

DOMESTIC TRANSFER PRICING REGULATIONS

(Taxation of specified domestic transactions in India)



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I. INTRODUCTION

Over the last several years, the Indian Finance Ministers have earned the distinction of reversing court rulings given against the revenue department, including landmark judgments of the highest court in India, by amending the tax laws to collect tax on disputes settled against them. As if this was not enough, the ministers have brought numerous retrospective amendments to specific tax laws going back all the way to 1961. The Union Budget has become such an event where retroactive changes to overthrow court rulings are made rampantly. No wonder that India is now ranked 132 out of 185 countries in global rankings on 'Ease of Doing Business'¹. On 'Paying taxes' ranking, India stands at 152nd on 185.

Keeping with this trend, the Finance Bill 2012, introduced groundbreaking yet controversial amendments having retrospective effects, that systematically negated the Supreme Court Ruling in the Vodafone case. In addition the draft General Anti Avoidance Regulations (GAAR), Advance Pricing Agreements (APAs) and Transfer Pricing Provisions on Specified Domestic Transactions (TPSDT) or Domestic Transfer Pricing were also introduced to the Income Tax Act, 1961, which already stand amended more than 8,000 times since 1962.

After slapping over 2500+ transfer pricing orders on companies with cross-border operations and attempting to raise Rs. 80,000 crores² in the financial year 2011-12, the Finance Minister has now cast his net wider by including "Specified Domestic Transactions" under the purview of Transfer Pricing (TP) from the FY 2012-13.

Specified Domestic Transactions 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

¹ 2013 ranking 'Ease of Doing Business' – www.doingbusiness.org

² 1 Crore = 10 million

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 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. A new **Section 92BA** in the Income Tax Act 1961 was inserted to explain “**specified domestic transactions.**” They include transactions aggregating more than **Rs. 5 crores** and not being 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;
 - (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 other transaction as may be prescribed by the CBDT via notifications.

2. VALUATION

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 any other method as prescribed by the Central Board of Direct Taxes (*no guidance available as yet*)

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. REFERENCE TO TRANSFER PRICING OFFICER (TPO)

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 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 renewed calculation. This in turn will be used by the AO to re-compute the total income of the assessee by making additions.

4. DOCUMENTATION

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 submit the same to the assessing officer on or before the due date of filing the return of income. Due care should be taken for physical submission of audit report with AO, as due to e-filing of IT return, one can miss the same.

5. PENALTY IMPLICATIONS

Nature of penalty prescribed	Quantum of penalty
1) Addition to Income on account of concealment or furnishing of inaccurate details. (section 271(1)(c))	100% to 300% of tax on addition to Income.
2) Failure to maintain documentation / furnish documentation to tax authorities, when called for. (section 271G)	2% of value of the international transaction entered into between related parties (i.e. mainly the value of export billing recorded in the books).
3) Failure to furnish Accountants' Certificate (section 271BA)	INR 100,000/- (fixed)

Nature of penalty prescribed	Quantum of penalty
4) Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information / document. (section 271AA)	2% of value of the international transaction entered into between related parties (i.e. mainly the value of export billing recorded in the books).

The penalties are not tax deductible, but are discretionary.

6. TAX BURDEN, IF TRANSACTION IS NOT AT ALP

Illustration 1:

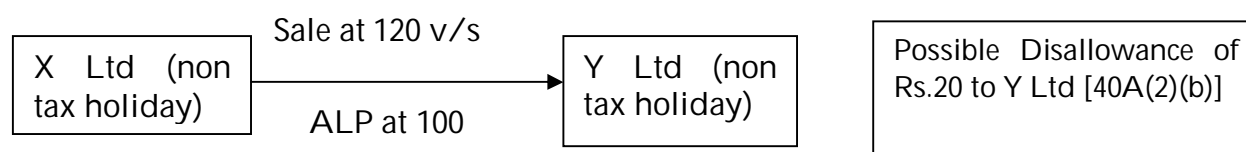


Illustration 2:

