


“Transfer Pricing of Domestic Transactions & Provisions of Section 40A(2)(b) – Contradictory or Complimentary”

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Outline

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 - ▶ Overview of the provisions
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Rationale for introducing Transfer Pricing

Legislation introduced with effect from 1 April 2001

Considering the need of hour the Finance Minister in his Budget Speech of 2001 explained the rationale for introducing Transfer Pricing Regulations

*“The presence of multinational enterprise in India and their **ability to allocate profits in different jurisdictions by controlling prices in intra group transactions** has made the issue of transfer pricing a matter of serious concern”*

The legislative intent behind the introduction of detailed transfer pricing provisions was later discussed by CBDT in its Circular No 14 / 2001 as follows:

*“The basic intention underlying the new transfer pricing regulations **is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the Country’s tax base**”*

Brief background

- ▶ In order to check whether the Taxpayers carrying on business with related parties made excessive and unreasonable expenditure, provisions of section 40A(2) was introduced.
- ▶ Further, in order to check whether the profits of eligible units for availing the deduction under section 80A, 80IA, 10AA etc were not inflated, provisions were introduced in section 80A, 80IA, 10AA.
- ▶ However, there was no machinery in the Act to monitor/check whether the transactions with the related parties are valued at arm's length price or not.

Brief background

Under the pre- amended provisions:

Section 40A(2) - Expenses or payments not deductible in certain circumstances.

The existing provisions of clause (a) of sub-section (2) of the aforesaid section 40A provides that

- ▶ where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of the said section and
- ▶ the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to fair market value of the goods, services or facilities
- ▶ for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as deduction.

Brief background

Relevant extracts of the Departmental Circular - Circular NO. 6-P, Dated 6-7-1968 and circular NO. 4-P[LXXVI-65], dated 7-6-1968

- ▶ It may be noted that the new provision is applicable to all categories of expenditure incurred in businesses and professions, including expenditure on purchase of raw materials, stores or goods, salaries to employees and also other expenditure on professional services, or by way of brokerage, commission, interest, etc.
- ▶ Where payment for any expenditure is found to have been made to a relative or associate concern falling within the specified categories, it will be necessary for the Income-tax Officer to scrutinise the reasonableness of the expenditure with reference to the criteria mentioned in the section.
- ▶ The Income-tax Officer is expected to exercise his judgment in a reasonable and fair manner. It should be borne in mind that the provision is meant to check evasion of tax through excessive or unreasonable payments to relatives and associate concerns and should not be applied in a manner which will cause hardship in *bona fide* cases.

Brief background

Under the pre- amended provisions:

Section 80IA - Deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development, etc

- ▶ The existing sub-section (8), provides that inter unit transfer of goods / services should correspond to market value. *Explanation to sub-section (8) of the aforesaid section 80-IA* provides for the definition of “**market value**” in relation to goods or services, means the price that such goods or services would ordinarily fetch in the open market.
- ▶ The existing provisions of *sub-section (10)* of the aforesaid section provide that where it appears to the Assessing Officer, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between **them is so arranged** that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom.
- ▶ These provisions have been made applicable for determination of profits of undertaking claiming deduction under section 10A etc.



Overview of the provisions

Overview of the provisions

Scope of TP provisions expanded w.e.f AY 2013-14 by including “SDT” if aggregate value of such transaction exceeds **INR 5 Crores**

“**Specified Domestic Transactions** “ 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 is made or to be made to a person u/s 40A(2)(b) ;
- ii. Any transaction referred u/s 80A ;
- iii. Any transfer of goods/services u/s 80-IA ;
- iv. Any business transaction u/s 80-IA(10) ;
- v. Any transaction under Chapter VI-A or u/s 10AA – to which provisions of Sec 80-IA (8) or (10) applies ; or
- vi. Any other transaction as may be prescribed.

If a transaction is classified/covered under SDT, i.e section 92BA is applicable

Fair market value

- ▶ FMV as contemplated by any of the specified provisions will need to be determined in accordance with ALP as defined in section 92F(ii) of the Act.

Arm's Length Price

- ▶ ALP as determined by adopting most appropriate method as per section 92C(1) will be considered as measure of FMV for transactions specified under section 92BA. This makes it mandatory for the taxpayer to compute ALP as per methods specified under section 92C (including sixth method recently notified on 23 May 2012). The taxpayer cannot adopt any other unspecified method for computing ALP.

Documentation

- ▶ The taxpayer is also obliged to maintain contemporaneous documents under section 92D as also obliged to obtain & furnish auditor's report under section 92E of the Act.

