

Transfer Pricing on Domestic Transactions

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Background

- ▶ Transfer pricing bleeding ground for the corporate but breeding ground for consultants
- ▶ Transfer pricing addition in first six years equal to addition made addition made in last year – refer *‘Trend of Adjustments Over The Years’*
- ▶ Domestic transfer pricing will open a flood gates for transfer pricing litigation
- ▶ Both taxpayer and consultants must work closely and more resources should be employed to handle it successfully

Trend Of Adjustments Over The Years

TP audit trends indicate greater scrutiny, leading to increased adjustments and resultant litigation

Financial Year	No. of TP Audits Completed	Number of Adjustment Cases	% of Adjustment Cases	Amount of Adjustment (Rs. in Crores)
2004-05	1,061	239	23	1,220
2005-06	1501	337	22	2,287
2006-07	1,768	471	27	3,432
2007-08	219	84	39	1,614
2008-09	1,726	670	39	6,140
2009-10	1,830	813	44	10,908
2010-11	2,301	1,138	49	23,237
2011-12	2,638	1,343	52	44,531

Source: White Paper May 2012, Ministry Of Finance, Department Of Revenue

Arm's Length Principle

- ▶ Prices set for transactions between group entities should, for tax purposes, be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.
- ▶ Section 92F (ii) of the Act
“arms length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions”

Specified Domestic Transaction

- ▶ The Finance Act 2012 extended the scope of Transfer Pricing provision to ‘Specified Domestic Transactions (‘SDT’)
- ▶ The SDT would include the following:
 - Expenditure for which payment is made or to be made to domestic related parties–40A 2(b) payment
 - Tax Holiday/ Deductions claimed by the taxpayer, where;
 - Transfer of goods or services between various businesses of same taxpayer
 - More than ordinary profits derived from transactions with closely connected persons

Transfer Pricing provisions to apply to the ‘Specified Domestic Transactions’ if the aggregate value exceeds five crores

Specified Domestic Transaction

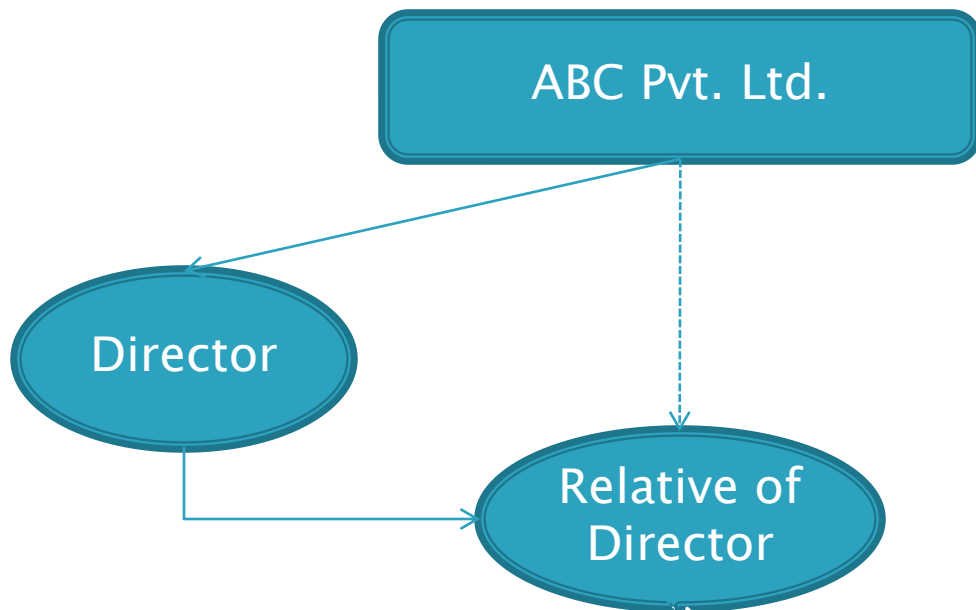
- ▶ 92BA. For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:—
 - (i) any expenditure in respect of which payment has been made or is to be made to a person referred to in section 40A(2)(b) –

