Transfer Pricing for Specified Domestic Transactions – An Insight

Finance Act, 2012 has made sweeping changes to the tax landscape in India. One such change pertains to the application of transfer pricing provisions to 'Specified Domestic Transactions'. In theory, all taxpayers crossing the threshold for specified domestic transactions would now be required to comply with the transfer pricing regulations. However, there are several challenges when it comes to practical application of the transfer pricing regulations to such transactions. This article seeks to hypothecate how transfer pricing would be applicable to specified domestic transactions, analysing some relevant Indian case laws, highlighting key differences and similarities, and noting some practical issues and unanswered questions. Further guidance on areas lacking clarity should help the cause of the taxpayers as well as tax professionals.

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Background

While examining related party transactions between two Indian Companies in the case of *Glaxo SmithKline*[1], the Supreme Court suggested that the CBDT should consider making Transfer Pricing Regulations applicable to domestic transactions. While making this suggestion, the Supreme Court categorically referred to two situations where transfer pricing provisions could be relevant in the context of domestic transactions. The two situations being:

- Transactions between loss-making and profit-making group entities
- Transactions between two related units (of the same taxpayer) having differential tax rates

[1] *CIT vs. Glaxo SmithKline Asia (P) Ltd. (2010) 236 CTR 113 (SC)*

In the case of *CIT vs. Glaxo SmithKline Asia (P) Ltd, (2010) 236 CTR 113 (SC)*, the Supreme Court suggested that the CBDT should consider making Transfer Pricing Regulations applicable to domestic transactions.

By way of an amendment *vide* Finance Act, 2012, even specified domestic transactions are now required to adopt the arm's length principle.[2] The amendment, however, does not appear to have considered the Honourable Supreme Court's suggestions completely, and has sought to make transfer pricing applicable to all specified domestic transactions.

Until now, in the domestic context, the determination of fair value of transactions with related parties has been governed by the following categories of provisions:

- Specified payments to related parties
- Transfer of goods or services between taxpayer's units eligible for tax holidays, and other units
- Transactions by taxpayer having units tax holiday, with parties having close connection with such taxpayer.

Henceforth, the concept of arm's length price will supersede the notions of fair valuation as per the relevant sections, in respect of specified domestic transactions.

Practical Application of transfer pricing to specified domestic transactions

This section examines the probable manner in which current transfer pricing regulations will be applied to specified domestic transactions, as well as some practical challenges likely to be faced in the process.

Compliance requirements

Essentially, there are two-fold compliance requirements under the Indian transfer pricing regulations.

The first part of the compliance requirements relates to maintenance of robust and contemporaneous documentation. In this connection, Section 92D of the Income Tax Act, 1961 (the Act), read with Rule 10D of the Income Tax Rules, 1962 (the Rules) prescribes stringent documentation requirements on the part of the taxpayer, to justify the arm's length nature of transactions entered into by it, which are subjected to the transfer pricing regulations. Until now, Section 92D dealt with only international transactions. However, the Finance Act, 2012 has also included specified domestic transactions within the ambit of Section 92D.

It is interesting to note that although Section 92D has been amended to include specified domestic transactions, a similar amendment has not yet been made to Rule 10D. As a result, as of now, Rule 10D appears to apply only to international transactions. On a strict conjoint reading of Section 92D and Rule 10D, it appears that the taxpayer subjected to transfer pricing regulations in respect of specified domestic transactions is required to maintain sufficient documentation to prove the arm's length nature of such transactions. However, the documentation does not necessarily need to be in line with Rule 10D requirements.

The second part of the compliance requirements relates to obtaining an accountant's report, and submitting the same with the revenue authorities. Again, the relevant Section (Section 92E) has been amended to include specified domestic transactions, however, the relevant Rule (Rule 10E), and the format of the accountant's report (Form 3CEB) are yet to be amended. In the absence of clarity regarding Form 3CEB, it is not clear whether separate accountant's reports (Form 3CEBs) will need to be filed for international transactions and specified domestic transactions, or a single Form 3CEB will include both these categories of transactions.

