DOMESTIC TRANSFER PRICING REGULATIONS

(Taxation of specified domestic transactions in India)

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TABLE OF CONTENTS

I. INTRODUCTION

Transactions between related parties have always been suspected as a tool to shift profits and thereby reduce the overall tax liability of a company or a group operating from multiple locations having different tax laws. Even before the concept of Specified Domestic Transaction was introduced in the Indian tax laws, several other provisions existed to curb the tax avoidance by inter-company transactions between domestic companies of the same group.

In order to mitigate tax arbitrages in transactions entered into between domestic companies, the concept of Specified Domestic Transactions was introduced in the Income-tax Act, 1961 by Finance Act, 2012.

Specified Domestic Transactions (SDT/DTP) refer to transactions between associated enterprises within the domestic territory. The declared rationale is the possibility of tax arbitrage resulting from such transactions, owing to differential tax rates, presence of accumulated losses and tax benefits availed by units operating under the same legal tax entity.

The provisions related to this Domestic Transfer Pricing seem to be brought in the statute after considering instructions / suggestions of the Supreme Court which, so far were over turned by retrospective amendments. The Supreme Court in the case of *Commissioner of Income tax v. Glaxosmithkline Asia (P) Ltd* [2010] observed that in the case of 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—

- ✓ **If one of the related companies is loss making and the other is profit making and profit is shifted to the loss making concern;**
  Explanation - When one party to the transaction has accumulated losses in their books of accounts, the related parties may be tempted to shift the profit from profit making entity to the party with accumulated loss in a bid to profiteer from reduced combined tax obligation; And

- ✓ **If there are different rates for the two related units (on account of different status, area based incentives, nature of activity, etc) and if profit is diverted towards the unit on the lower side of tax arbitrage.**

Explanation - For example, sale of goods or services from non-SEZ area, [taxable division] to SEZ unit [non-taxable unit] at a price below the market price so that taxable division will have less taxable profit and non-taxable division will have a higher profit exemption.

All these complications arise in cases where the transactions take place between related parties as defined in section 40A(2) of the Income-tax Act, 1961.The Act empowers the Assessing Officer to scrutinise any expenditure incurred between such related parties and subjectively determine it as unreasonable or excessive and disallow it. Further, under Chapter VI-A and section 10AA, the Assessing Officer is empowered to re-compute the income (based on fair market value) of the undertaking to which profit linked deduction is provided if there are transactions with the related parties or other undertakings of the same entity.

However, no specific method to determine reasonableness of expenditure or fair market value to re-compute the income in such related transactions is provided under these sections. As a result, the Central Board of Direct Taxes (CBDT) suggested that Transfer Pricing Regulations be applied to domestic transactions between related parties under section 40A(2) of the Act.

II. SPECIFIED DOMESTIC TRANSACTIONS, THE LAW

1. **Section 92BA** in the Income Tax Act 1961was inserted to explain "**specified domestic transactions.**" They include transactions aggregating more than **Rs. 20 crores** and not being an International transactions, such as:-
   (i) Expenditure incurred between related parties such as:
   - Specified persons having substantial interest (i.e. more than 20% voting power or share in profits) in taxpayer's business and vice-versa;
   - Sister concerns.

However this clause has been removed by Finance Act, 2017.

(ii) Internal transactions between various units / undertakings of the assessee in respect of goods or services;
(iii) Any transfer of goods or service of assessee with Tax Holiday Undertakings such as SEZ's, telecom services, industrial park developers, etc.;

(iv) Internal transactions with more than one undertaking / units of the assessee, out of which one or more undertaking is enjoying the tax holiday;
(v) More than ordinary profits arising to the tax-holiday undertaking owing to non-allocation or non-charging of expenses by related assessee;
(vi) any business transacted between the persons referred to in sub-section (4) of section 115BAB;
(vii) Any other transaction as may be prescribed by the CBDT via notifications.

2. <u>VALUATION</u>

The sections declares that "*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 Arm's Length Price.*"

As per Section 92C, the Arm's Length Price (ALP) has to be determined applying any of the prescribed methods, being the most appropriate method:
(i) Comparable Uncontrolled Price Method (CUP)
(ii) Resale Price Method (RPM)
(iii) Cost Plus Method (C+)
(iv) Profit Split Method (PSM)
(v) Transactional Net Margin Method (TNMM)
(vi) Or such other method as prescribed by the Central Board of Direct Taxes*(no guidance available as yet) 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*

ALP is defined as a price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

3. <u>REFERENCE TO TRANSFER PRICING OFFICER (TPO)</u>

Section 92CA provides that where any person, being the assessee, has entered into a specified domestic transaction in any previous year, and the Assessing Officer (AO) considers it necessary to do so, he may, with the previous approval of the Principal Commissioner or Commissioner, refer the computation of the Arm's length price in relation to the said specified domestic transaction to the TPO.

