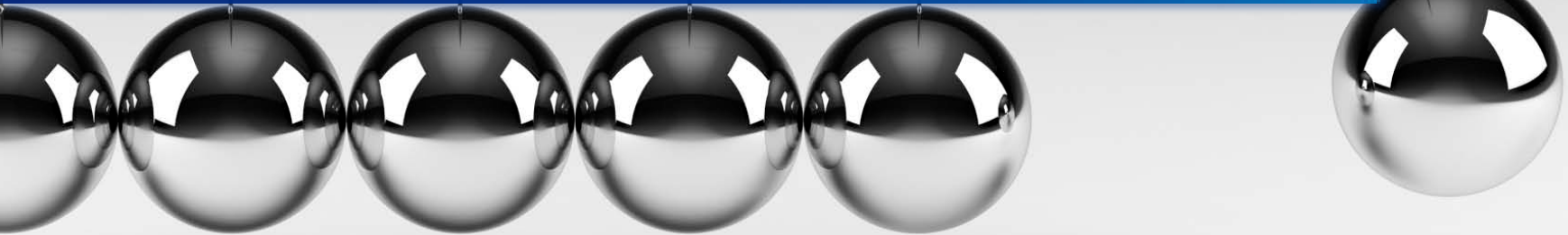


**B S R & Co. LLP**

# **Specified Domestic Transactions**

**Pankil Sanghvi**  
**Director**

**10 October 2015**



The image features an abstract background composed of several overlapping, semi-transparent geometric shapes in various shades of blue, ranging from light sky blue to deep navy blue. The shapes are primarily parallelograms and trapezoids, creating a sense of depth and movement. The word "Background" is written in a clean, white, sans-serif font, centered within a dark blue parallelogram shape on the right side of the image.

**Background**

# Genesis of Domestic Transfer Pricing Regulations

- Supreme Court (SC) in the case of ***CIT v Glaxo SmithKline Asia (P) Ltd [195 Taxman 35 (SC)]***
  - Recognized — Revenue neutrality of domestic transactions except in case of tax arbitrage on account of tax holiday or loss making situations
  - Certain sections of the Act provide for determination of expenses / profits having regard to fair market value (FMV). However the manner of determination of FMV is not prescribed. Accordingly to reduce litigation, SC suggested that Finance Ministry should consider making TP applicable to such sections
- **Intent of Law – Explanatory Memorandum to Finance Bill 2012**
  - Objectivity in ascertaining reasonableness of expenditure incurred between related parties and the appropriateness of profits earned by the business undertakings claiming tax holidays or deductions
  - Create an obligation on assessee's to maintain proper documentation

# Domestic Transfer Pricing regime in India

- Scope of TP regulations expanded to include 'specified domestic transactions' (SDT)
  - Expenses or payments made to domestic related persons as specified in Section 40A(2)(b) of the Income-tax Act, 1961 (the Act)
  - Transactions between undertakings of same taxpayer or transactions by taxpayer with closely connected persons for the purpose of Chapter VI-A (which includes tax holiday provisions like 80IA of the Act) and Section 10AA of the Act
- SDT regime applicable from FY 2012-13 where value of SDTs in aggregate exceeds INR 5 crores annually – **threshold increased to INR 20 crores annually from FY 2015 – 16**
- Preparation of Form No 3CEB and transfer pricing (TP) study report mandatory even for SDTs – hence onus of identifying and reporting all covered transactions on the tax payers
- Non-compliance with reporting requirements would now result in onerous additional penalties



**SDTs -  
Payments to  
related parties  
[Sec 40A(2)(b)]**

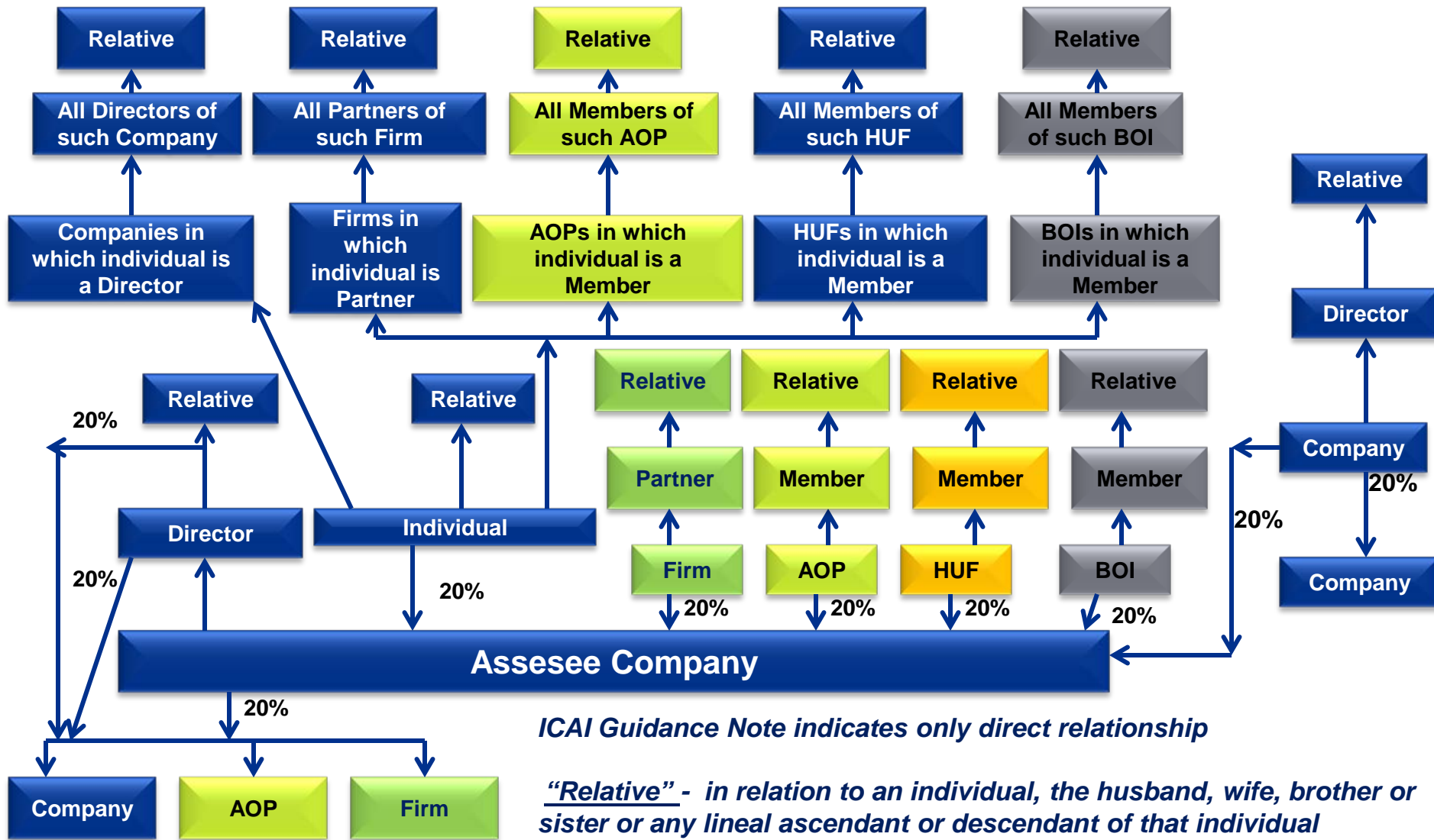
# Section 40A(2)(b) – only expenditure covered