Methods for determining arm's length price

Section 92C, which deals with computation of arm's length price specifies the use of five methods, and such other method as may be prescribed. Correspondingly, Rule 10B prescribes the manner of using each of the five specified methods, and Rule 10AB prescribes the sixth transfer pricing method.

Until now, Section 92C was specifically applicable only to international transactions, and has now been extended to also include specified domestic transactions. However, Rule 10B and 10AB currently deal only with situations involving international transactions, and are yet to be amended in order to give practical effect to the amendment to Section 92C.

[2] See Section 92(2A) and 92BA. Several other amendments have also been made to give practical effect to these provisions.

Scrutiny by Transfer Pricing Officer

Section 92CA, which provides for reference to the transfer pricing officer, has also been amended to include specified domestic transactions. However, question arises regarding the applicability of monetary limits for selecting cases for a transfer pricing scrutiny. It may be noted that the CBDT had issued an instruction[3] prescribing the monetary threshold (₹5 crore) for selecting cases for a transfer pricing scrutiny and reference to transfer pricing officer. The question arises regarding the applicability of this threshold to specified domestic transactions. While the current wordings are restricted to only international transactions, it cannot be assumed that specified domestic transactions would not be subjected to scrutiny. On the other hand, if the monetary limit of ₹5 crore is considered to be inclusive of specified domestic transactions, all cases involving specified domestic transactions would be subjected to compulsory scrutiny by the Transfer Pricing Officer, since the threshold for a transaction to be considered as a specified domestic transaction itself is ₹5 crore, which is the threshold prescribed by the above noted Instruction.

The option to approach the Dispute Resolution Panel (DRP) would also be available to a taxpayer where a transfer pricing adjustment in respect of specified domestic transactions is proposed consequent to an Order of the Transfer Pricing Officer.

Allowability of corresponding adjustments

The Indian transfer pricing regulations clearly stipulate that corresponding adjustments would not be permitted in the context of 'international transactions'.[4] In other words, if there is an upward adjustment to the taxable income of the taxpayer, a corresponding downward adjustment would not be allowed to be made to the taxable income of the associated enterprise of such taxpayer.

However, a plain reading of the provision suggests that this would not be automatically applicable to specified domestic transactions.[5] Accordingly, in the absence of any clear provision in this regard, the availability of corresponding adjustments in respect of specified domestic transactions appears to be uncertain.

If corresponding adjustments were denied even in cases involving specified domestic transactions, if the transfer prices in respect of such transactions are found to be inappropriate by the revenue authorities, the same could result in double taxation for the group.[6]

Deadlines for compliance and scrutiny

The due date for tax compliance (including filing of the tax return, as well as transfer pricing documentation and accountant's report) for all categories of taxpayers having international transactions would now become applicable to taxpayers entering into specified domestic transactions also.

Similarly, additional timelines available to the revenue authorities for completion of the scrutiny proceedings would also be extended for taxpayers entering into specified domestic transactions.

Differences between applicability of transfer pricing to international and specified domestic transactions

Broadly, general principles of transfer pricing would now be applicable to specified domestic transactions. However, there are several differences between how transfer pricing regulations were being applied practically to international transactions, and how these will now be applied to specified domestic transactions.

Some key differences are as under:

Threshold for applicability of transfer pricing regulations

By definition, transactions will be considered to be specified domestic transactions, if the sum of various transactions covered within the definition exceeds ₹5 crore, and any domestic transactions

Amendment made in Finance Act, 2012 does not appear to have considered the Supreme Court's suggestions completely, and has sought to make transfer pricing applicable to all specified domestic transactions.

[3] Instruction No. 3 of 2003 dated 20-5-2003

[4] Refer Second Proviso to Section 92C(4).

[5] The second Proviso to Section 92C (4) denies a corresponding adjustment to the 'associated enterprise'. However, 'associated enterprise' is not a relationship covered for the purposes of specified domestic transactions. Also refer Section 3.3 of this article for discussion on the relationships covered for specified domestic transactions.