Specified Domestic Transaction

- ▶ Section 40A(1)
 - Applicability restricted to the computation of income under the head “Profits and gains of business or profession”
- ▶ Section 40A(2)
 - Applicable on expenditure in respect of which payment has been made or it to be made
 - Expenditure in respect of goods, services or facilities
- ▶ Q & A
 - Interest free loan given to related party
 - Corporate guarantee without any charge
 - Goods sold at lower value
 - Capital expenditure

Specified Domestic Transaction

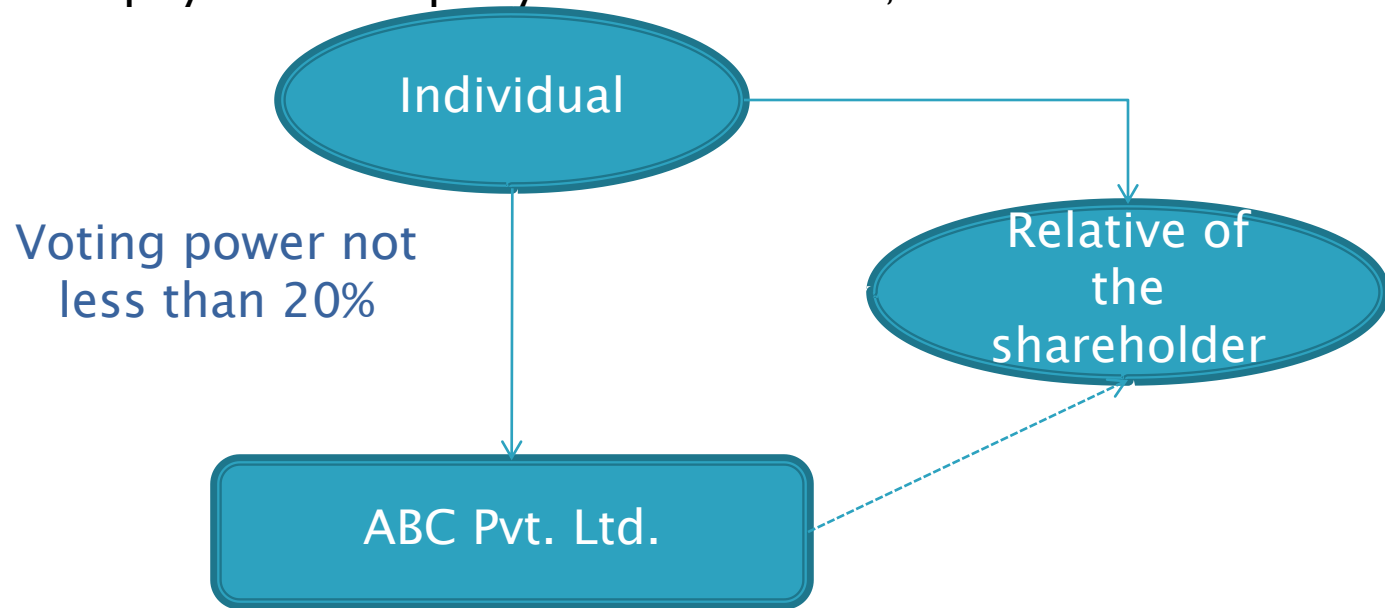
In case if the taxpayer is Company it would cover;



Till FY 2011-12, payment made to the Foreign Directors were not covered under TP Provisions but now it would get covered