## The proposed section

- Refers only to 'expenditure' incurred in payments made or to be made to persons specified under Section 40A(2)(b) of the Act
- Does not refer to any 'income'
- Expenditure by one group entity is income for another group entity - arms length analysis may consider both transacting parties
- Only the entity incurring the expense will need to complete the prescribed compliances

**Capital expenditure and Availing of free services – debatable**

# Section 40A(2)(b) – chart showing related parties



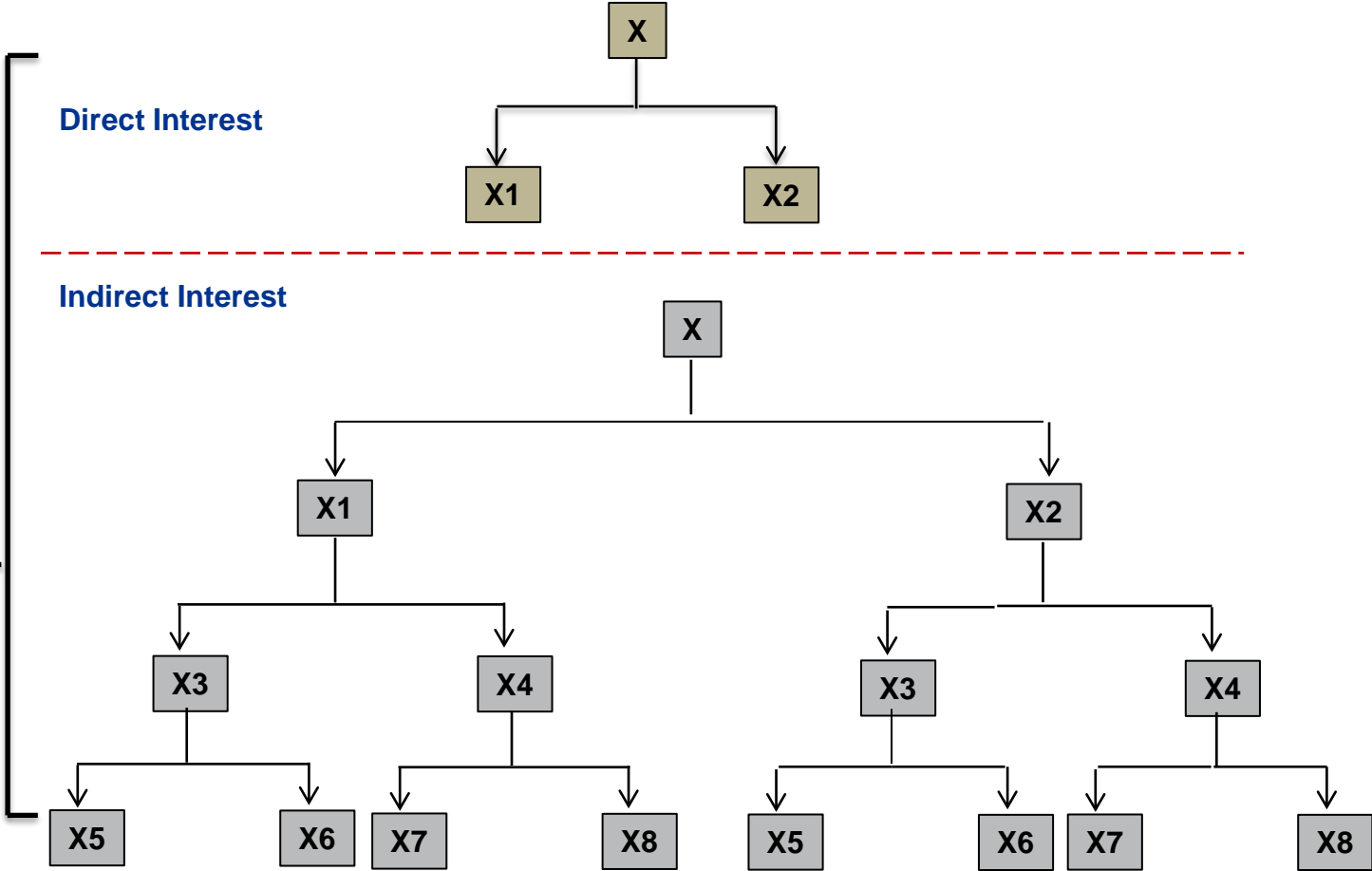
# Indirect interest illustrated

## Related parties as mentioned u/s 40A(2)(b)

Transactions between sister concerns now covered



Coverage - Substantial direct and indirect interest?