[6] In fact, in the absence of a specific provision allowing corresponding adjustments, the better view appears to be that such corresponding adjustments will not be allowed even in cases involving specified domestic transactions.

In several cases, it has been held that where two related parties were in the same tax bracket, there was no motive for them to shift profits, and a disallowance under Section 40A(2) is not warranted.

below this threshold would not be covered within the ambit of transfer pricing regulations. On the other hand, there is no such prescribed threshold for international transactions, and transactions worth even a single rupee are subjected to transfer pricing regulations.

Revenue Loss to the Government

Any mispricing in the case of international transaction has the potential to cause revenue loss for the Government.[7] However, specified domestic transactions need not always result in a revenue loss to the Government. For instance, a transaction between two related parties does not result in a tax arbitrage for the group and revenue leakage for the Government, if each of them:

- is subjected to the same tax bracket,
- does not enjoy any special tax holidays or benefits, and
- does not have any carried forward losses eligible for set off.

CBDT Circular No. 6-P, dated 6-7-1968, which explains the provisions of the Finance Bill, 1968 (the year when Section 40A (2) was incorporated in the Income Tax Act), also mentions, in the context of Section 40A (2), as under:[8]

> *"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". (Emphasis supplied)*

In fact, in several cases, it has been held that where two related parties were in the same tax bracket, there was no motive for them to shift profits, and a disallowance under Section 40A(2) is not warranted.[9]

However, notwithstanding the tax neutrality of such transactions, the same appear to be subject to transfer pricing compliances, scrutiny, and could even result in transfer pricing adjustments[10].

Coverage of relationships

The kind of relationships covered by transfer pricing for international transactions, and that for specified domestic transactions are different. Transfer pricing for international transactions is applicable to transactions between 'associated enterprises' as defined under Section 92A. On the other hand, relationships included for applicability of transfer pricing to specified domestic transactions continue to be as per the particular Sections under which the transactions were being covered until now.

For instance, transactions with an associated enterprise as per Section 92A which is not a related party as per Section 40A (2), will not be considered as specified domestic transactions.[11] Conversely, transactions with entities which are related parties as per Section 40A (2), but not associated enterprises as per Section 92A could now be considered as specified domestic transactions.[12]

Similarly, tax holiday units also cover specific relationships for applicability of transfer pricing, as against 'associated enterprises' for the purposes of international transactions. Inter-unit transfers by tax holiday units to non-tax holiday units of the same taxpayer; or transactions by such taxpayer with a person having close connection with the taxpayer would be considered as specified domestic transactions and subjected to transfer pricing regulations.

Coverage of transactions

The coverage of transactions subjected to transfer pricing is also different between international

[7] There could also be situations where international transactions do not actually result in a revenue loss to the Government. Discussion on such situations is beyond the scope of this article.

[8] Para 74

[9] For instance, refer *CIT vs. Indo Saudi Services (Travel) (P.) Ltd. [2008] 219 CTR 562 (Bom); CIT vs. V.S. Dempo & Co. (P.) Ltd. [2011] 196 TAXMAN 193 (Bom.); Orchard Advertising (P.) Ltd. vs. Addl. CIT [2010] 8 taxmann.com 162 (MUM); DCIT vs. Lab India Instruments (P.) Ltd. [2005] 93 ITD 120 (PUNE)*

[10] Subject to clarity regarding availability or otherwise of corresponding adjustments – refer Section 2.4 of this article for a discussion on this subject.

[11] For instance, payments to subsidiaries (which would be considered as Associated enterprises as per Section 92A(2)(a)), may not be subjected to transfer pricing for specified domestic transactions. Refer *CIT vs. V.S. Dempo & Co. (P.) Ltd. (supra)* in this regard. Entities which fulfill other criteria of Sections 92A(2)(a) to (m) but are not related parties as per Section 40A(2) would also not be covered.