Concept of Arm's Length Price

- ▶ Concept of ALP applicable for determining taxable income arising from international transactions, 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
- ▶ Comparability and Functions, Assets and Risks (FAR) fundamental to the concept of ALP
 - ▶ Comparison of conditions in a controlled transaction with conditions in transactions between uncontrolled enterprises
 - ▶ Compensation usually reflects functions performed (taking into account assets used and risks assumed)
- ▶ ALP concept usually relevant for transactions between “separate enterprises”; may need to be applied by analogy to SDT involving inter-unit transfer of goods/ services

Computing Arm's Length Price

- ▶ ALP is required to be computed using any of the following methods being the **most appropriate method**
 - ▶ Comparable uncontrolled price method (CUP)
 - ▶ Resale price method (RPM)
 - ▶ Cost plus method (CPM)
 - ▶ Profit split method (PSM)
 - ▶ Transactional net margin method (TNMM)
 - ▶ Such other method as may be prescribed by the Board - method prescribed in May 2012 by inserting Rule 10AB (Sixth method)

Unspecified method – Rule 10AB

Other sixth method – Rule 10AB notified on 23 May 2012

“For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction or a specified domestic transaction shall be 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 relevant facts.”

- ▶ Rules provide guidance on application of the methods and factors to be considered in selecting the most appropriate method
- ▶ Permitted variance from the ALP
 - ▶ 1% in case of wholesale traders
 - ▶ 3% in other cases

Prescribed TP Documentation

Entity related	Price related	Transaction related	Supporting documents
<ul style="list-style-type: none">▶ Profile of industry▶ Profile of group▶ Profile of unit of the entity claiming tax holiday▶ Profile of related parties	<ul style="list-style-type: none">▶ Transaction terms▶ Functional analysis (functions, assets and risks)▶ Economic analysis (method selection, comparables)▶ Forecasts, budgets	<ul style="list-style-type: none">▶ Agreements▶ Invoices▶ Pricing related correspondence (letters, emails etc)	<ul style="list-style-type: none">▶ Official publications, reports by Government, institutions of repute, Stock exchanges▶ Financial statements

- ▶ Due date for maintenance of TP documentation for FY 2012-13 is November 30, 2013
- ▶ Documentation required to be contemporaneous
 - ▶ First year of documentation would need to be exhaustive and capture all of the prescribed set of information/documents, as applicable
 - ▶ For the subsequent years, only a comparability analysis update would be sufficient if factual/functional analysis do not undergo a change



Implications of the amendment

Implications of the amendment

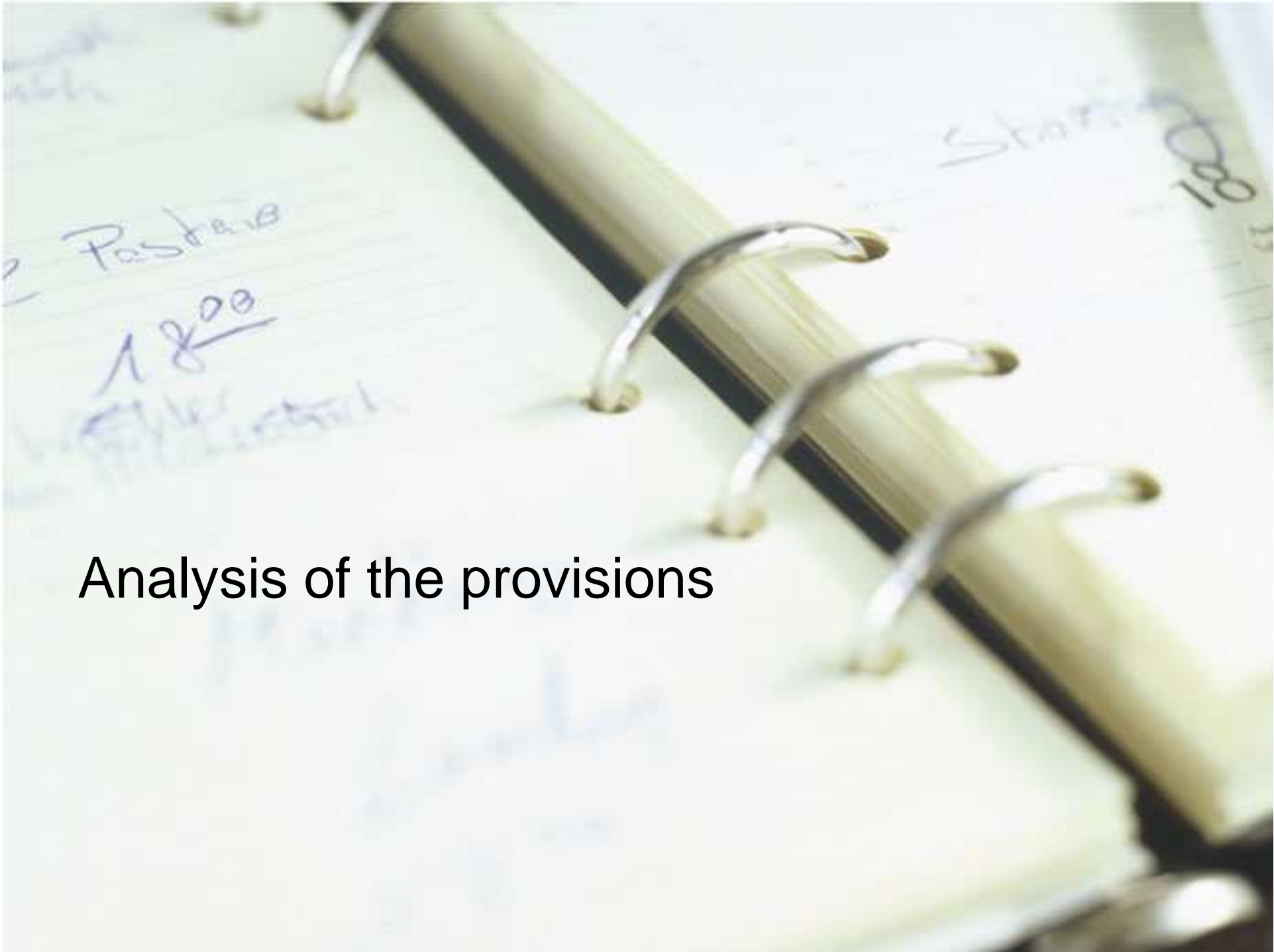
SDT : Significant Transactions which may be impacted

