

DOMESTIC TRANSFER PRICING

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Introduction

- Previously TP applicable only to international transactions
- By virtue of Finance Act, 2012, TP provision ambit has been extended to 'Specified Domestic Transactions' between related parties w.e.f 1st April, 2012
- SC in the case of CIT vs. Glaxo Smithkline Asia Pvt. Ltd [2010- 195 Taxman 35 (SC)] recommended introduction of domestic TP provisions
- The onus was on revenue authorities, now obligation on the taxpayer to report/document and substantiate arm's length price for such SDT
- Shift to more technical and focused ALP concept

SDT – Objective

Bringing in a more technical and focused ALP concept



Thereby doing away with tax arbitrage abuse which instigates from differential tax rate, tax holidays/benefit availed by undertakings and presence of accumulated losses



Ultimately protecting the revenue of the Indian Government

Illustrating the objective behind introduction of SDT

India

Shifting of expenses/losses

India

I Co.
Tax Holiday
undertaking

Related Enterprise
in Domestic Tariff
Area (DTA)

Tax Exemption

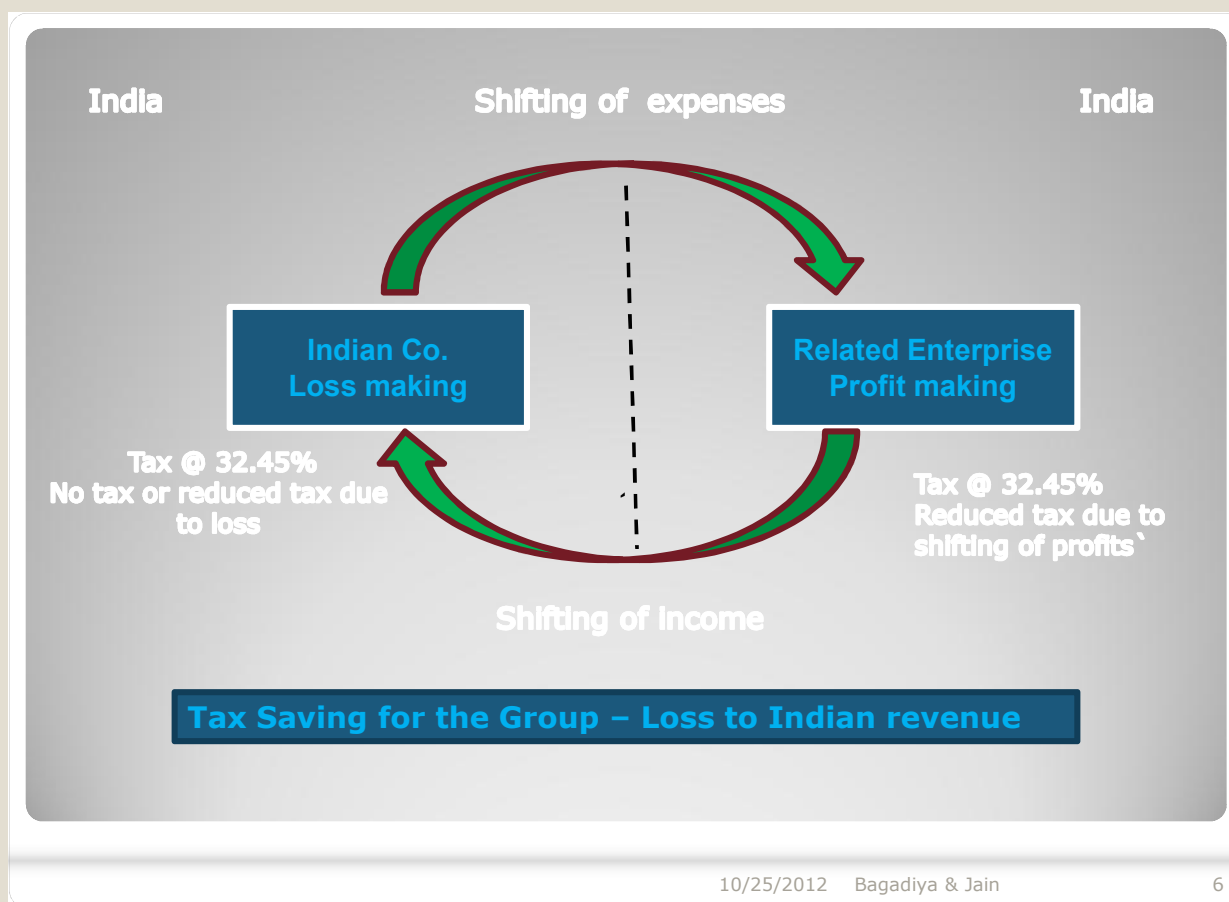
Tax @32.45%

Shifting of Income/profits