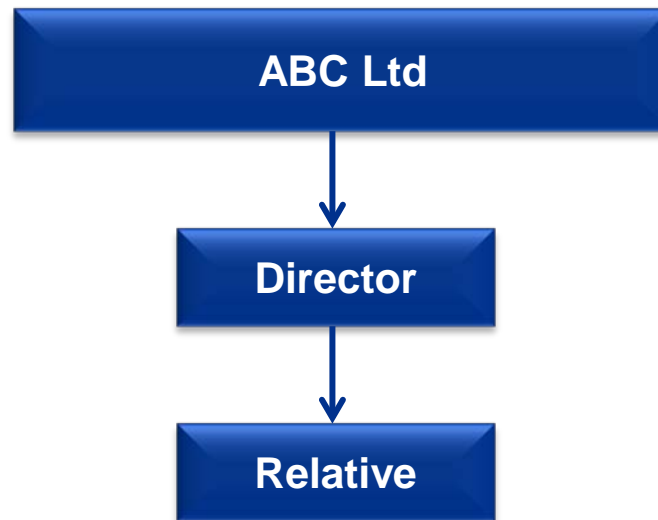




# Specified persons under Section 40A(2)(b)...

## Section 40A(2)(b) – amounts paid / payable by assessee company (say ABC Ltd) to:...

- i. directors of ABC Ltd.
- ii. any relative\* of any director of ABC Ltd.

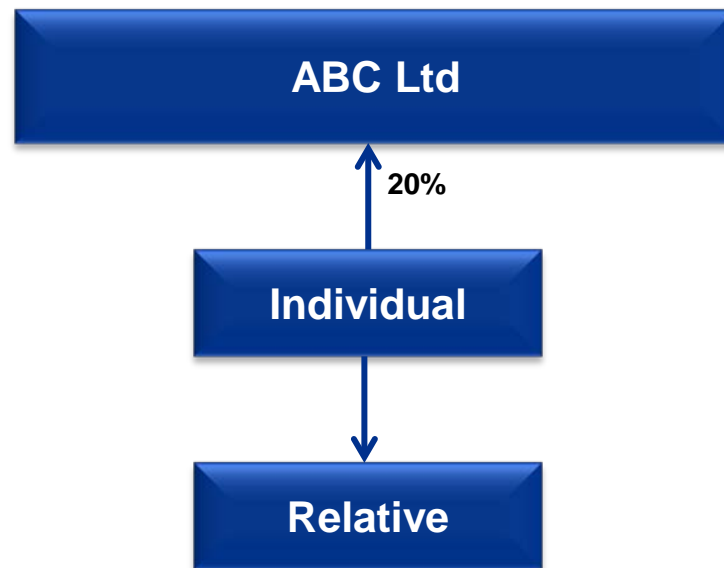


***\* As per section 2(41) of the Act, relative in relation to an individual, means the husband, wife, brother, or sister or any lineal ascendant or descendant of that individual***

# ...Specified persons under Section 40A(2)(b)...

## ...Section 40A(2)(b) - amounts paid / payable by ABC Ltd to:...

- iii. individuals owning 20% or more equity\*\* in ABC Ltd.
- iv. any relative of the aforesaid individual.