- ▶ Transfer of goods between related domestic companies eligible for tax holiday and others.
- ▶ Inter-unit transfer of goods / services between tax holiday eligible business / units and other businesses / units of the taxpayer in India
- ▶ Interest, corporate guarantee receipt /payment, cash pooling and related funding transactions between related parties in India
- ▶ Rent payments within Domestic associated enterprises e.g. between SEZ Developer and SEZ units
- ▶ Expenditure incurred in case of Director fees, managerial remuneration.
- ▶ Transactions of reimbursement of expenditure
- ▶ Transaction under Cost sharing agreements/ Cost Contribution agreements. Payments for use of/ access to common facilities like office/ Finance charges/ Human Resource services etc.
- ▶ Transaction of Brand Equity Charges

Implications of the amendment

Domestic TP not restricted to transaction with residents

- ▶ S. 92BA excludes International Transaction from within its scope
- ▶ Trigger for AE relationship different for International and Domestic TP
- ▶ Illustrative examples where transactions with non-resident may be covered under Domestic TP
 - ▶ Remuneration paid by an Indian company to a non-resident director
 - ▶ Remuneration paid by a FC having PE to non resident director
 - ▶ Payment by Indian Co to Foreign Co. where Foreign Co. holds 20% to < 26% in Indian Co.



Analysis of the provisions

Scope of section 40A(2) v/s 92BA

- ▶ Domestic TP applies to expenditure for which payment is made or is to be made to a person referred to in s. 40A(2)(b)
 - ▶ Coverage is wide; conceptually different from AS-18 - Related Party Disclosures
- ▶ Applies to transactions on or after 1 April 2012, Will not apply on basis of payment on or after 1 April 2012
- ▶ Applies to 'payment' which results in 'expenditure'
 - ▶ Arguably includes constructive payment
 - ▶ Dividends/DDT not covered since not an expenditure
 - ▶ Payment of loan or share capital is not an expenditure
 - ▶ Will also not be applicable to asset purchases etc
- ▶ Introduced by Finance Act, 1968 to disallow excessive or unreasonable payments to taxpayer's relatives or associate concerns.
- ▶ Unreasonableness to be judged vis-a-vis
 - ▶ Fair market value of goods or services or facilities
 - ▶ Legitimate needs of the business or profession
 - ▶ Benefit derived or accruing to the taxpayer
- ▶ Conditions are cumulative from taxpayer's perspective (Refer Coronation Flour Mills (2009) 314 ITR 1 (Guj))

If a transaction is classified/covered under SDT, i.e section 92BA is applicable

Key points to be noted are:

- It is to be borne in mind that **Section 92BA does not impact operation of basic scope of provisions of section 40A(2) or section 80A(6) / 80-IA(8) or 80-IA(10)**. It merely provides that **FMV as contemplated by any of the specified provisions will need to be determined in accordance with ALP as defined in section 92F(ii) of the Act.**
- Thus, section 92BA applies, only if the conditions of section 40A(2) / section 80A(6) etc. are fulfilled and thereupon FMV needs to be determined in accordance with section 92BA
- Firstly, the AO has to establish that there is tax avoidance and that the conditions for invoking the provisions of section 40A(2) / section 80A(6) etc. are fulfilled, only then provisions of 92BA r.w.s 92 for computing FMV can be applied.