Tax Saving for the Group – Loss to Indian revenue

Particulars (Ordinary Situation)	Co. A (SEZ)	Co. B (DTA)
Income	500	1000
Income from related party	100	-
Expenses	300	800
Expense to related party	-	100
Profit/ Loss	300	100
Tax rate applicable	0%	32.45%
Tax	-	32.45 (100*32.45%)

Particulars (Planned Situation)	Co. A (SEZ)	Co. B (DTA)
Income	500	1000
Income from related party	200	-
Expenses	300	800
Expense to related party	-	200
Profit/ Loss	400	-
Tax rate applicable	0%	32.45%
Tax	-	-



Particulars (Ordinary Situation)	Co. A (DTA)	Co. B (DTA)
Income	400	1100
Income from related party	100	-
Expenses	600	700
Expense to related party	-	100
Profit/ Loss	(100)	100
Tax rate applicable	32.45%	32.45%
Tax	-	32.45 (100*32.45%)
Particulars (Planned Situation)	Co. A (DTA)	Co. B (DTA)
Income	400	1100
Income from related party	150	-
Expenses	600	700
Expense to related party	-	150
Profit/ Loss	(50)	50
Tax rate applicable	32.45%	32.45%
Tax	-	16.23 (50*32.45%)

*** By shifting of income from a profit making company to a loss making company, the group could reduce its tax liability by 16.23 for the current year, though the impact will be reversed in future years given carry forward of losses.**

