

# Domestic Transfer Pricing



The scope of transfer pricing regulations was extended to domestic transactions too from the financial year 2012-13, on some categories, known as specified domestic transactions; earlier, that was limited only to the cross-border transactions, which had been introduced to prevent the evasion of taxes. The Finance Act, 2012 introduced this extension in the scope of existing transfer pricing provisions as an important change in the Indian income-tax laws, creating a significant impact on the corporate and non-corporate business houses of our country, which have multiple associates or subsidiaries. These domestic transfer pricing provisions do not exist in every other nation across the world. The author discusses this important development and tries to present it with clarity in the interests of the auditing fraternity. Read on to know more about the transfer pricing provisions as applicable to domestic entities...

## Introduction

Income-tax laws of India already have *transfer-pricing* provisions relating to cross-border transactions between two or more associated enterprises since 2001. The basic objective of introducing these provisions is to prevent the evasion of tax in India. However, the Finance Act, 2012 introduced a very unique nature of transfer-pricing provisions in relation to some specified domestic transactions, which is an important change in the Indian income-tax laws and has significant effect on Indian corporate/non-corporate business houses having many associates or subsidiaries. It is important to note here that only in a few countries, including India, domestic transfer pricing provisions have been introduced.

As the financial year 2012-13 is the year from which domestic transfer-pricing provisions have been made applicable, so it is quite worthy to discuss those provisions to make clear our own views, before turn to the the tax and transfer-pricing audit.



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**If any assessee is enjoying any tax benefit under Section 80A, 80I, or, 10AA, both income and expenditure shall be computed as per the arm's length price subject to the threshold limit of ₹5 crore. It can be pointed out in this respect that the concept of associated enterprise is not applicable for domestic transfer pricing provisions.**

### Introduction of Domestic Transfer-Pricing Provisions

Upto 31<sup>st</sup> March 2012, there were no transfer-pricing provisions in the Income-tax Act, 1961 regulating the domestic transactions between the associated enterprises. The concept of transfer-pricing provisions for domestic transactions was first recommended by the Supreme Court of India in the case of *CIT vs. Glaxo SmithKline Asia (P.) Ltd.* [2010] 195 Taxman 35, with a logic to regulate the evasion of taxes by way of profit manipulation between group companies, particularly when one of the companies is enjoying a tax holiday or certain exemption in tax. The Finance Act, 2012 brought out domestic transfer-pricing provisions based on the recommendations of the Supreme Court of India, but instead of introducing in the case of limited domestic transactions, such provisions were enacted for all domestic entities whether or not enjoying tax holidays or benefits. This is quite irrational in case of corporate entities, being associates, having same rate of tax; no one enjoys any tax benefit or exemption because the impact on the exchequer will be revenue neutral.

### Changes in Finance Act, 2012

Before the enactment of domestic transfer pricing provisions, Section 40A(2)(a) of the Income-tax Act, 1961 governed the transactions between relatives and associated enterprises. As per that Section, if the assessing officer considers any expenditure as *excessive or unreasonable* in regard to *fair-market value* of the goods, then she/he may disallow the same for the purpose of income tax payable. However, there was no method prescribed in the erstwhile Section 40A(2)(b) for calculating the fair-market value.

Clause 2A has been inserted to Section 92 of the Income-tax Act, 1961 in the Finance Act, 2012, with effect from 1<sup>st</sup> April 2012, which reads:

*“(2A) Any allowance for an expenditure or interest or allocation of any cost or expense or any income*

*in relation to the specified domestic transaction shall be computed having regard to the arm's length price.”*

Further, a *proviso* has been inserted to the Section 40A(2)(a) of the Income-tax Act, 1961:

*“Provided that no disallowance on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.”*

The meaning of specified domestic transaction has been specified in the Section 92BA of the Income-tax Act, 1961 in which following transactions have been covered:

- Any expenditure in respect of which payment has been made or is to be made to a person referred to in the clause (b) of sub-section (2) of Section 40A.
- Any transaction referred to in Section 80A
- Any transfer of goods or services referred to in the sub-section (8) of Section 80IA
- Any business transacted between the assessee or other person as referred to in the sub-section (10) of Section 80-IA
- Any transaction, referred to in any other section under Chapter VI-A or Section 10AA, to which provisions of the sub-section (8) or the sub-section (10) of Section 80-IA are applicable, or
- Any other transaction as may be prescribed (not prescribed yet).

Further, it has been prescribed in the section that aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of ₹5 crore.

Therefore, reading the Section 40A(2A) and Section 92BA in conjunction, we can understand:

1. Any expenditure for which payment has been made to any related party shall be routed through transfer-pricing formalities.
2. Any transaction, i.e. income, expenditure, or, both, is under the scanner of Transfer Pricing Regulations, if the enterprise is enjoying a tax benefit under Section 80-IA, or Section 10AA, or Section 80A.
3. A residuary clause has been kept for taxing any other transactions which shall be brought into effect afterwards.