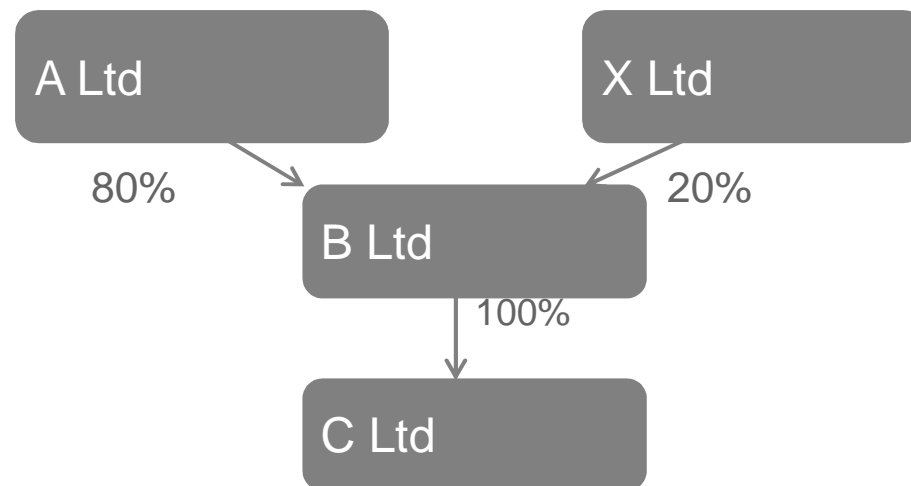
Illustrative coverage of s. 40A(2)(b) relationship

Taxpayer	Illustrative coverage
Individual	<ul style="list-style-type: none">➤ Relatives➤ Firm in which he is partner➤ Company in which he is director /has more than 20% shareholding
Firm	<ul style="list-style-type: none">➤ Partners/ relatives➤ Company/ firm in which partner / relative has substantial interest (>20%)
Company	<ul style="list-style-type: none">➤ Director/ relatives➤ Company/firms in which director / relatives have substantial interest (> 20%)➤ Parent (> 20%)➤ Sister subsidiary (common parent holding > 20%)

Impact of amendment in – Sec 40A(2)

- ▶ Section 40A(2) generally covers relationships based on holding of 'substantial interest'.
- ▶ Issue may arise whether the beneficial ownership of shares as referred in Explanation to section covers derivative relationship.

Consider the following relationship:

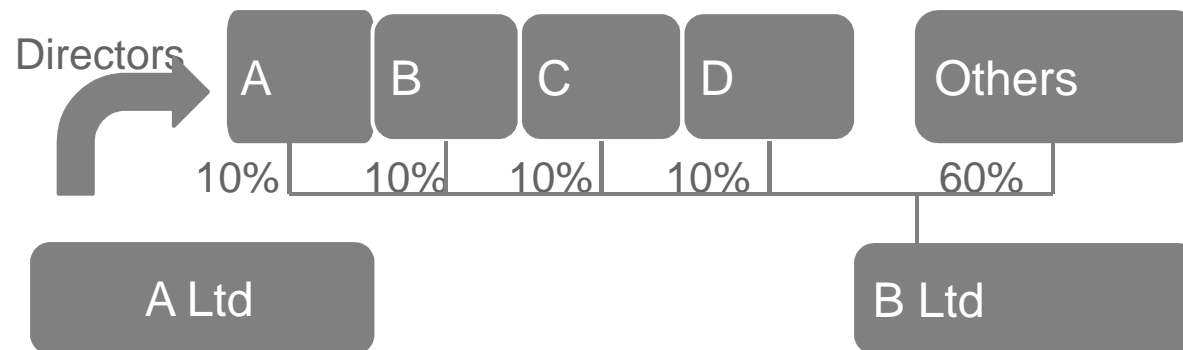


- ▶ If A holds more than 50% in B and B holds more than 50% in C, can A be regarded as having substantial interest in C.
- ▶ *It is fairly arguable that in absence of any factors suggesting that intermediate entity is not an independent entity, only direct holding should be considered.*

Impact of amendment in – Sec 40A(2)

- ▶ Another issue which may arise is where an entity is held through a related party like director, whether 20% threshold needs to be examined qua an individual director or qua all directors put together.