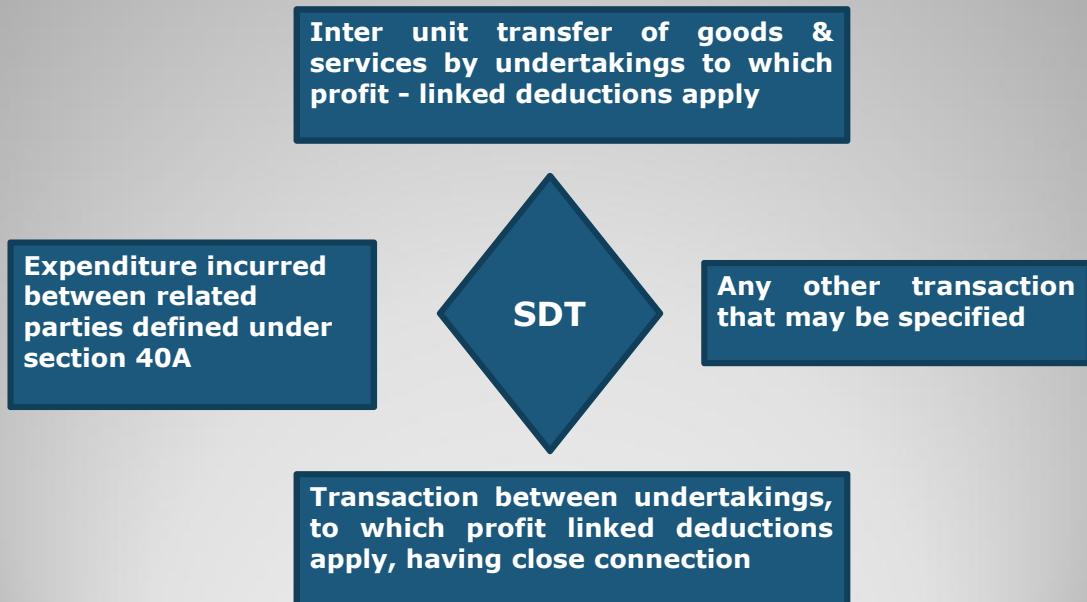
Meaning of SDT – Section 92BA

For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:-

- (i) any expenditure in respect of which payment has been made or is to be made to a person referred to in section 40A(2)(b);
- (ii) any transaction referred to in section 80A;
- (iii) any transfer of goods or services referred to in sub-section (8) of section 80-IA;
- (iv) any business transacted between the assessee and other person as referred to in section 80-IA (10);
- (v) any transaction, referred to in any other section under Chapter VIA or section 10AA, to which provisions of section 80-IA(8) or section 80-IA(10) are applicable; or
- (vi) any other transaction as may be prescribed,

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of five crore rupees.

92BA- Summarised



Analysis of Section 92BA

Section	Relevance with provisions of Sec 92BA
92 : Computation of income having regard to ALP	✓
92A : Meaning of AE	✗
92B : Meaning of International transaction	✗
92C : Methods of computation of ALP	✓
92CA: Reference to TPO	✓
92CB : Safe harbour rules	✗
92CC : Advance Pricing agreement	✗
92CD : Effect of TP agreement	✗
92D : Maintenance of information and documents	✓
92E : CA's Report	✓
92F : Definitions: Accountant, ALP, Enterprise, PE, Specified date, Transaction*	✗

***Sec 92F – Definitions does not define terms relevant for domestic TP transactions**

Sec. 92 – Computation of income from international transaction having regard to ALP

- (1) Computation of income from international transaction having regard to ALP.
- (2) mutual agreement etc for allocation or apportionment or contribution to any cost or expense shall be determined having regard to ALP.

(newly inserted)

(2A) Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to specified domestic transaction shall be computed having regard to ALP.

- (3) section does not apply if the effect is reducing the income or increasing the loss.

Sec. 92 C – Computation of ALP

The words "*specified domestic transaction*" has been inserted appropriately in various sub-sec.

(1) Any of the following methods, being most appropriate method :

- (a) Comparable uncontrolled price method;
- (b) Resale price method;
- (c) Cost plus method;
- (d) Profit split method;
- (e) Transactional net margin method;
- (f) other method of determination of arm's length price

refer rule 10B

(any method that takes in to account the price which has been charged or paid or would have been charged or paid for same or similar uncontrolled transaction with or between non – associated enterprises)

(2) Most appropriate method as per criteria laid down in rule 10C considering FAR analysis also.

FAR : Functions performed, Assets employed, Risks assumed [Rule 10C(2)]

Section 92CA - Reference To TPO

The word "*specified domestic transaction*" has been inserted in various sub-sections.

- ✓ (1) AO may refer the computation of ALP to TPO
- ✓ (2) TPO to issue notice to Assessee to produce evidence in support of ALP
- ✗ (2A) Any other international transaction coming to notice of TPO*
- ✗ (2B) Non-furnishing of CA's report and TPO's power *
- ✓ (3) TPO shall pass the order determining ALP
- ✓ (4) AO to compute total income accordingly
- ✓ (7) TPO's power of summons (s.131), survey (s.133A) and collecting information u/s 133(6) applies even in Domestic Transaction

Sec. 144C (15)(b).....Reference to DRP

- AO to forward draft of proposed order to eligible assessee
- eligible assessee means – any person in whose case order u/s 92CA is passed