### Persons Covered under Section 40A(2)(b)

Nature of Assessee	Person referred to
Individual	-Any relative of an assessee -Any individual who has substantial interest in the business of an assessee
Company, Firm, AOP, BOI, or, HUF	1. Any director of a company, a partner of the firm or a member of the AOP, BOI or HUF, or any relative of such director, partner or member 2. Any company, firm, AOP, BOI or HUF in which any director/partner/member or any relative of them has substantial interest  For this purpose, a person is deemed to have substantial interest in the business of a company if the person is the beneficial owner of shares having more than 20% of the total voting power.

Therefore, by reading the above two provisions of the Act in conjunction, it is evident that expenditures in relation to which payment has been made to persons mentioned in Section 40A(2)(b) of the Act, shall be computed at the *arm's length price* subject to the condition that the aggregate amount shall cross the limit of ₹5 crore. However, if any assessee is enjoying any tax benefit under Section 80A, 80I, or, 10AA, both income and expenditure shall be computed as per the *arm's length price* subject to the threshold limit of ₹5 crore. It can be pointed out in this respect that the concept of *associated enterprise* is not applicable for domestic transfer pricing provisions.

The applicability of *domestic transfer pricing* concept can be presented graphically for convenience:

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**The assessee has to maintain an extensive set of documentation and information as prescribed in Rule 10D of the Income-Tax Rules, 1962. These requirements can be broadly divided into two parts: *Mandatory List* documentation and information that an assessee must maintain, and *Recommended List* of documents that an assessee has to maintain mainly to substantiate its *arm's length price*.**

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### Situation 1

X Ltd. (Non Tax Holiday unit) → Y Ltd. (Non-Tax holiday unit)  
(If X Ltd. sold goods to Y Ltd. at ₹120 instead of at ALP of ₹100, ₹20 shall be disallowed in the hands of Y Ltd.)

### Situation 2

X Ltd. (Tax Holiday unit) → Y Ltd (Non-Tax holiday unit)  
(If X Ltd. sold goods to Y Ltd. at ₹120 instead of at ALP of ₹100, ₹20 shall be disallowed in the hands of X Ltd. for showing lesser income and ₹20 will be disallowed in the hands of Y Ltd. for excessive expenditure claimed).

### Manner of Computation of Arm's Length Price

Section 92C of the Income-tax Act, 1961 read with Rule 10B of the Income-Tax Rules, 1962 prescribes the following methods of computing ALP:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Profit split method
- Transactional net margin method

Further, Rule 10C of the Income-Tax Rules, 1962 prescribes that, out of the above named methods, the method which is best suited to the facts and circumstances of the case and which provides most reliable measure of the *arm's length price* should have been selected in this regard.

In selecting the most appropriate method for determining the *arm's length price*, following should be taken into consideration:

1. Nature and class of transactions;
2. Class or classes of associated enterprises entering into the transactions and functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
3. Availability, coverage and reliability of data necessary for application of the method;
4. Degree of comparability existing in the specified domestic transaction and the uncontrolled transaction and between enterprises entering into such transactions;
5. Extent to which reliable and accurate adjustments can be made to account for the differences, if any, between the specified domestic transaction and the comparable uncontrolled transaction or between enterprises entering into such transactions; and
6. Nature, extent and reliability of assumptions required to be made in application of a method.

### How Each of the Above Methods will Operate

Each of the above named methods for determining *arm's length price* will be:

S.I no.	Arm's Length Price Determining methods	Description of the method
1	Comparable Uncontrolled Price Method	<ol style="list-style-type: none"> <li>1. Determine the price charged or paid for the property transferred and services rendered.</li> <li>2. Find out comparable price of any independent uncontrolled transaction in open market between two unrelated enterprises.</li> <li>3. Adjust the price based on the above.</li> <li>4. Such adjusted price will be treated as the <i>arm's length price</i>.</li> </ol>
2	Resale Price Method	<ol style="list-style-type: none"> <li>1. The resale price of the property purchased or services obtained from an associated enterprise to an unrelated party is to be determined.</li> <li>2. Amount of gross profit of an unrelated enterprise from the purchase and sale of the same or similar property or providing similar kind of services in a comparable uncontrolled transaction or a number of such transactions.</li> <li>3. <i>Arm's length price</i> is to be determined after making adjustments in respect of the above.</li> </ol>
3	Cost plus method	<ol style="list-style-type: none"> <li>1. Direct and indirect costs incurred for the property transferred or services provided to an associated enterprise are to be determined.</li> <li>2. The normal gross profit markup in case of comparable uncontrolled transactions is to be determined.</li> <li>3. <i>Arm's length price</i> would be determined after adding the profit mark-up with the cost.</li> </ol>
4	Profit Split method	<ol style="list-style-type: none"> <li>1. Combined net profit of the associated enterprises is to be determined.</li> <li>2. Relative contribution made by each associate enterprise to the earning of such combined net profit is to be determined on the basis of capital employed and risk assumed by each associated enterprise.</li> <li>3. The combined net profit is then split amongst associated enterprises on the basis of their relative contribution.</li> <li>4. The profit thus apportioned is to be taken into account for determining the <i>arm's length price</i>.</li> </ol>
5	Transactional Net Margin	<ol style="list-style-type: none"> <li>1. Net profit margin realised by an enterprise in respect of transactions entered with associated enterprises is to be computed</li> <li>2. Similarly, net profit margin realised by an enterprise from comparable uncontrolled transactions is to be determined</li> <li>3. The net profit margin determined in (2) above, is to be adjusted by taking into account the factors which can materially affect the net profit margin in the open market.</li> <li>4. The net profit margin thus established is then taken into account to determine <i>arm's length price</i>.</li> </ol>