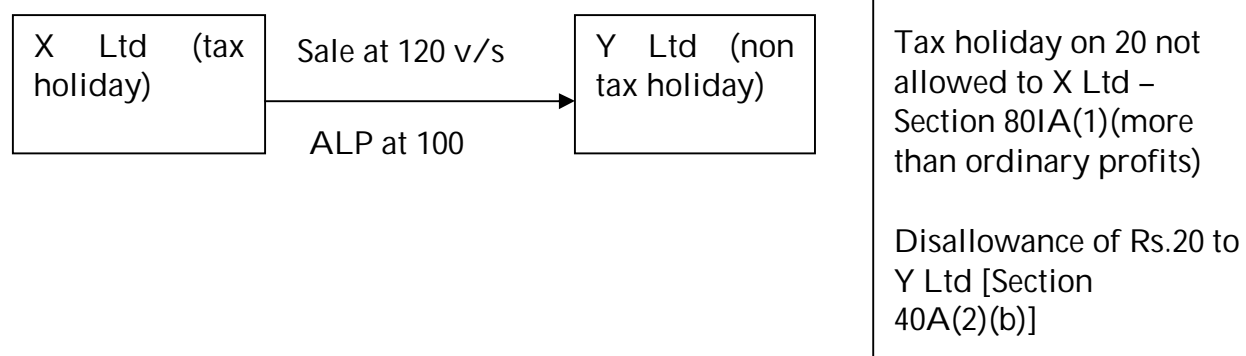
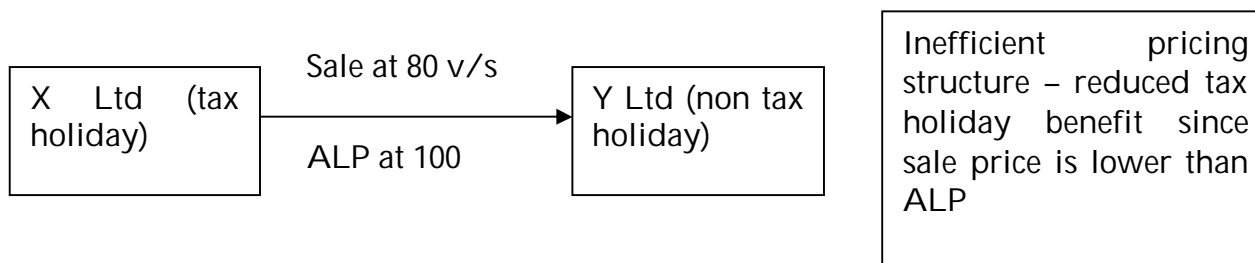


Illustration 3:



7. 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.

The Finance Act, 2012 has amended **section 40A (2) (b)** (meaning of related persons) to include companies having same holding company. In plain terms where a company has substantial interest in another company, then any transactions between them are required to be reported in tax audit (if applicable) and is subject to determination of value keeping in mind the market value of the transactions and an assessing officer can make additions on this ground, if the transactions are not found to be accordance to market value.

8. Transactions likely to come under the scanner of authorities:

- Interest free loans to group companies
- Granting of Corporate Guarantees / Performance guarantees by parent company to its subsidiaries;
- Intra-group purchase / sale / service transactions;
- Payment made to key personnel of the assessee e.g. transactions with the directors / CFO CEO etc
- Payment made to key personnel of the Group companies;
- Payment made to relatives of key personnel of the assessee / group companies.

9. 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 principle³.

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.

³ Multi Country Analysis of Existing Transfer Pricing Simplification Measures – 2012 Update, 6th June 2012

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 your country establish a general obligation to comply with the arm's length principle?	Yes, Section 147 of the Taxation (International and other provisions) Act 2010	The governing statute, 26 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: <ul style="list-style-type: none"> ▪ 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.5 crore;
- ii) When the value of aggregate of international transaction and specified domestic transaction is more than Rs.5 crore but the value of specified domestic transactions is less than Rs.5 crore.

The company who has the aggregate value of domestic transactions more than Rs.5 crore anyways has to comply with the transfer pricing regulations.

2. **Increased compliance burden on all effected assessee:** in terms of maintaining TP documentation, selecting the most appropriate method and being subject to scrutiny by the TPO.
3. **Increased administrative burden on revenue department:** Indian revenue department, which is still grappling with developing adequate expertise to address international transaction, will now have to double up for domestic transaction as well. However, with the possibility to increase revenue in the near term, government is least bothered about putting an administrative framework in place. Presently TPO are present at only 5-6 locations and limited in numbers. With the limit of Rs. 50 million, the tax department will certainly not be able to deal with transactions falling under this category.

In case department identifies a case of excessive cost or under invoicing of sales and resultantly makes adjustment enhancing the tax liability of the concerned assessee, there is no provision to provide corresponding benefit to the other party to the transaction.

4. **Impact on litigation:** Although the Supreme Court had suggested introduction of TP to the domestic turf in a bid to bring legislative clarity and reduce litigation, given the litigative record of Revenue department⁴ especially with respect to TP sphere one would have reasons to doubt whether litigation will reduce or increase. So far, it appears that revenue department makes a tax payer pay arbitrarily rather than legally and collects revenue which is not due.
5. **Formulation of product pricing methods:** Methods of arm length pricing alongwith 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.
6. **Robust TP Documentation:** Assessee will also be subject to stringent penal provisions as provided U/s 271AA, 271G, 271BA and 271(1)(c). As a corollary, maintenance of robust TP documentation would be accorded paramount significance.
7. **Benchmarking Transactions:**

Particulars	Challenges
Salary and bonuses paid to partners	Whether the limit as mentioned in section 40(b) would be the ALP? Benchmarking?
Remuneration paid to Directors	Whether the limit as mentioned in Schedule XII would be the ALP? Benchmarking?
Transfer of land	Whether rates mentioned in the stamp duty ready reckoner be considered as ALP?
Joint development agreements, Project management fees	Benchmarking?
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)?

⁴ Research shows that revenue department's success in last 4 years at 10-20% at Tribunal Level, 30% at High Court Level, and 10% at the Supreme Court. (Business Standard 17th January 2013)

8. 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. Related parties also need to be defined, and the manner of determining direct/indirect relations to the entity.

These new 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 now 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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