* **92CA (2A) & (2B)** do not cover specified domestic transactions and hence the TPO cannot suo moto upon the transaction coming to his notice apply the TP provisions

Section 92D : Maintenance and keeping information and document by persons entering into an international transaction as well as SDT

Entity Related



- ✓ Profile of Industry
- ✓ Profile of group
- ✓ Profile of related parties

Price Related



- ✓ Transaction terms
- ✓ FAR related
- ✓ Economic Analysis (method selection, comparable benchmarking)
- ✓ Forecasts, budgets, estimates

Transaction Related



- ✓ Agreements
- ✓ Invoices
- ✓ Pricing related correspondence (letters, e-mails, fax, etc.)

The onus of proving SDT at ALP is on tax payer

Penalty

Section	Default	Quantum of penalty
271(1)(c)*	In case of a post-inquiry adjustment, there is deemed to be a concealment of income	100-300% of tax on the adjusted amount
271AA	<ul style="list-style-type: none"> •Failure to maintain documents •Failure to report a transaction in accountants report 	2% of the value of transaction
271G	Failure to furnish information/ documents during assessment u/s 92D	2% of the value of the transaction
271BA	Failure to furnish accountant's report u/s 92E	INR 1,00,000

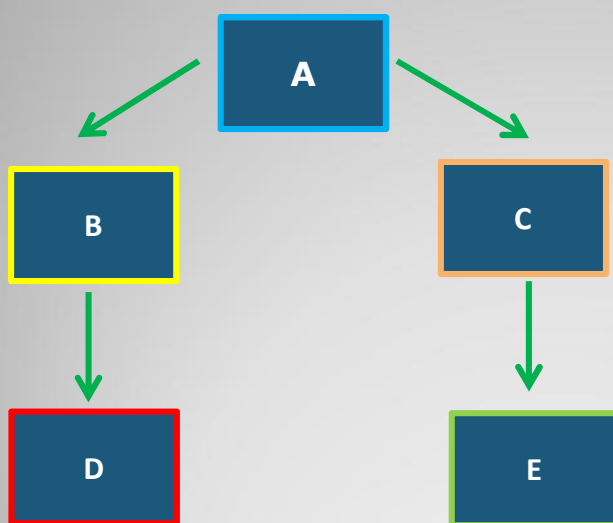
*However, penalty for concealment of income shall not be levied if the taxpayer demonstrates that price charged or paid has been determined in 'good faith' and with 'due diligence'

40A(2)(b) Transactions – Persons covered

In case of a company (let's take Company In X) payments to the following persons are covered :

Type of person	When Covered
Investor Company	<i>Any Company (say Company Z) which is a beneficial owner of shares carrying not less than 20% of voting power in Company X</i>
Sister Company	Any Company in which Company Z is a beneficial owner of shares carrying not less than 20% of voting power
Investee Company	A company in which <i>Company X is a beneficial owner of shares</i> carrying not less than 20% of voting power
Group Company	<ul style="list-style-type: none"> Any company of which a director (or relative of such director) is a beneficial owner of shares not carrying less than 20% of voting power in <i>Company X</i>; and Any company in which a director (or relative of such director) of <i>Company X is a beneficial owner of shares carrying not less than 20% of voting power</i>;
Certain individuals	<ul style="list-style-type: none"> any director of Company X or of Holding Co., or to any relative of such director; and any individual who is a beneficial owner of shares not carrying less than 20% of voting power in Company X or any relative of such individual