Consider the following relationship:



- ▶ For example, all directors of A Ltd. may be shareholders in B Ltd. such that individual shareholding of each director does not exceed the threshold of 20% but the aggregate shareholding of all directors put together exceeds 20%. Whether B Ltd. can be regarded as related party to A Ltd. in such scenario?
- ▶ *It is fairly arguable that only individual holding should be considered and not the aggregate holding.*

S. 40A(2)(b) – controversial transactions

- ▶ Inter-linking of S.40A(2) (a) and S.40A(2)(b)

- ▶ Benchmarking of remuneration
 - ▶ Remuneration to partners regulated by s.40(b) (Circular 636)
 - ▶ Directors remuneration regulated under Company Law (1968 Circular 6-P)

- ▶ Payment to related parties covered under non-business heads
 - ▶ Interest payment to related party claimed as deduction u/s 57 ; s.58 (2) extends s. 40(A)(2) to Income from other sources.
 - ▶ Cost of capital asset acquired from related party

- ▶ Payments for capital assets under business head
 - ▶ Depreciation claimed u/s. 32
 - ▶ Full deduction claimed u/s. 35(1)(iv)

Interplay between S. 40(b) – S.40A(2)(b) – S. 92BA

Whether Domestic TP provisions will apply to payments made by partnership firm/LLP to its partners?

- On coverage of payments to partners under Domestic TP, s. 92BA(i) refers to any expenditure in respect of which payment has been made or is to be made to a person referred in s. 40A(2)(b).
- ▶ Payments to partners are simultaneously covered by two provisions viz. s. 40A(2)(a) and s. 40(b).
 - ▶ Deductibility of payments to partners by partnership firm/LLP is governed by provisions of s. 40(b) of the Act, which covers payments to partners in the nature of interest, salary, bonus, commission or remuneration,
 - ▶ S. 40A(2)(b) also covers partners of a firm within relationships specified therein (Refer, clause (ii) of s. 40A(2)(b)), which covers all other payments to partners for goods and services e.g. rent for premises, supply of goods, etc.

Issue

- ▶ Whether on scope of s. 40A(2)(a) (viz. that it covers payments to partners other than those referred in s. 40(b)), Domestic TP will extend only to such payments which are not covered by s. 40(b).

Interplay between S. 40(b) – S.40A(2)(b) – S. 92BA

- ▶ The provisions of Section 40(b) and 40A(2) operate in different fields and the provisions of Section 40A have no application in the cases where Section 40(b) has been applied.
- ▶ The AO has no power to go into the question of reasonableness of remuneration paid by the firm to its partners and he can only examine whether the remuneration provided is within the prescribed limits as laid down in Section 40(b) or not. If all conditions are fulfilled then he cannot disallow any part of remuneration on ground that it is excessive.

Benchmarking of remuneration/payments made to partners by Partnership Firm/LLP

Assuming payments to partners covered by s. 40(b) are covered within scope of s. 92BA(i), benchmarking of remuneration to working partners will pose challenges to the taxpayer as it will depend upon various factors

