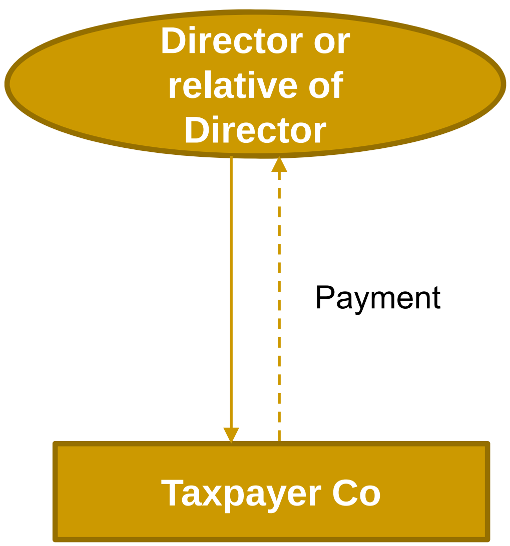
- Related party payments likely to be subject to detailed scrutiny to assess whether payments are consistent with ALP
  - ✓ Adjustments could lead to economic double taxation in the absence of correlative relief
- Intra-enterprise arrangements may be reviewed to assess reasonableness of tax holiday eligible profits
  - ✓ Impact on extent of profits that may be eligible for tax holiday
- Profits of tax holiday eligible taxpayers may be evaluated to assess whether more than ordinary profits are derived on account of dealings with closely connected persons
  - ✓ Impact on extent of profits that may be eligible for tax holiday
- Documentation/ compliance and reporting obligation on taxpayer
  - ✓ Stringent penalty for non-compliance
- Assessment of transactions by specialized transfer pricing officers

Challenges

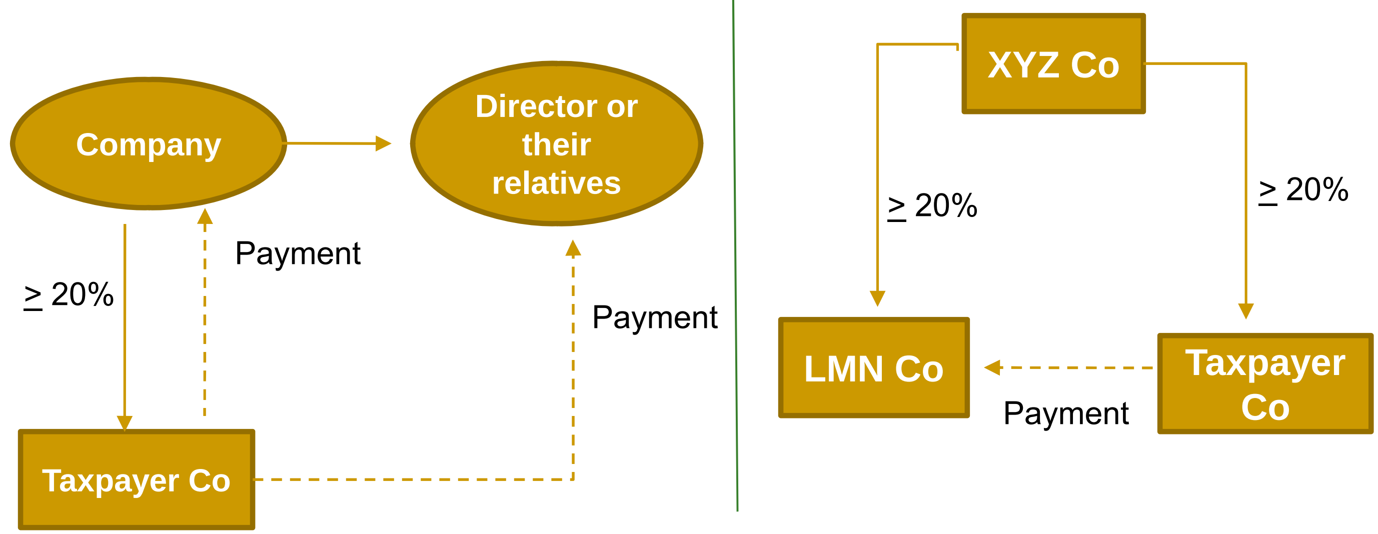
Sr. No.	Types of payments/transactions	Challenges
1	Salary and Bonuses paid to the partners	▪ Benchmarking ▪ Whether the limit as mentioned in section 40(b) would be the ALP?
2	Remuneration paid to the Directors	▪ Benchmarking ▪ Whether the limit as mentioned in Schedule XIII would be the ALP?
3	Transfer of land / Renting arrangements	▪ Whether the rates mentioned in the ready reckoner be considered as the ALP?
4	Joint Development Agreements	▪ Benchmarking?
5	Project management fees	▪ Benchmarking?
6	Allocation of expenses between eligible unit and non- eligible unit	▪ Whether this allocation would be SDT –Sec 80-IA(10)?
7	Definition of Related Party	▪ Directly v/s Indirectly?
8	Capital Expenditure	▪ Whether covered u/s 40A(2)(b)