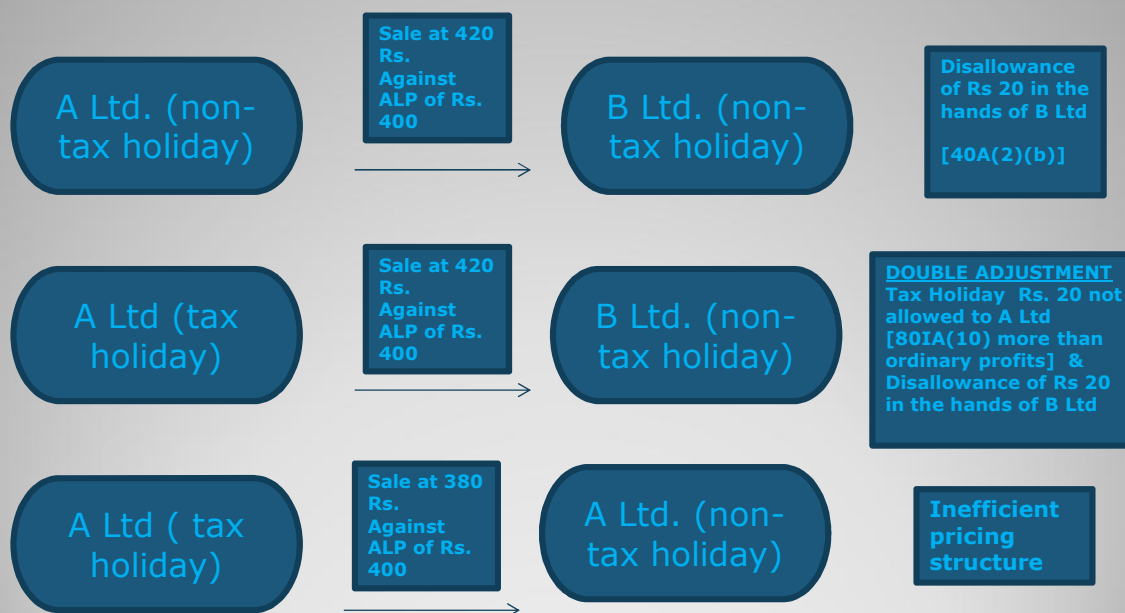
Type of transactions covered (illustrations for payments made by a Company)...Amendment to Section 40A to cover payments made to company having common Parent Co



Transaction Covered

A & B	✓
A & C	✓
A & D	✗
A & E	✗
B & C (effect of amendment)	✓
D & E	✗
C & D	✗
D & E	✗

Consequences if transaction not at ALP



Section 80IA(8) & 80IA(10) – Deduction in respect of profits & gains from industrial undertaking or enterprise engaged in infrastructure development, etc..

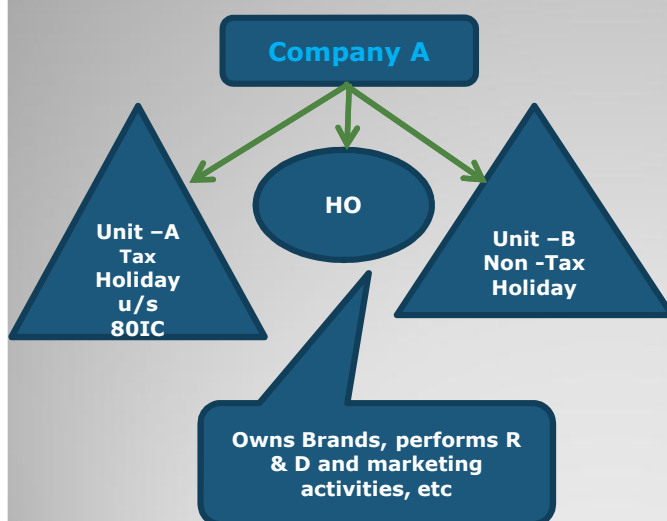
80IA(8)	80IA(10)
Inter unit transaction of goods and services	<ul style="list-style-type: none"> •Business transacted with any person generates more than ordinary profits •Owing to either close connection or any other reason
Applicable where transfer is not at market value	Applicable to tax holiday units earning more than ordinary profit
Onus on tax payer	<ul style="list-style-type: none"> •Primary onus on Tax payer •Onus on tax authorities as well