Specified Domestic Transaction

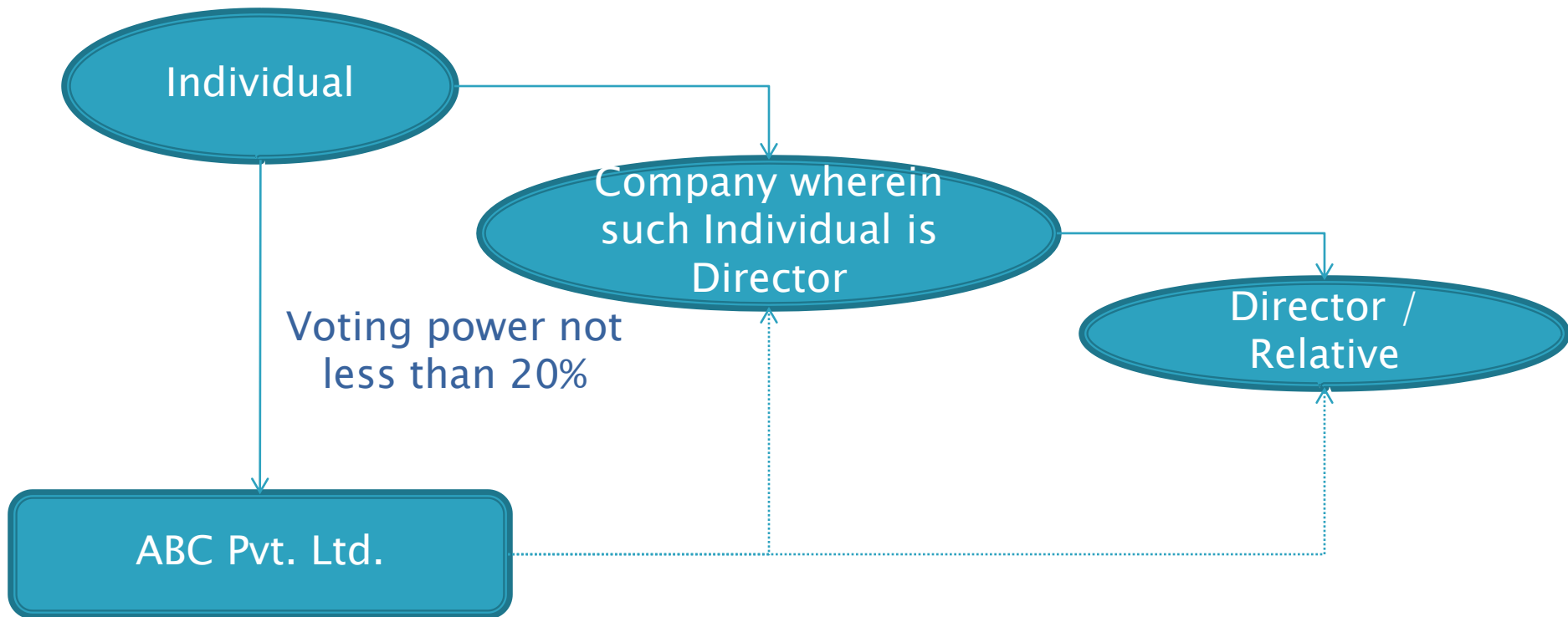
In case if the taxpayer is Company it would cover;



For an international transaction limit is 'voting power not less than 26%'