Thank You

Clause (ii)



Clause (iv)



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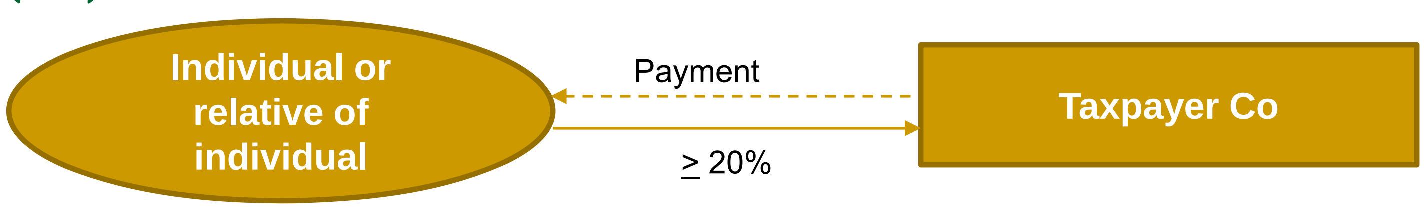
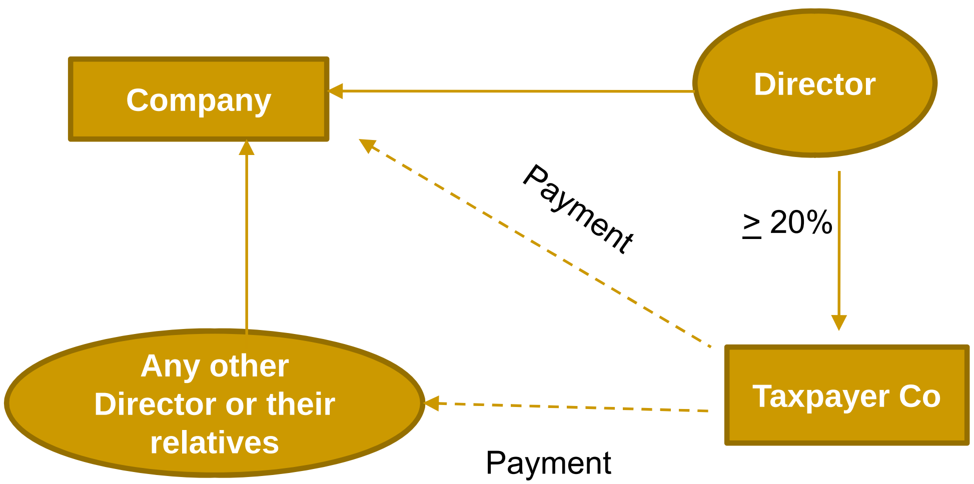


Annexure 1

Clause (v)



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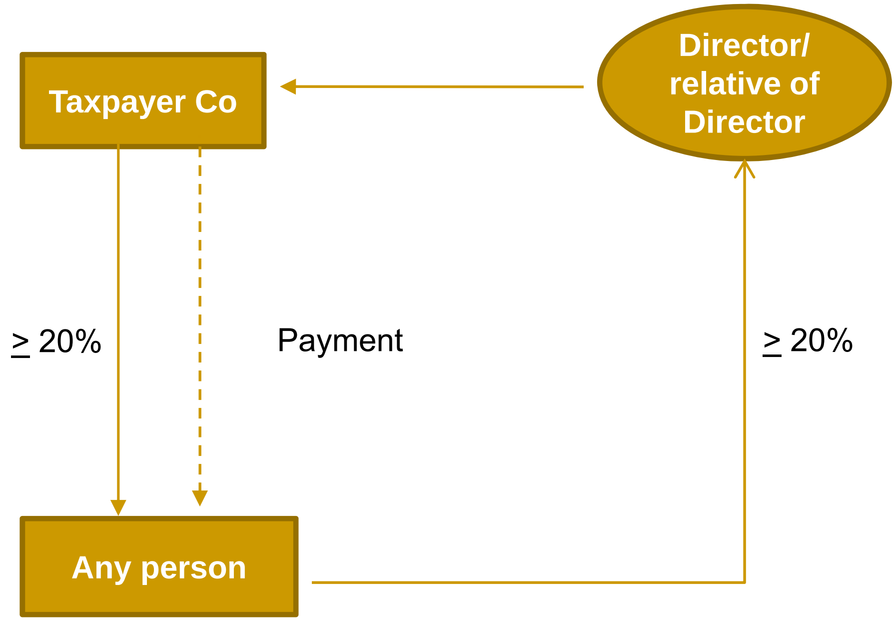

Annexure 1