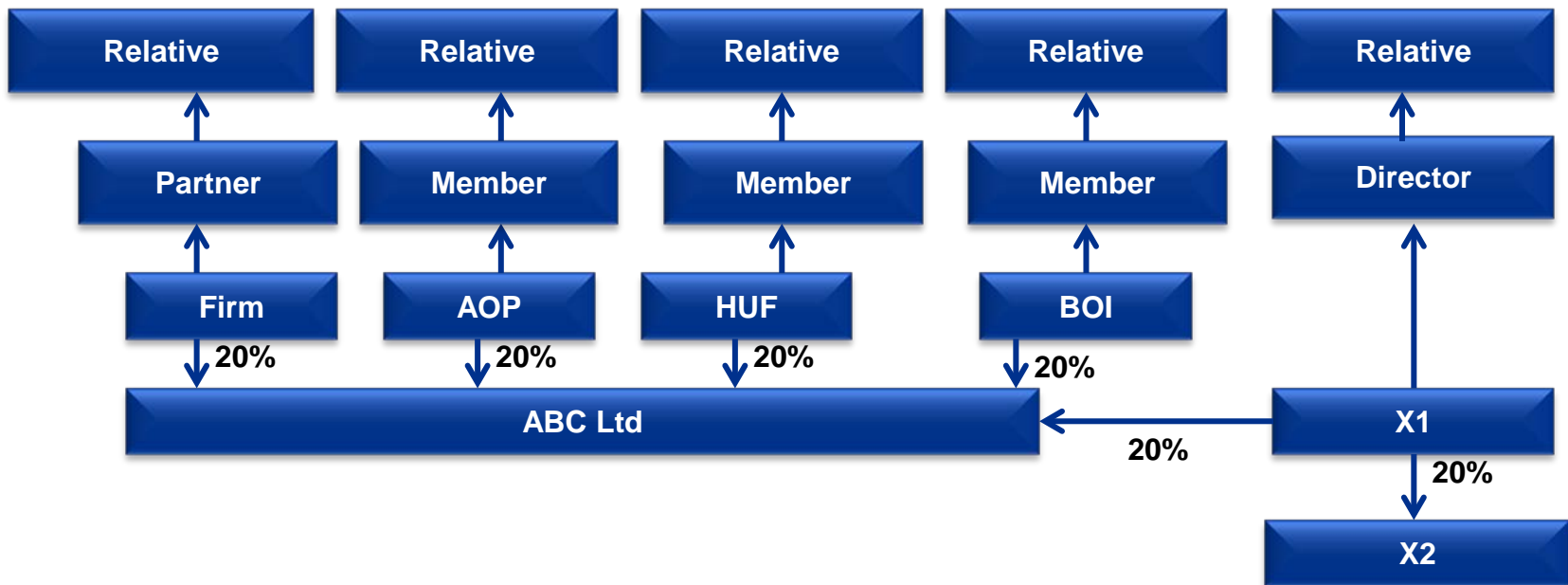


**\*\* Circular No. 6-P, dated 6 July 1968 refers to direct and indirect relationship**

# ...Specified persons under Section 40A(2)(b)...

## ...Section 40A(2)(b) - amounts paid / payable by ABC Ltd to:...

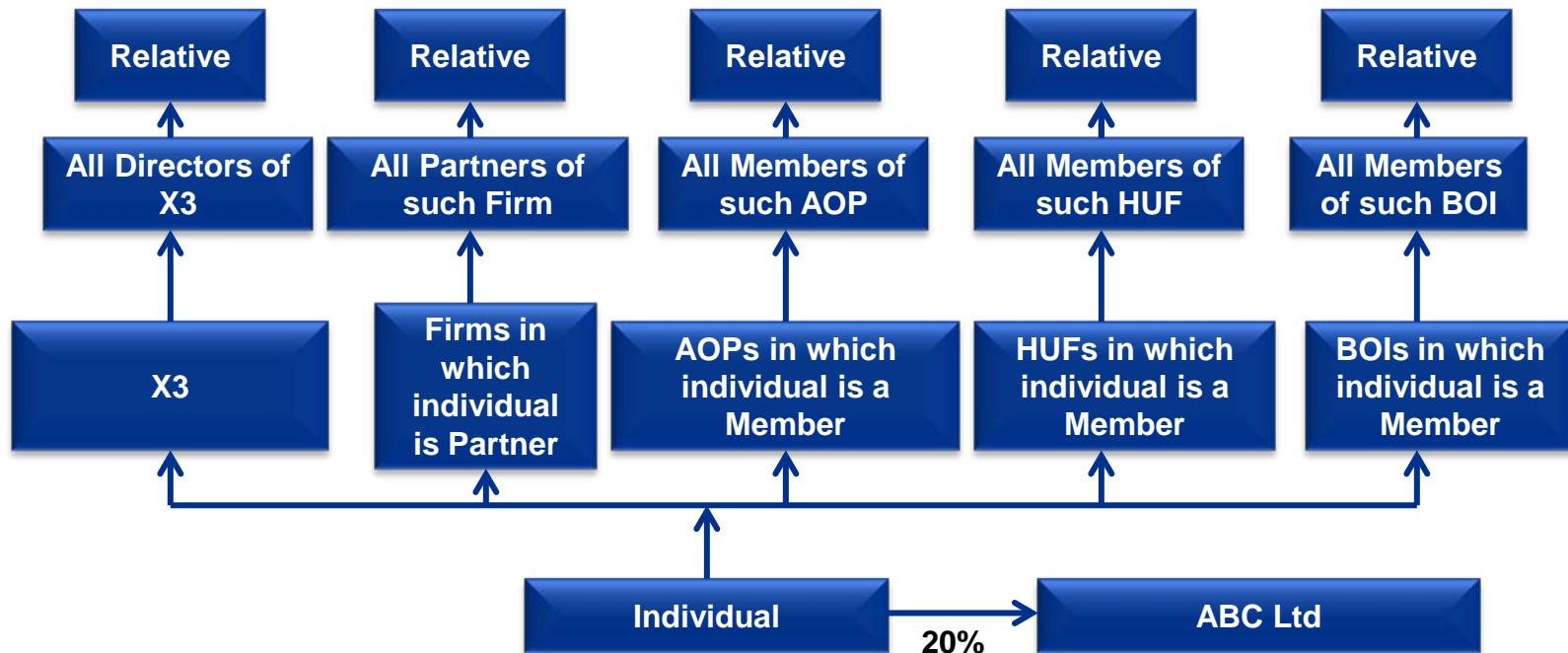
- v. a company (say X1), firm, association of persons or Hindu undivided family owning 20% or more equity in ABC Ltd.
- vi. any company (say X2) in which the aforesaid company (mentioned in point (v)) owns 20% or more equity.
- vii. any director, partner or member of the aforesaid company (X1), firm, association of persons or Hindu undivided family (mentioned in point (v)).
- viii. any relative of the aforesaid director, partner or member (mentioned in point (vii)).



# ...Specified persons under Section 40A(2)(b)...

## ...Section 40A(2)(b) - amounts paid / payable by ABC Ltd to:...

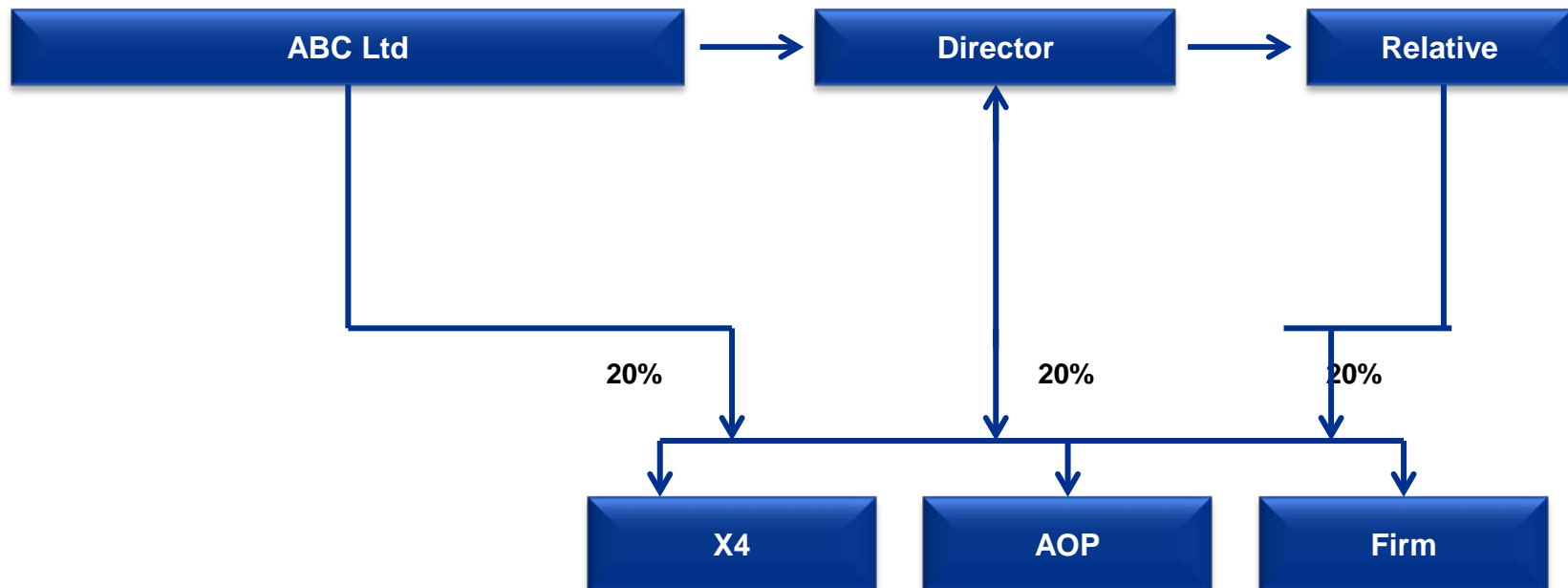
- ix. a company (say X3), firm, association of persons or Hindu undivided family of which any director, partner or member owns 20% or more equity in ABC Ltd.
- x. any director, partner or member of the aforesaid company (X3), firm, association of persons or Hindu undivided family (mentioned in point (ix)).
- xi. any relative of the aforesaid director, partner or member (mentioned in point (x)).