The TPO may ask the assessee for documents supporting the calculation of the Arm's Length Price and will accordingly pass an order with an appropriate ALP, which could be as provided by the assessee, or a revised calculation. This in turn will be used by the AO to re-compute the total income of the assessee by making additions.

4. DOCUMENTATION

Taxpayers need to identify, analyse and report the transactions which qualify as SDTs. Further, taxpayers need to ensure that such identified SDTs are aligned with ALP, based on the selection and application of the most appropriate transfer pricing method. 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. Further, the assessee has to take an accountant's report (Form 3CEB) duly signed and verified and is required to furnish the same electronically one month prior to the due date of filing the return of income.

The CBDT has revised Form 3CEB to incorporate DTP provisions via notification 41/2013 dated 11 June 2013. They have to provide following details such as:

- List of related parties
- Nature and value of SDTs

5. METHOD USED TO DETERMINE THE ALP FOR SDT ASSESSMENT:

The Central Board of Direct Taxes (CBDT) issued instruction no.15/2015 on 16th October 2015, providing guidance to the Assessing Officer (AO) and Transfer Pricing Officer (TPO) regarding administration of assessments related to specified domestic transactions.

The guidelines specify that cases for SDTs assessments should not be selected for scrutiny based on the value of domestic transactions reported by the taxpayers in the Accountant Report i.e. Form No. 3CEB, but should be based on risk parameters.

6. PENALTY IMPLICATIONS

Nature of Default/ Event	Quantum of Penalty
Under reported Income [Section 270A(7) of IT Act , 1961]	A penalty of 50% of the amount of tax payable on the under-reported income.
Under reported income is in consequence of misreporting of Income [Section 270A(8) of IT Act , 1961]	A penalty of 200% of the amount of tax payable on the under-reported income. Section 270A(9)(f) of the Act provides that the case of misreporting of income shall be failure to report any international transaction or any transaction deemed to be an international transaction or any specified domestic transactions.
Section 271AA relates to penalty for failure to keep and maintain information and document in respect of international transactions or specified domestic transactions	A sum equal to two percent of the value of each international transaction entered into by such person. (Also applicable mutatis mutandis to specified domestic transactions too)
Section 271BA provides that the person who has entered into specified domestic transactions is required to furnish a report from an accountant as required by section 92E.	In case of failure to submit report u/s 92E, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of one hundred thousand rupees. (Rs 1,00,000/)
Section 271G provides that if any person who has entered into an international transaction or specified domestic transaction is required to furnish any such information or document as required by sub-section (3) of section 92D.	On failure to furnish such information, the Assessing Officer or the Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent, of the value of the international transaction or **specified domestic transaction** for each such failure. The power to levy this penalty has also been extended now to the Transfer Pricing Officer.

Nature of Default/ Event	Quantum of Penalty
If the books of accounts contain a (i) false entry or (ii) any entry which has been omitted (section 271AAD)	100% of the amount of false entry or omitted entry

The above penalties can be avoided if the taxpayer proves that there was reasonable cause for such failures. Adjustment related penalty cannot be levied where it is proved that the taxpayer acted in 'good faith' and exercised 'due diligence'. **Penalties are not tax deductible but are discretionary.**

7. <u>TAX BURDEN, IF TRANSACTION IS NOT AT ALP</u>

Illustration 1:

Sale at Rs.120

ALP at 100

Illustration 2:

Sale at Rs.120

ALP at 100

Illustration 3:

Sale at 80 v/s

ALP at 100

8. IMPLICATION AND RELATED AMENDMENTS

Finance Act, 2012 has also introduced Advanced Pricing Agreements (APAs). However, the APAs are applicable only to International Transaction and hence not applicable to Domestic TP transactions.

9. TRANSACTIONS LIKELY TO COME UNDER THE SCANNER OF AUTHORITIES:

- Purchase/lease of movable and immovable property
- Transaction of slump sale
- Purchase of shares / other securities
- Prepaid expenses
- Guarantee fee payable to the guarantor
- Reimbursement of expenses
- Intra-group purchase / sale / service transactions;

10. PROVISIONS IN OTHER COUNTRIES

In 26 out of 41 respondent countries of the Organisation for Economic Co-operation and Development (OECD), transactions among domestic related parties are subject to the arm's length principle[1].

These include:
Austria, China, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Indonesia, Ireland, Israel, Luxembourg, Malaysia, Mexico, Netherlands, Norway, Poland, Portugal, Russia, Slovenia, Spain, Turkey, the United Kingdom and the United States.