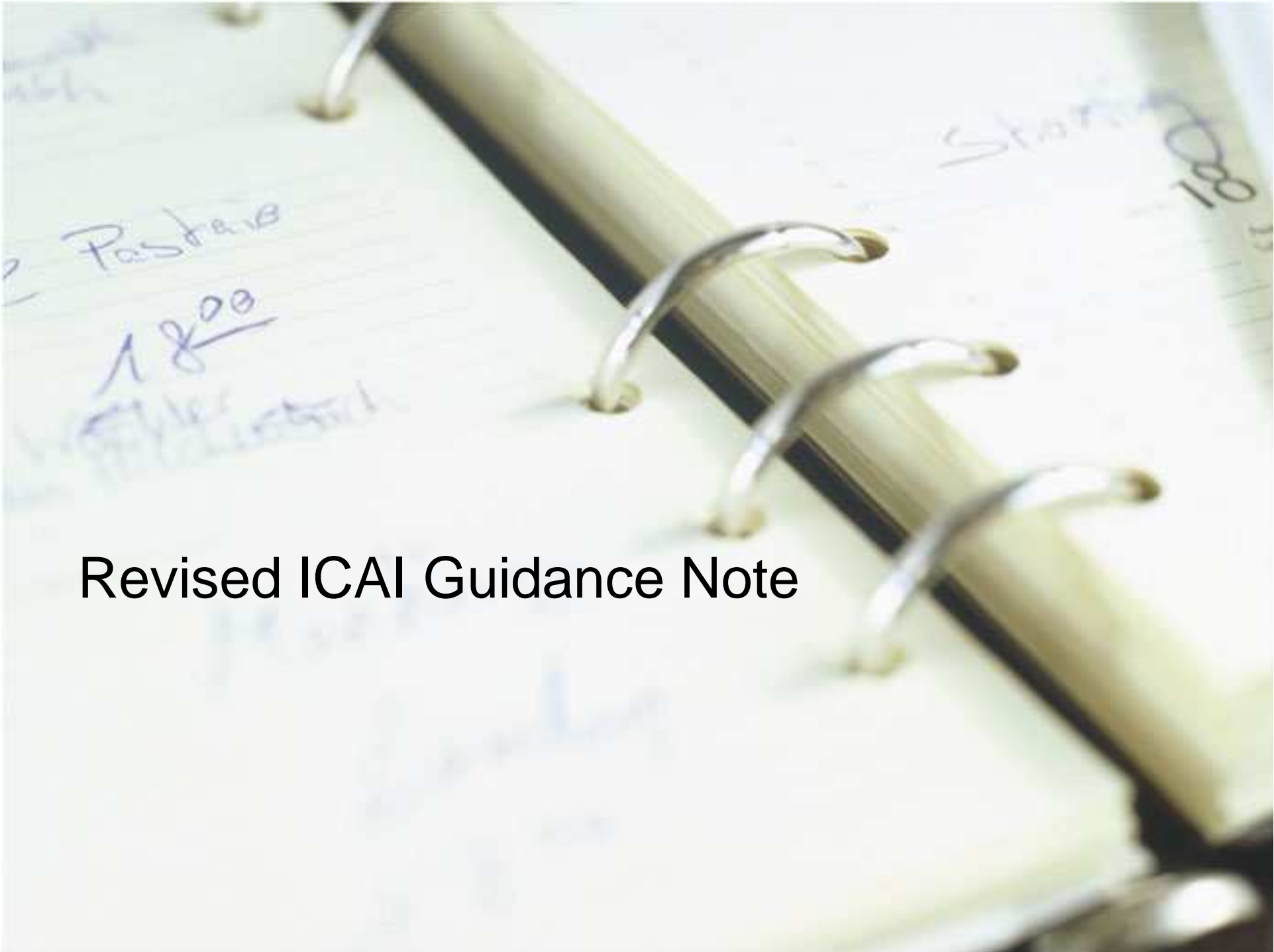
Challenges for benchmarking

- ▶ The partner does not look at remuneration as his reward in isolation. He reckons impact on profit share as his in-built calculation
- ▶ The payment is subjected to statutory limit, even if its at arm's length
- ▶ Furthermore, a partner who holds mutual agency relationship and risk of unlimited liability may stand on a materially different footing compared to a non partner. Accordingly, it may not be possible to benchmark remuneration with say, percentage/profit linked remuneration paid to a consultant/ employee of comparable technical expertise or experience.

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
- ▶ Recent instances of tax authorities initiating penalty proceedings where taxpayers do not furnish TP documentation within the time provided, which is typically 30 days



Revised ICAI Guidance Note

Guidance Note On Report Under Section 92E Of The Income Tax Act, 1961 (Transfer Pricing)

Key observations on Specified Domestic Transactions

1) Threshold limit

- ▶ No internal threshold for each limb of the definition.
- ▶ Computation of threshold limit

The threshold limit for SDT can be computed either on net basis (i.e. without including indirect tax levies like service tax, VAT, etc.) if the assessee is availing credit of those indirect taxes or on gross basis if the assessee is not availing credit, depending upon the method of accounting regularly followed.

2) Expenditure in respect of payments made to persons referred to in section 40A(2)(b) of the Act

- ▶ Transactions in the nature of 'income' not covered
- ▶ Expenditure claimed as deduction under 'income from other sources' also covered

Section 58(2) of the Act states that provisions of section 40A of the Act are also applicable for computation of taxable income under 'income from other sources'.