Specified Domestic Transaction

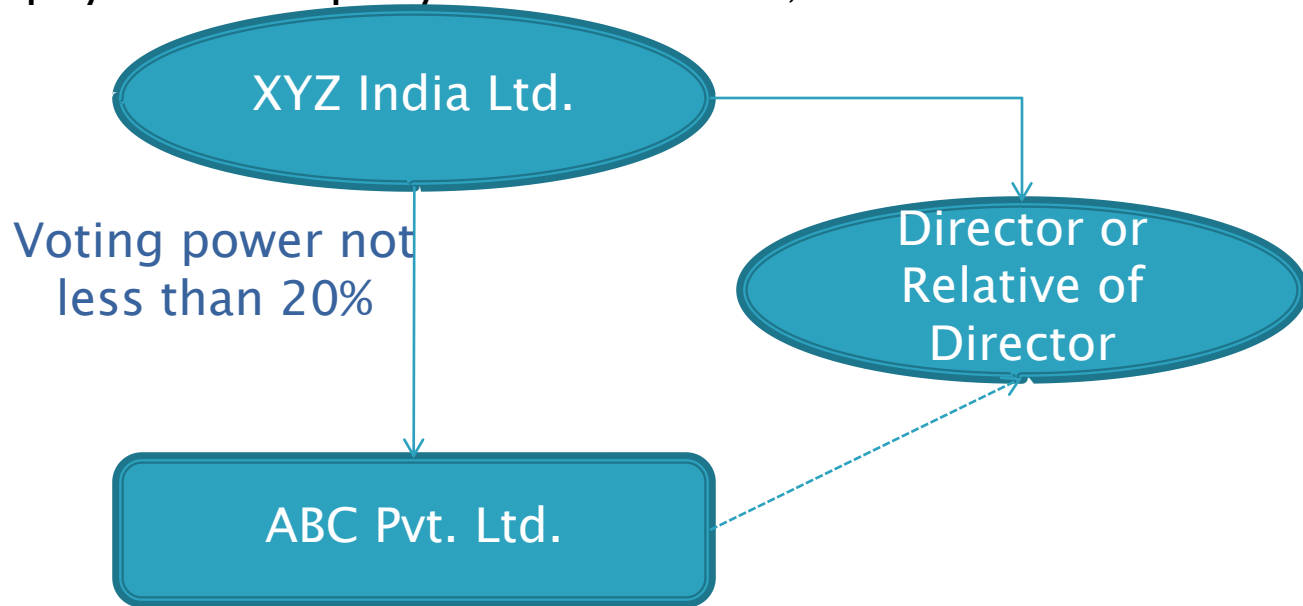
In case if the taxpayer is Company it would cover;



For an international transaction limit is 'voting power not less than 26%' + additional two relationships are also not covered

Specified Domestic Transaction

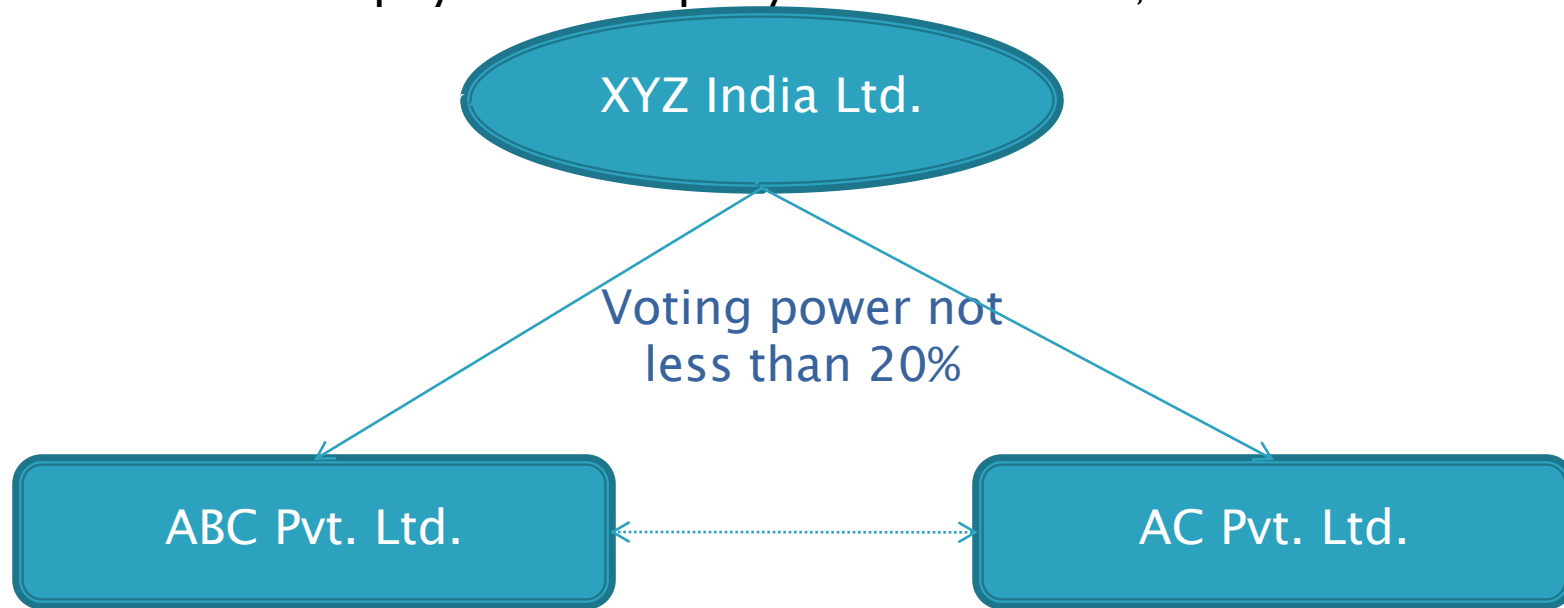
In case if the taxpayer is Company it would cover;