# ...Specified persons under Section 40A(2)(b)

## ...Section 40A(2)(b) - amounts paid / payable by ABC Ltd to:

- xii. any person (including a Company – say X4) carrying on business or profession in which ABC Ltd owns 20% or more equity.
- xiii. any person (including a Company – say X4) carrying on business or profession in which any director of ABC Ltd owns 20% or more equity.
- xiv. any person (including a Company – say X4) carrying on business or profession in which any relative of any director of ABC Ltd owns 20% or more equity.





**SDTs – units  
availing a tax  
holiday**

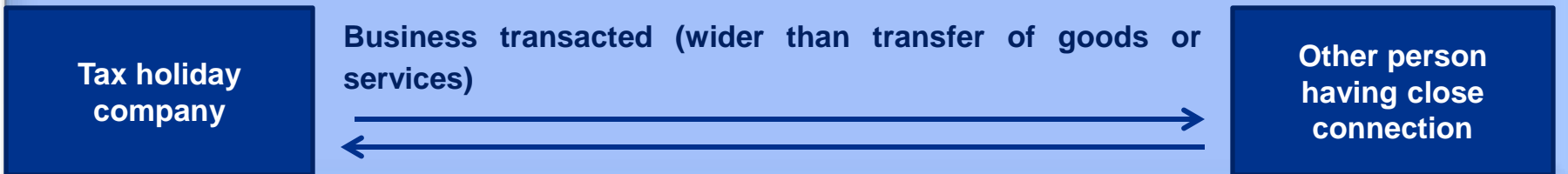
# Anti abuse conditions under tax holiday provisions

Sub-section (8) of section 80-IA (and similar such provisions in Chapter VI –A)



Not corresponding to market value [adherence to arm's length price (ALP) proposed]  
Appropriate allocation keys to be used to allocate costs and overheads for computation of tax holiday  
Revenue will challenge use of ad-hoc allocation keys

Sub-section (10) of section 80-IA (and similar such provisions in Chapter VI –A)



More than ordinary profits earned by business unit claiming deduction (adherence to ALP proposed)

Corresponding provisions to the above would be covered in Chapter VI-A and Section 10AA

Transactions to be reported in Accountant's Report and their arms' length nature to be substantiated in the TP Report

# Tax Holiday impacted under SDT...

Section	Nature of undertaking covered
80IA	Undertakings engaged in <ul style="list-style-type: none"><li>• Developing, operating and maintaining, developing and operating and maintaining infrastructure facilities</li><li>• Providing various telecom services</li><li>• Developing, developing and operating or maintaining and operating an industrial park</li><li>• Generation/ transmission or distribution of power</li><li>• Reconstruction / revival of power generating plants</li></ul>
80IAB	Undertakings engaged in developing a Special Economic Zone
80IB	Undertakings located/ engaged in <ul style="list-style-type: none"><li>• Industrially backward districts as notified</li><li>• Scientific research and development</li><li>• Refining mineral oil / commercial production of natural gas</li><li>• Operating cold chain facility for agricultural produce</li><li>• Processing, preservation and packing of meat / meat products or poultry / marine/dairy products</li><li>• Operating and maintaining a hospital of specified capacity</li></ul>
80IC	Undertaking located in notified Centre/ Parks/ Areas in <ul style="list-style-type: none"><li>• Sikkim</li><li>• Himachal Pradesh/ Uttarakhand</li><li>• North – Eastern states</li></ul>



# SDT – Non-compliance may lead to significant exposure

## Transfer Pricing addition – Tax payable thereon

### Existing penalty provisions now also applicable to SDT

#### 2% of Transaction Value for:

- a) Non-maintenance of documents
- b) Non-submission of documents

#### In case of adjustment

- a) 100% to 300% of additional tax

### New penalty provisions introduced for SDT & International Transactions

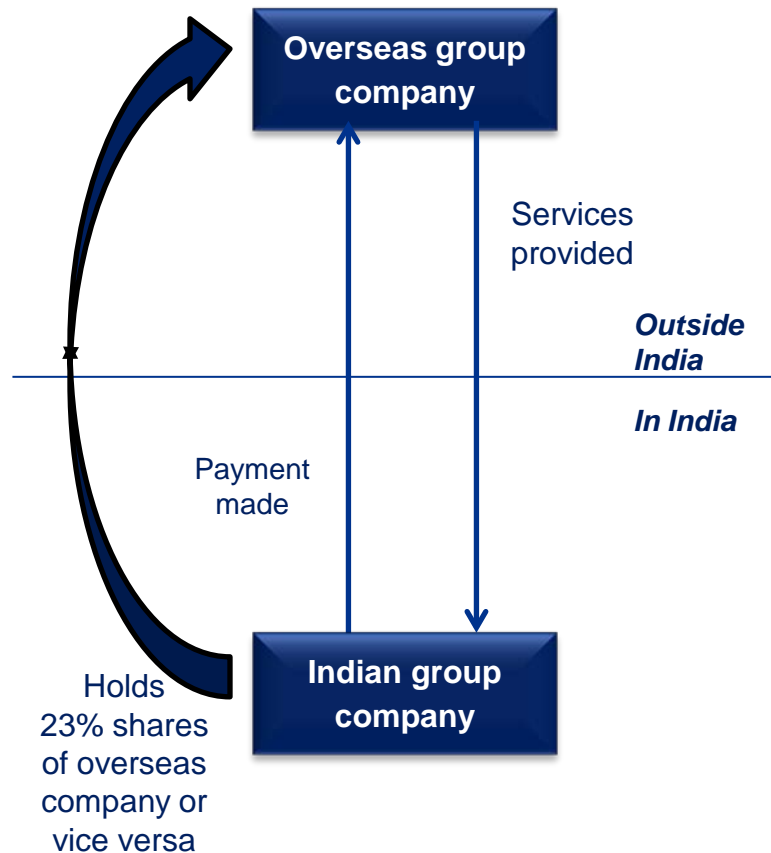
#### 2% of Transaction Value for:

- a) Non-reporting of transaction
- b) For incorrect maintenance/submission of documents



# Practical Issues - SDT

# Cross border transactions – whether covered under SDT



- There is no distinction under section 40A(2)(b) for domestic vs. overseas related parties
- Section 92BA mentions “other than international transaction”
- Definition of “International transaction” under section 92B does not cover section 92BA
- Whether a reference to “Associated Enterprise” in definition of “international transaction” – relevant contextually?

**Revised Guidance Note on Report under Section 92E issued by the ICAI in August 2013 seems to support the view that SDT should be applicable to cross border transactions**

# Period of applicability of SDT to tax holiday units?

## Illustration:

- ABC Ltd is a tax holiday unit under Section 80IA , commenced operations in AY 2003-04
- Eligible for tax holiday in 10 consecutive AYs out of 15 AYs i.e. till AY 2017-18
- Incurred losses till AY 2008-09, so did not claim deduction
- Claimed tax holiday till AY 2013-14
- From AY 2014-15, again started incurring losses, therefore no tax holiday benefits

Issue: For which period is SDT compliance to be undertaken?

**View 1 – In Perpetuity**

If an eligible unit, SDT provisions triggered for perpetuity

**View 2 – Till year in which tax holiday expires, or end of eligibility whichever earlier**

Cascading effect of transactions – even if no deduction claimed in initial years, TP provisions to apply

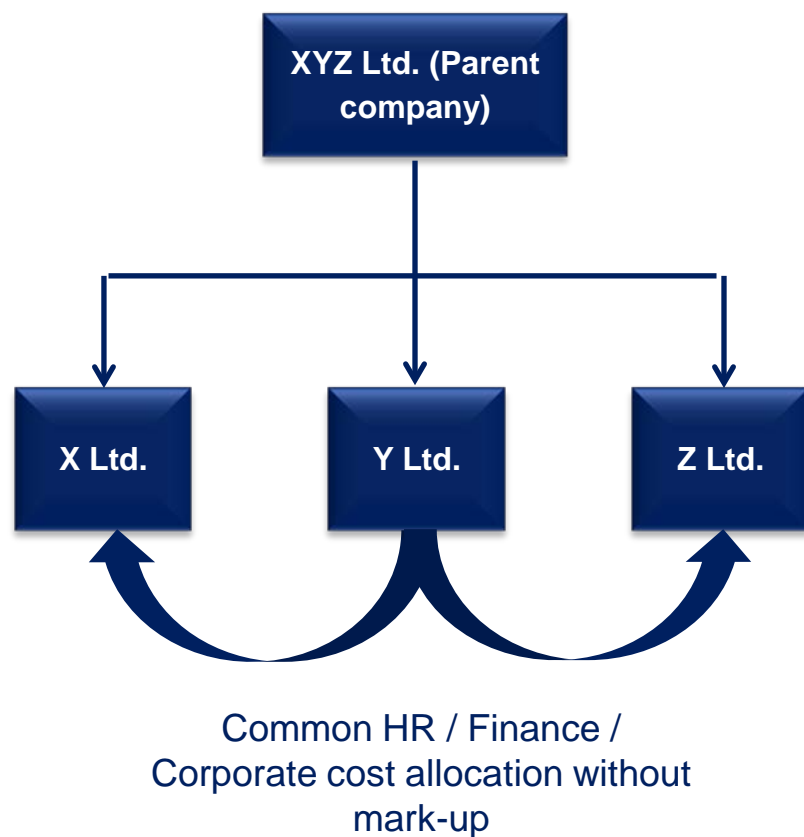
**View 3 – Only in years where tax holiday has been availed**

Applicable only in years in which substantive provisions apply and tax holiday claimed

# Direct v/s indirect ownership

- Section 40A(2)(b) silent on indirect ownership
- Circular 6P of 1968 (explaining 40A(2) as introduced) – mentions direct / indirect for downstream
- Circular (especially those in conflict with Act) not binding - Act is supreme
- Definition of 'associated enterprise' u/s 92A uses the expression 'directly or indirectly' and 'through one or more intermediaries' - Such language not used in Section 40A(2)(b)
- Revised Guidance Note on Report under Section 92E issued by the ICAI in August 2013 seems to support the view that only direct holdings should be considered
- Reporting penalty may be a concern – 2% of transaction value
- Retrospective amendment cannot be ruled out

# Cost allocation



- Cost allocation in 40A(2) without mark-up – acceptable?
- The need, benefit and evidence test should be satisfied
- Appropriate Cost allocation keys should be adopted
- Adequate documentation to be maintained

# Determination of the 5 crores limit

- Section 92BA just mentions “transactions entered into by the assessee”
- Whether ‘transactions entered’ alludes to book value or ALP
- No clarity in sec 92BA or 40A(2)
- If ALP is more than book value in one of the transactions can SDT be triggered – even though book value in aggregate is less than 5 crores
- Can the TPO determine ALP even where no reporting / benchmarking is carried out – i.e., where as per book value SDT not triggered?