- ▶ Only certain types of capital expenditure covered

The said provisions are applicable only to that capital expenditure which has been fully claimed as deduction under other provisions. Deduction claimed under section:

- ✓ 35(2AB) of the Act on expenditure on know-how;
 - ✓ 35 of the Act on expenditure on scientific research;
 - ✓ 35AD of the Act on expenditure on specified business.
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Guidance Note On Report Under Section 92E Of The Income Tax Act, 1961 (Transfer Pricing)

▶ Substantial Interest

Explanation to Section 40A(2) deems a person to have substantial interest if such person is 'beneficial owner' of shares carrying not less than twenty per cent of voting power. The expression "beneficial owner" needs to be construed in contrast to "legal owner" and not in the context of determining indirect ownership of shares. Hence, the emphasis is on covering the real owner of the shares and not the nominal owner.

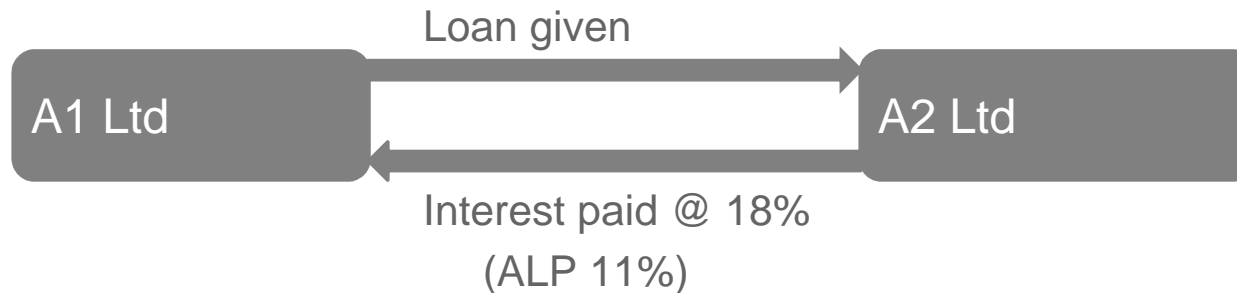
▶ For the purpose of Section 40A(2)(b), it may be appropriate to consider only direct shareholding and not derivative or indirect shareholding.

Consequently, in a situation where A Ltd. holds 50% in B Ltd. and B Ltd. holds 50% in C Ltd., under ordinary circumstances, A Ltd. cannot be regarded as having beneficial interest in C Ltd.



Case studies

Case Study 1 – Applicability of Domestic TP to intra-group loans



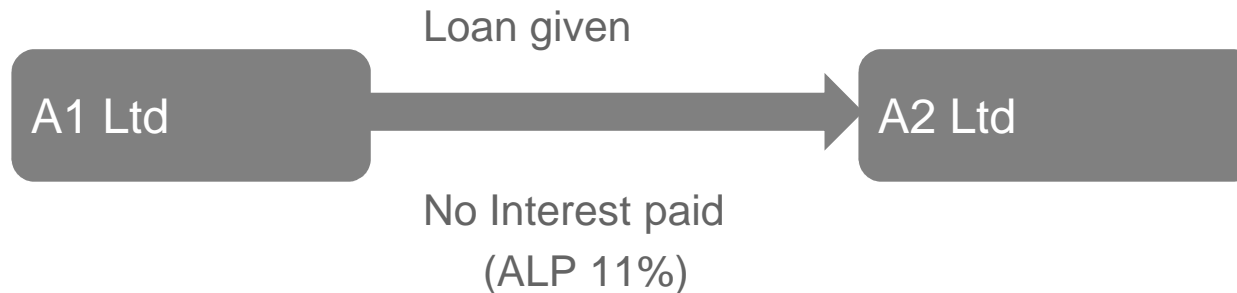
Facts:

- ▶ A1 Ltd and A2 Ltd are Indian companies and related parties under s 40A(2)(b).
- ▶ A1 Ltd has given loan to A2 Ltd on which A2 Ltd pays interest @ 18% p.a.
- ▶ The ALP interest rate considering the tenure, repayment terms, collateral offered, etc of the loan is determined at 11%. This rate of interest is also considered to be fair rate required to be paid by a borrower who is similarly placed. There is no explanation offered for payment at higher rate.
- ▶ A1 Ltd and A2 Ltd are not entitled to any profit linked tax holiday.
- ▶ Interest paid by A2 Ltd exceeds Rs. 5 Cr.

Issue:

- ▶ What is the impact of Domestic TP in hands of A1 Ltd and A2 Ltd?