For an international transaction limit is 'voting power not less than 26%' + Transaction with Directors/ relatives of Directors of the holding company are not covered

Specified Domestic Transaction

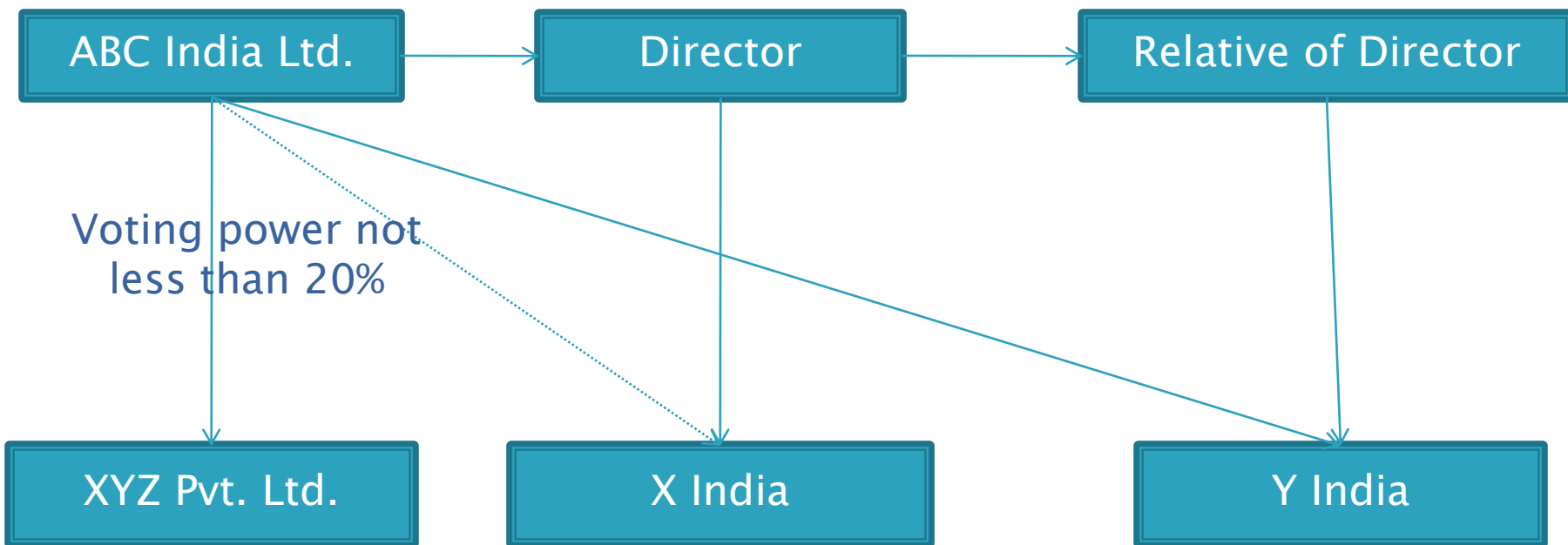
In case if the taxpayer is Company it would cover;