**Threshold increased to INR 20 crores annually from FY 2015 – 16**

# Capital expenditure

- Section 92BA says “any expenditure”
- Whether capital expenditure covered?
- Section 92(2A) says “allowance for expenditure”
- Depreciation does not constitute an allowance for expenditure. View upheld by SC in the case of Nectar Beverages P. Ltd. (182 Taxman 319)
- Whether acquisition of shares a capital expenditure or investment – whether such share acquisition needs to be reported?
- Whether reporting or benchmarking is required?
- Recently issued Guidance Note of the ICAI specifically includes “expenditure on purchase of tangible and intangible property” in ambit of Section 40A(2)(a) transactions
- Reporting penalty may be a concern – 2% of transaction value



# Only business or other sources also covered?

- Section 92BA only talks about “any expenditure” to related persons
- Does not specify “business income”
- Expenditure under CG / IFOS covered?
- Cost of acquisition and / or transfer expenses covered?
- Whether reporting to be done?

# Loans / guarantees without consideration

- Not relevant under SDT in a non tax holiday scenario
- 37(1) exposure for entity giving such loan / guarantee without consideration
- Whether SC judgment of S. A. Builders Ltd. applies – shareholders activity argument
- SLP by 3 member bench admitted in the case of Tulip Star Hotels Ltd.
- Whether shareholder activity argument still valid?

# Director's remuneration benchmarking

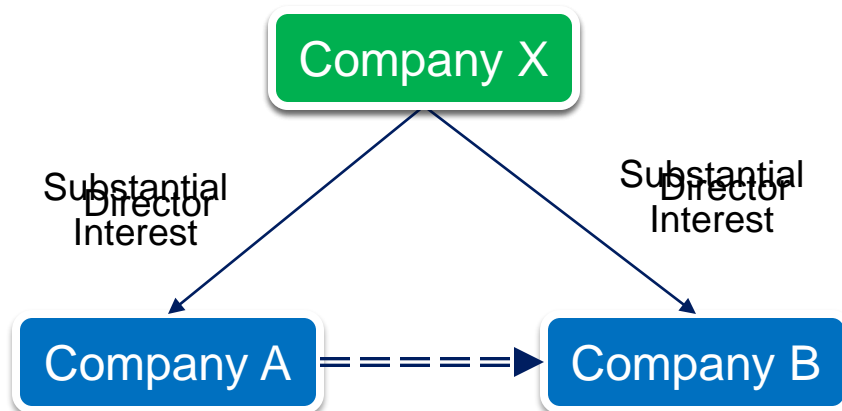
- Every director is a related party – No uncontrolled transactions possible
- Various approaches in benchmarking of director's remuneration possible to consider
- Transaction Net Margin Method (TNMM) – Transaction subsumed as part of overall TNMM
- Use of average ratio – Director's remuneration as a percentage of total cost or sales
- Comparison with survey carried out by external agencies
- Remuneration specified in appointment letter issued at the time of recruitment – may be treated as uncontrolled transaction
- Use of ceiling provided by the Companies Act, 1956 for managerial remuneration
- Section 40(b) for Partner's salary?

**Technical argument – No tax leakage since entire salary offered to tax (no expense deduction)**

The background consists of several overlapping, semi-transparent geometric shapes in various shades of blue (light, medium, and dark) and white. The shapes are primarily parallelograms and trapezoids, creating a dynamic, layered effect. The text is centered on a dark blue parallelogram shape.

# **Generic Case Studies**

# Case Study 1



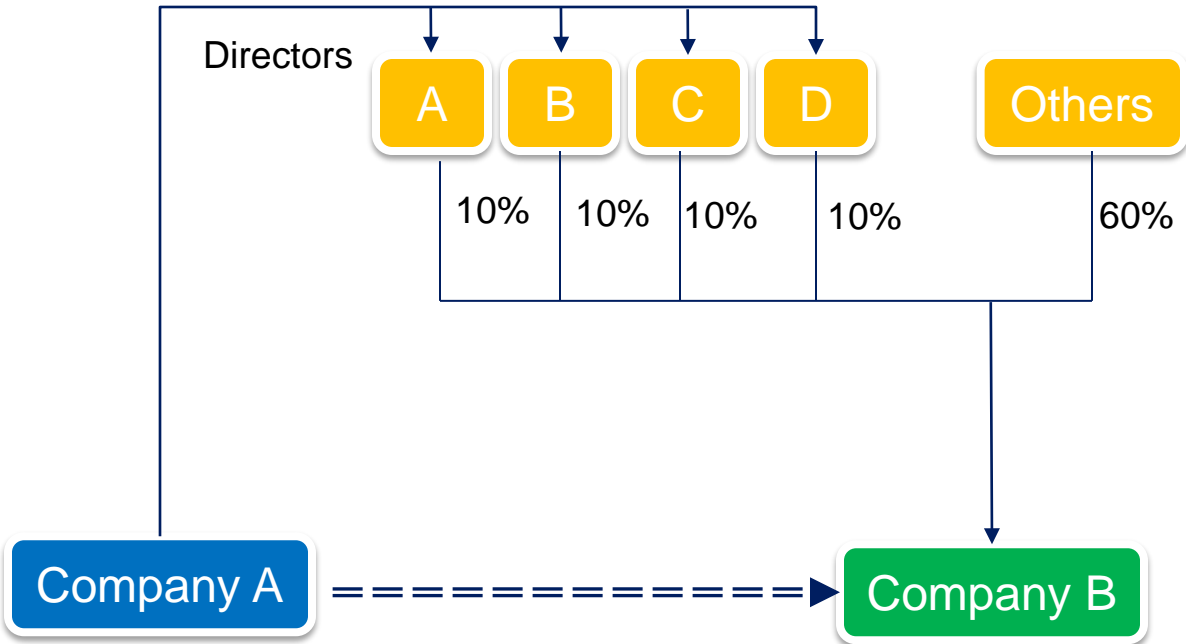
1. Whether Transactions between Co. A and Co. B are covered under SDT ?

2. Would the answer be different, if Mr. X had substantial interest in both?

3. Assuming Company X had substantial interest in both A and B, whether purchase of capital asset by A from B would constitute SDT ?