Case Study 2– Applicability of Domestic TP to intra-group interest-free loans



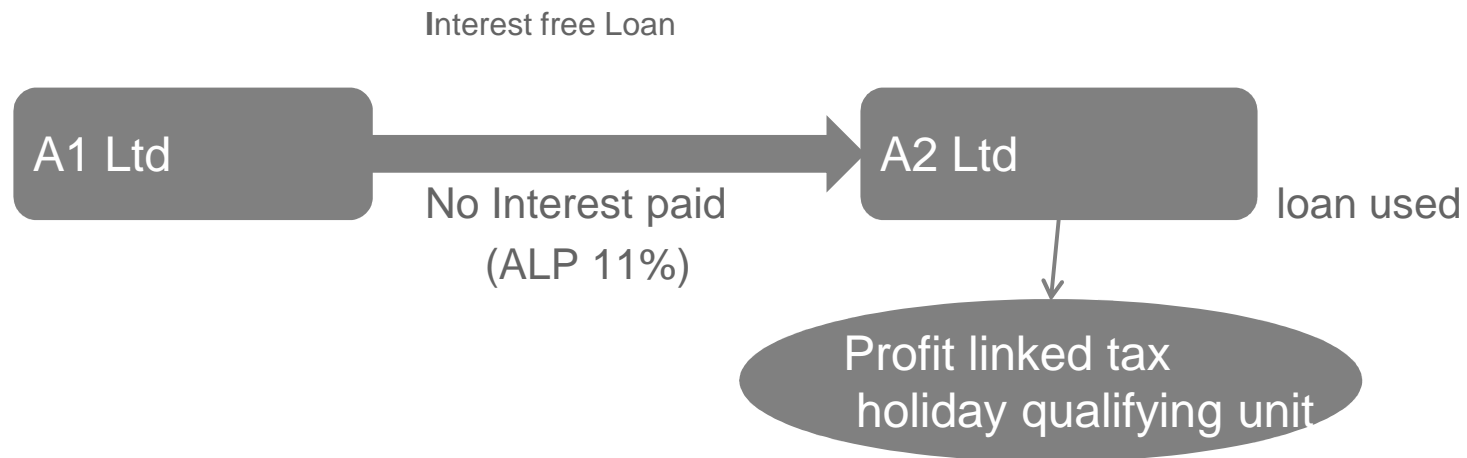
Facts:

- ▶ Facts remain the same as in earlier case study no. 1.
- ▶ However, instead of interest @ 18%, A1 Ltd gives interest free loan to A2 Ltd. Thus
- ▶ A2 Ltd does not pay any interest to A1 Ltd.

Issue:

- ▶ What is the impact of Domestic TP in hands of A1 Ltd and A2 Ltd?

Case Study 3– Applicability of Domestic TP to intra-group interest-free loans used for profit linked tax holiday qualifying unit



Facts:

- ▶ Facts remain the same as in earlier case study no. 2.
- ▶ An additional fact is that A2 Ltd has used interest free loan received from A1 Ltd in its
- ▶ undertaking which is entitled to profit linked tax holiday under s 10AA (SEZ Unit).

Issue:

- ▶ What is the impact of Domestic TP in hands of A1 Ltd and A2 Ltd?



Impact on taxpayers

Implications

- ▶ 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
- ▶ Documentation/ compliance and reporting obligation on taxpayer
 - ▶ Stringent penalty for non-compliance
- ▶ Assessment of transactions by specialized transfer pricing officers
- ▶ Benchmarking certain unique transactions
 - ▶ Director's remuneration
 - ▶ Comparison is subjective and not “uncontrolled” in all cases
 - ▶ Payments within regulatory limits could be considered as arm's length
 - ▶ Applicability of benefit test/ test of reasonableness
 - ▶ Possible methods – Sixth method, CUP, TNMM
 - ▶ Domestic Loans/ other financing arrangements
 - ▶ Possible approach could be to adopt domestic Prime Lending Rate (PLR) with appropriate adjustments

Key challenges and possible approach

- ▶ Computing threshold of 5 crores for applicability of SDT provisions
 - ▶ Income/expenditure to which SDT provisions apply will need to be considered on an aggregate basis
 - ▶ Threshold test is taxpayer specific and not transaction specific

- ▶ Parties with whom taxpayers have “close connection”
 - ▶ Term not defined and no threshold provided for determining whether “close connection” exists or not
 - ▶ Can be understood as group companies/associate companies

- ▶ Transactions which don't meet the arm's length test
 - ▶ Possible to make changes to the transactions in books of accounts where financials are not closed
 - ▶ In other cases, need to make an adjustment in the tax return

Concluding thoughts

- ▶ Transfer pricing in the context of international transactions has presented formidable challenges for taxpayers
- ▶ Taxpayers need to ensure compliance with TP documentation/Form 3CEB within the prescribed due date to ensure penalty protection
- ▶ Take corrective action as may be necessary for future

THANK YOU