- Close connection not defined
- To ally ordinary profits with arm's length price

Other Sections under Chapter VI-A.....to which s. 80-IA(8) or (10) are applicable

80-IA	Income from Infrastructure, Telecommunication, Industrial Park & Power sector etc.
80-IAB	Income of an undertaking or enterprise engaged in development of SEZ
80-IB	Income from certain Industrial undertaking and Housing Projects etc.
80-IC	Income from certain Industrial undertaking set up in Sikkim, HP...etc.
80-ID	Income from hotels etc in Delhi, Faridabad and other specified districts.
80-IE	Income from eligible business undertaking in North Eastern States

Case Study illustrating application of ALP on units eligible for profit linked deductions



- Company A has three units: Unit A and Unit B (Manufacturing units) and Head Office unit
- Head Office performs functions of R&D, marketing and distribution of goods produced by the manufacturing units
- Profitability is ascertained by allocating the expenses incurred by the Head Office in an appropriate ratio between Unit A and Unit B
- Whether the reported profitability of the tax holiday undertaking can be varied by the tax authorities on the grounds that:
 - HO is separate undertaking; and
 - Costs allocable to Unit A should be charged using mark up or alternatively imputing a royalty cost?

...Example continued

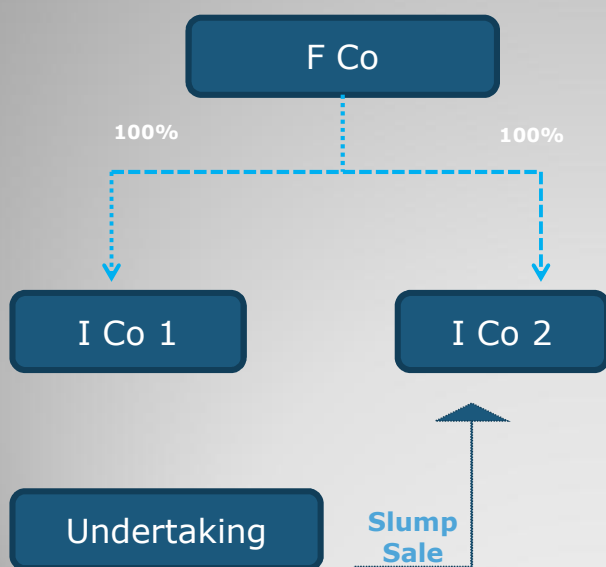
Computation of profits based on allocation of common costs

Profit & Loss Account	Rs.
Sales	100
Material cost	45
Administration & Other Expenses	20
Allocation of HO costs	10
Allocation of R & D and marketing expenses	10
Depreciation	5
Profit Eligible for tax Holiday	10

Computation of profits based on a "cost plus allocation of HO costs

Profit & Loss Account	Rs.
Sales	100
Material cost	45
Administration & Other Expenses	20
Allocation of HO costs plus mark up of 20%	12
Allocation of R & D and marketing expenses plus mark up of 20%	12
Depreciation	5
Profit Eligible for tax Holiday	6

Case Study - Transfer of an Undertaking



• Transfer of Undertaking from I Co 1 to I Co 2 through Business Transfer Agreement
 • I Co 2 will claim depreciation on the assets purchased under the business transfer agreement

Points to consider:

Whether transfer of undertaking is a specified domestic transaction and SDT implication are triggered???

What will be the impact in the hands of I Co 2 from 40A(2)(b) perspective is the claim of depreciation – Whether claimed on a higher base or on the correct base price?

Can there be an argument that depreciation is an allowance and not an expenditure?