For an international transaction limit is
'voting power not less than 26%'

Specified Domestic Transaction

In case if the taxpayer is Company it would cover;



For an international transaction limit is 'voting power not less than 26%' + relationships through Directors and relatives not covered

Specified Domestic Transaction

(ii) any transaction referred to in section 80A



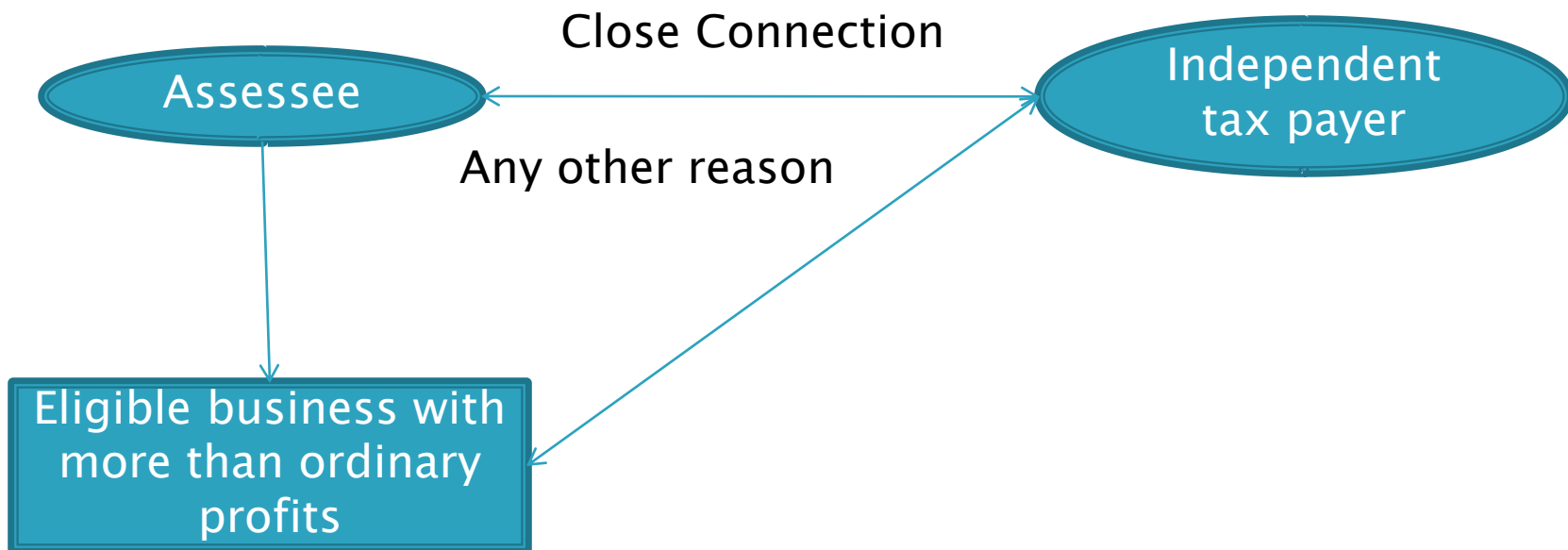
Specified Domestic Transaction

(iii) any transfer of goods or services referred to in sub-section (8) of section 80-IA



Specified Domestic Transaction

(iv) any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA



Specified Domestic Transaction

(v) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable;

- 10AA – Special provisions in respect of newly established Units in Special Economic Zones.
- 80IAB – Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of Special Economic Zone.
- 80IB – Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings.
- 80 IC – Special provisions in respect of certain undertakings or enterprises in certain special category States
- 80ID – Deduction in respect of profits and gains from business of hotels and convention centres in specified area.
- 80IE – Special provisions in respect of certain undertakings in North-Eastern States

Specified Domestic Transaction

(vi) any other transaction as may be prescribed

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of five crore rupees.