The arm's length principle among domestic related parties is more an anti-avoidance issue than a transfer pricing issue.

Questions	**United Kingdom**	**United States**
Does the legislation in	Yes,	The governing statute, 26

[1] Multi Country Analysis of Existing Transfer Pricing Simplification Measures – 2012 Update, 6th June 2012

Questions	United Kingdom	United States
your country establish a general obligation to comply with the arm‟s length principle?	Section 147 of the Taxation (International and other provisions) Act 2010	U.S.C. Section 482, does not explicitly mention the arm‟s length Principle. However, the Commissioner has issued extensive regulations under Section 482, which establish the arm‟s length principle as the standard for transfer pricing adjustments.
Does your country have transfer pricing simplification measures in place?	Yes Small and medium enterprises are exempt from Transfer Pricing Rules	Yes SME's and small transactions covered by APA having an aggregate value not greater than 50 million p.a. have simplified APA procedures. Low-value adding intra-group services have simplified transfer pricing methods. Loans between associated enterprises have to follow safe harbour interest rate.
Are there administrative practices that simplify the application of transfer pricing in practice?	No (Although a general assessment of the transfer pricing risks of an MNE will include a consideration of the level of controlled transactions and hence tax at risk)	The tax authority has the following criteria below which audit is not required for transfer pricing purposes: ▪ Loans subject to safe harbour interest rate ▪ Low value services mentioned above

III. ISSUES

1. Areas of concern for certain domestic transactions

There is no clarification with regard to Indian Companies having both international transactions as well as domestic transactions. Since the company has to comply with transfer pricing regulations owing to their international transaction, the question remains whether the specified domestic transactions are required to be reported in the following scenario:

i) When the value of aggregate of international transaction and specified domestic transaction is less than Rs.20 crore;

ii) When the value of aggregate of international transaction and specified domestic transaction is more than Rs.20 crore but the value of specified domestic transactions is less than Rs.20 crore.

The company who has the aggregate value of domestic transactions more than Rs.20 crore anyways has to comply with the transfer pricing regulations.

2. **Increased compliance burden on all affected assessee**: in terms of maintaining TP documentation, selecting the most appropriate method and being subject to scrutiny by the TPO.

3. **Formulation of product pricing methods:** Methods of arm length pricing along with TP concepts and considerations like risk-reward planning, benchmark driven pricing, supply chain re-engineering, location planning study, etc. would help in formulation of product pricing methods and also enable legitimate tax cost management (TCM) avenues.

4. **Robust TP Documentation**: Assessee will also be subject to stringent penal provisions as provided U/s 271AA, 271AAD, 271G, 271BA and newly introduced 270A . As a corollary, maintenance of robust TP documentation would be accorded paramount significance.

5. **Benchmarking Transactions:**

Particulars	Challenges
Transfer of land	Whether rates mentioned in the stamp duty ready-reckoner can be considered as ALP?
Allocation of expenses between the same taxpayer having an eligible unit and non-eligible unit	Whether these allocations would be SDT – Sec 80-IA (10)?

6. **Coverage and simplification:** It is not clear if the SDT provisions cover areas such as Marketing intangibles, Corporate guarantee etc. Relief clauses for exclusion of entities that have transactions with low risk of tax erosion still have to be instilled.

These provisions would have ramifications across industries, which benefit from the said preferential tax policies such as SEZ units, infrastructure developers or operators, telecom services, industrial park developers, power generation or transmission, etc. Apart from this, business conglomerates having significant intra group dealing would be largely impacted.

India has so far not shown any element of innovation in framing tax laws– from drafting of laws to approach of taxation and attitude of tax department. In countries like the US, income is taxed at federal, state and municipal levels where such transaction may require tracking so people do not shift income between states. In many countries, there is **group taxation,** which could have been introduced in India instead. The law discussed so far is not even fair, as adjustment on one side will not reduce the income in the hands of the other side. Therefore, it seeks to tax the same amount two times. Obviously, this new mechanism seems to be a retrograde, unfair and desperate attempt to garner more money for the government as it’s unable to widen its tax base for over a decade.

IV. WHAT WE CAN DO FOR YOU

1) Help identify transactions which will be covered under the expanded scope of transfer pricing regulations.
2) Determine Arm's Length Price for ongoing and proposed transactions;
3) Provide tax-efficient solutions;
4) Ensuring maintenance of requisite information and documents to avoid penalties;
5) Issuance of Accountant's report in Form 3CEB.

Important Note:

This communication is intended to provide a general introduction and guidance on the subject matter and should not be regarded as a basis for taking decisions on specific matters. In such instances, separate advice should be taken.

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