Points requiring emphasis

- Whether payment for capital expenditure Or expenditure capitalized is also covered ?
- Whether the provisions will apply in case the payer's income is chargeable to tax under the head 'Income from other sources', because section 58(2) says –The provisions of section 40A shall, so far as may be, apply in computing the income chargeable under the head "Income from other sources" as they apply in computing the income chargeable under the head "Profits and gains of business or profession" ?
- Whether new provision applies to -
 - Public Charitable Trust having a business undertaking paid excessive remuneration to trustee/s
 - Co-operative Societies
 - Social Clubs

Challenges

Type of payments/ transactions	Challenges
<ul style="list-style-type: none"> • Salary and Bonuses paid to the partners 	<ul style="list-style-type: none"> • Benchmarking? • Whether the limit as mentioned in section 40 (b) would be the ALP?
<ul style="list-style-type: none"> • Remuneration paid to the Directors 	<ul style="list-style-type: none"> • Benchmarking? • Whether the limit as mentioned in Schedule XIII would be the ALP?
<ul style="list-style-type: none"> • Transfer of land 	<ul style="list-style-type: none"> • Whether the rates mentioned in the ready reckoner be considered as ALP?
<ul style="list-style-type: none"> • Joint Development agreements 	<ul style="list-style-type: none"> • Benchmarking?
<ul style="list-style-type: none"> • Project management fees 	<ul style="list-style-type: none"> • Benchmarking?
<ul style="list-style-type: none"> • Allocation of expenses between the same taxpayer having an eligible unit and non-eligible unit 	<ul style="list-style-type: none"> • Whether these allocation would be SDT – Sec 80-IA(10)?
<ul style="list-style-type: none"> • Definition of Related Party 	<ul style="list-style-type: none"> • Directly v/s Indirectly

...Challenges...

1. Transfer pricing provisions are not applicable in case where income is not chargeable to tax at all.
[*Amiantit International Holding Ltd.*, (2010) 322 ITR 678 (AAR)]
2. Provisions of section 40A(2) are not applicable to a co-operative society.
[*CIT vs. Manjara Shetkari Sahakari Sakhar Karkhana Ltd.*(2008) 301 ITR 191 (Bom.)]
3. When a person commits an offence by not maintaining the books of accounts as contemplated by section 44AA, the offence is complete. After that there can be no possibility of any offence as contemplated by section 44AB and therefore, the imposition of penalty is erroneous.
[*Surajmal Parasmal Todi vs. CIT* (1996) 222 ITR 691 (Gauhati)]
Note : This decision may be helpful in the context of sections 271AA, 271G and 271BA.
4. Correlative adjustments - if excessive or unreasonable expenses are disallowed in the hands of tax payer at time of the assessment then corresponding adjustment to the income of the recipient will not be allowed in the hands of recipient of income. Hence, it would lead to double taxation in India.

Way forward

- To Identify and map the relationship between domestic related parties specified u/s 40A(2)(b)
- Identify and map the SDT
- Revisit the pricing mechanism applied by the company for SDT applying the most appropriate prescribed methods
- To note that variations in profits of tax holiday units for FY 2013 compared to FY 2012 may raise concerns from tax officers.

The onus of proving SDT at ALP is on the tax payer

Glossary

AAR	Authority For Advance Ruling
AE	Associated Enterprise
ALP	Arms Length Price
AO	Assessing Officer
CA	Chartered Accountant
CIT	Commissioner Of Income Tax
DRP	Dispute Resolution Panel
DTA	Domestic Tariff Area
FMV	Fair Market Value
FY	Financial Year
HP	Himachal Pradesh
HUF	Hindu Undivided Family
ITAT	Income Tax Appellate Tribunal
ITR	Income Tax Return
LLP	Limited Liability Partnership
PE	Permanent Establishment
SC	Supreme Court
SDT	Specified Domestic Transaction
SEZ	Special Economic Zone
TP	Transfer Pricing
TPO	Transfer Pricing Officer

About Bagadiya & Jain

•Bagadiya & Jain is a dynamic professional firm established in 2005, with a vision of providing expert advisory services to businesses & organisations in the field of Corporate Financing, Management Consultancy, International Taxation, FEMA and Domestic Taxation.

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Thank You