Specified Domestic Transaction

Issues specific to Non Tax Holiday Unit

- ▶ Computation of arm's length price of remuneration paid to Director
- ▶ As applicability is quite wide – other transacting party may not share the data

Issues specific to Tax Holidays Unit

- Head Quarter services & administrative services
- Capital financing transaction
 - Intra-company
 - Close connection

Specified Domestic Transaction

Case Study 1

- ▶ Taxpayer is a manufacturer and trader of pharmaceutical goods, diagnostic kits, medical instruments etc. The taxpayer has two units – Unit A (Tax Holiday) & Unit B (Non-Tax Holiday)
- ▶ Financial position

Particulars	Unit A	Unit B	Corporate	Total
Sales	1,000	500	–	1,500
Direct Cost	400	300	–	700
Indirect Cost			700	700
Allocation	467	233		
Profit	133	–33		100
OPM	13.3%	–0.067%		6.67%

Specified Domestic Transaction

Case Study 1

▶ Query

- Whether mark-up should be charged on the cost incurred by the corporate office or not?
- If mark-up is charged @10% revised position can be;

Particulars	Unit A	Unit B	Corporate	Total
Sales	1,000	500	–	1,500
Direct Cost	400	300	–	700
Indirect Cost			700	700
Allocation	513	257		
Profit	87	-57	70	100

Specified Domestic Transaction

Case Study 1

▶ Section 801A(8)

Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business and, in either case, the consideration, if any, for such transfer as recorded in the accounts of the eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of the deduction under this section, the profits and gains of such eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date....

Specified Domestic Transaction

Case Study 1

- ▶ Section 80IA(8)
 - Goods or services
 - Held for the purposes of business carried on by the assessee

The word 'business' is not defined exhaustively in the Income-tax Act, but it denotes an activity with the object of earning profit. To say that a business is being carried on, means no more than that profit is to be earned by a process or production – Senairam Doongarmall v. CIT [1961] 42 ITR 392 (SC).

The word 'business' is one of wide import and it means an activity carried on continuously and systematically by a person by the application of his labour and skill with a view to earning an income – Barendra Prasad Ray v. ITO [1981] 129 ITR 295 (SC).

Specified Domestic Transaction

Case Study 2

- ▶ Company A is involved in non eligible business whereas its subsidiary Company B is involved in eligible business enjoying 80IA benefit.
- ▶ During the year, Company A took a loan from a Bank and extended such loan as interest free loan to its subsidiary.
- ▶ Query
 - Whether domestic transfer pricing is applicable or not?
 - If yes, under which section ?

Specified Domestic Transaction

Case Study 2

- ▶ Section 80IA (10)

Where it appears to the Assessing Officer that, 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.”

Specified Domestic Transaction

Difference between 'FMV' and 'ALP'

- ▶ Section 2(22B)

'fair market value' in relation to a capital asset means –

(i) the price that the capital asset would ordinarily fetch on sales in the open market on the relevant date

- ▶ Section 92F(ii)

“arm's length price” means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions;

Responsibility of the Tax Payer

- ▶ Taxpayer must compute the arm's length price of international transactions as per the methods prescribed under section 92C.
- ▶ Burden of proof is on the taxpayer to establish the arm's length price and to maintain related documents.
- ▶ Must obtain a report under Form 3CEB from a Chartered Accountant and file it before tax authorities within due date of filing of return of income.
- ▶ For assessment year 2011-12 and onwards, due date would be 30 November.
- ▶ Tax payer must submit the transfer pricing document to the tax authorities, within 30 days of the receipt of notice from the department.

Responsibility of the Tax Payer

- ▶ Penalties
 - Non maintenance of documents, fail to report transaction, maintain or furnishes an incorrect information or document – 2% of the value of international transaction – Section 271AA
 - Non filing of Form 3CEB – Rs.100,000/- - Section 271BA
 - Failure to furnish information or document to tax authorities – 2% of the value of international transaction – Section 271G

Thank You



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