Each of the above mentioned methods has its own merits and demerits, and each of these methods is suited to a certain kind of transaction. Selecting a method for calculating the *arm's length price* is very important for the purpose of income-tax assessment, because at the end we have to make the transfer pricing officer satisfied as the method of calculating the *arm's length price* is the best suited method.

Briefly, we can say with regard to method selection:

1. Evaluate the nature of transactions entered into between associated enterprises
2. Evaluate the industry in which the enterprise is operating
3. Evaluate the degree of availability of comparable uncontrolled price for same kind of transactions in same line of business

4. Calculate transfer price in two or more methods and judge the results
5. Always keep ready with two or more methods because if one method is not acceptable to the TP officer, then the other can be applied.

### Documentation

The assessee has to maintain an extensive set of documentation and information as prescribed in Rule 10D of the Income-Tax Rules, 1962. These requirements can be broadly divided into two parts: *Mandatory List* documentation and information that an assessee must maintain, and *Recommended List* of documents that an assessee has to maintain mainly to substantiate its *arm's length price*. The list of documentation is quite huge and it is not possible to list out the same in this article. However, some of them are:

- Ownership structure
- Group profile
- Business overview
- List of associated enterprises
- Details of specified domestic transactions
- A detailed documentation regarding comprehensive transfer pricing study like functions performed, risk assumed, capital employed, comparability analysis, benchmarking study, assumptions, policies, details of any adjustments done in respect of calculating *arm's length price*, etc.

In this regard, it should be mentioned that documentation shall be kept with the assessee herself/himself and it shall have to be submitted before the TPO at the time of assessment.

### Transfer Pricing Audit

An independent Chartered Accountant's report in the Form 10CCB is to be submitted by an assessee to the department within the date of filing returns, i.e. 30<sup>th</sup> September, for each year.

### Penalties for Non-Compliance

Non-Compliance	Penalty
Non-maintenance of documents	2% of transaction value
Non-reporting of transactions	2% of transaction value
Incorrect maintenance/submission of documents	2% of transaction value
For concealment/furnishing inaccurate particulars	100% to 300% of tax due

### Certain Issues

Domestic transfer pricing is a welcome change in the Finance Act, 2012. However, the same should have been introduced only in entities where one of them enjoys tax holiday or tax exemptions, because if both entities are in the same tax bracket, the effect would be revenue-neutral in respect of earning of the government.

Further, due to a wide coverage of SDT, following key points may crop up:

#### 1. Managerial remuneration

As per Section 40A(2b), directors of a company and their relatives are the related parties to the company and, therefore, remuneration paid to directors is reported in the tax audit report by Chartered Accountants. However, while applying TP methods, the following questions may arise:

- Which method should be applied in determining the ALP?
- How comparable the uncontrolled remuneration is to be judged because directors' remuneration depends upon other factors like efficiency, qualification, experience which may not be the same for two persons?
- Would the ceiling specified by the Companies Act, 1956, be sufficient to prove ALP?

These points remain unanswered till date and we may expect certain clarification regarding the same.

#### 2. Cost application

Cost allocation is a major issue in respect of big MNCs in allocation of common costs incurred mainly for the purpose of branding, publicity and advertisement, managerial remuneration, etc. The basic question may crop in this case as to what the method of ALP should be and what the key would be to allocate the cost. The sanctity of cost allocation key may be questioned by the TPO and nothing has been prescribed by the provisions of the law in this regard.

### Conclusion

Introduction of domestic transfer pricing provision is a welcome change in the Budget 2012. However, its wide coverage would increase the cost burden upon many companies to comply with the provisions of law. It is high time that both the industry as well as Chartered Accountants should be alert enough to abide by the formalities of SDTs. Though there are many things which remain unanswered till now, we have to suggest our clients on the basis of the understanding the provisions of the law. ■