4. What if the Capital Expenditure of Co. A is eligible for 100% deduction u/s 35 of the Income Tax Act ?

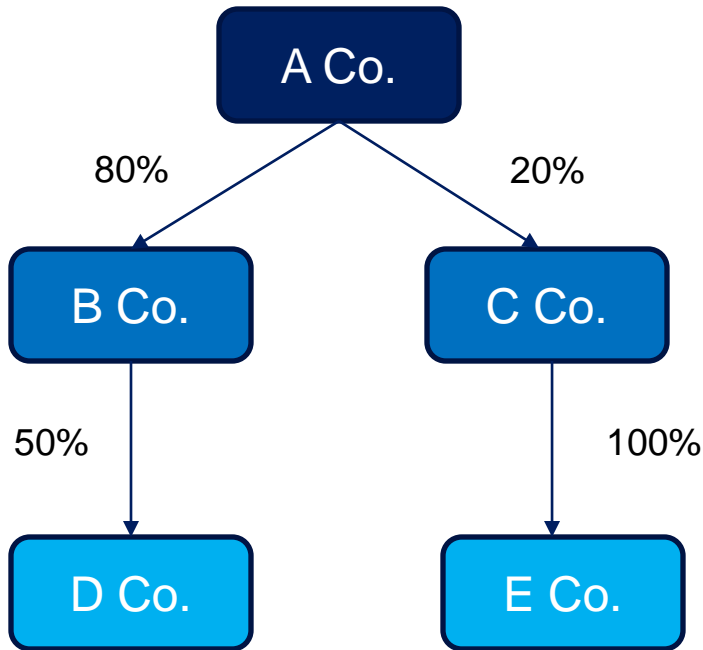
# Case Study 2



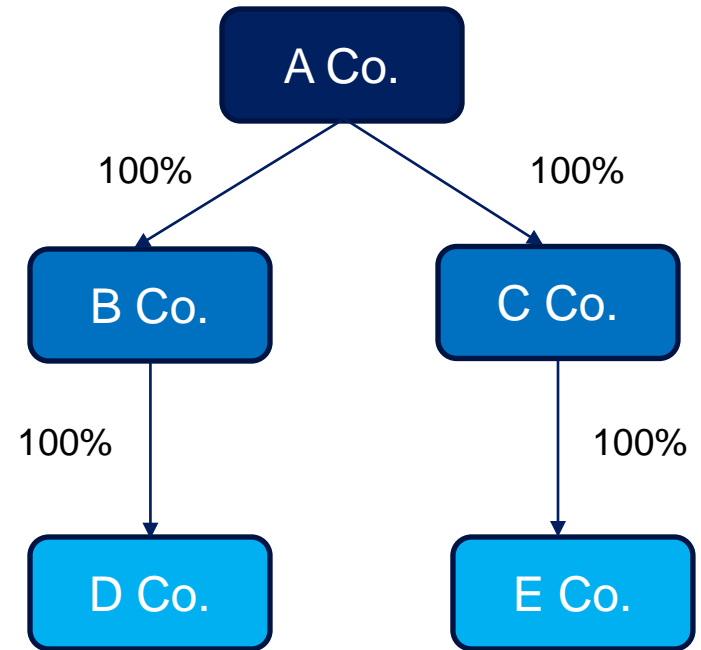
Whether Transactions between Co. A and Co. B are covered under SDT ?

# Case Study 3

**Situation 1**

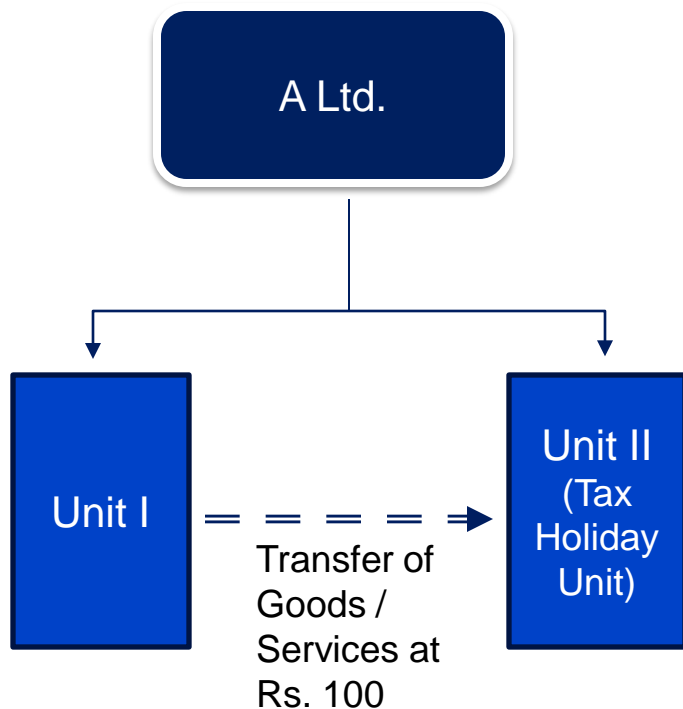


**Situation 2**



Whether A Co. has substantial interest in D Co. / E Co. in the above situations ?

# Case Study 4



	Unit I	Unit II Tax Holiday Unit	Total
Income	100	200	300
Expense	50	100	150
Profit	50	100	150
Deduction	-	100	100
Taxable Profit	50	-	50

What will be the Tax Consequence if ALP is (a) Rs. 80 and (b) Rs. 120 ?



# Case Study 4

Situation 1: ALP = Rs. 80

	Unit I	Unit II Tax Holiday Unit	Total
Income	100	200	300
Expense	50	100	150
Profit	50	100	150
Deduction	-	100	100
Taxable Profit	50	-	50

Situation 2: ALP = Rs. 120

	Unit I	Unit II Tax Holiday Unit	Total
Income	100	200	300
Expense	50	100	150
Profit	50	100	150
Deduction	-	80	80
Taxable Profit	50	20	70

# Questions & Answers



Questions

&

Answers



# Abbreviations Used

Abbreviations	Full Form
ALP	Arm's Length Price
FMV	Fair Market Value
FY	Financial Year
SC	Supreme Court
SDT	Specified Domestic Transactions
TNMM	Transactional Net Margin Method
TP	Transfer Pricing

# Thank you

The information contained herein is of a general nature. The content provided here treats the subjects covered here in condensed form. It is intended to provide a general guide to the subject matter and should not be relied on as a basis for business decisions. A detailed analysis of the tax and regulatory implications should be done prior to implementation in order to determine the feasibility of the transaction at the time of implementation.

Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation. Specialist advice should be sought with respect to any individual circumstances.

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