[12] An example of such a situation could be an equity holding of, say 25% by a company in another company. While the threshold for 'associated enterprise' relationship is 26%, as per Section 92A (2)(a), the threshold for a related party relationship is only 20%, as per Section 40A(2)(b) read with the explanation to Section 40A(2).

transactions and specified domestic transactions.
The definition of international transactions is very wide and covers several types of transactions.[13]
However, all transactions are not covered within the ambit of specified domestic transactions. For instance, Section 40A (2) only covers payments to related parties on account of payments for goods, services or facilities. Evidently, receipts from such related parties would not be covered within the ambit of specified domestic transactions.[14]
Payment for capital goods also does not appear to be covered.
Further, as regards taxpayers having tax holiday units, specified domestic transactions would cover all inter-unit transfers of goods and services[15]; or all transactions between such a taxpayer with another person having a close connection with the taxpayer.
Similarly, there are transactions which get typically covered within the gamut of specified domestic transactions, but are generally not encountered in cross-border dealings with associated enterprises. Examples of these kinds of transactions include managerial remuneration, rental charges for use of immovable property etc.

Availability of Advance Pricing Agreements
Advance Pricing Agreements (APAs) have been introduced in the Indian transfer pricing regulations by the Finance Act, 2012, to reduce uncertainty and litigation with the revenue authorities.
Section 92CC, which deals with the concept of APAs, reads as under:[16]

> *"The Board, with the approval of the Central Government, may enter into an advance pricing agreement with any person, determining the arm's length price or specifying the manner in which arm's length price is to be determined* ***in relation to an international transaction*** *to be entered into by that person."* (Emphasis supplied)

Accordingly, it is evident that the option of applying for APAs is available only in respect of international transactions, and not in respect of specified domestic transactions—the tax positions which could continue being uncertain.

Section 92C, which deals with computation of arm's length price specifies the use of five methods, and such other method as may be prescribed.

Similarities between pre and post-amendment scenarios

A perusal of some of the relevant judicial precedents would suggest that the principles involved in a transfer pricing analysis have also been considered valid in the pre-amendment scenario. Further, some concepts under the pre-amendment laws would yet continue being applicable even when transfer pricing regulations are made applicable to specified domestic transactions. These include:

Coverage of Relationships and Transactions
As noted above, the coverage of transfer pricing regulations in terms of relationships and transactions covered will continue to be governed as per the respective existing Sections, and would not be replaced by the relationships or transactions as per Chapter X of the Act.

Comparability considerations
On various occasions, the Court had to delve into comparability considerations, to gauge whether the so-called comparable presented before it were indeed comparables, for determining the fair market value of the transactions under consideration. Some relevant principles are summarised hereunder:

FUNCTIONAL COMPARABILITY
The arm's length principle emphasises functional comparability for determination of appropriate comparables. However, even without a mention of the arm's length principle, the considerations of comparability have been upheld by Indian Courts in various decisions.

[13] A seemingly all-pervasive definition of international transactions as existing in Section 92B (1) has been further expanded by the Finance Act, 2012, by way of an explanation with retrospective effect from 1.4.2002.
[14] For instance, refer *CIT vs. A.K. Subbaraya Chetty & Sons [1980] 123 ITR 592 (Mad); CIT vs. Udhoji Shrikrishnadas [1983] 139 ITR 827 (MP); Durga Rice & Gen Mills vs. AO [ITA No. 360/Chd/2012]*.
[15] A plain reading of the provisions suggests that other inter-unit transfers, for instance, transfer of assets would not be covered within the ambit of specified domestic transactions.
[16] Refer Section 92CC(1)

In the case of *Lab India Instruments*[17], it was held that commission paid @ 20% to sister concern cannot be compared with commission @ 10% paid to third parties, since the functions performed by such sister concern and the third parties were different and not comparable.[18]

Similarly, in the case of *Hive Communication*[19], in the context of Directors' remuneration, it was held that remuneration paid to two directors performing different functions (especially in the context of the industry in which the taxpayer operates), cannot be compared for the purposes of disallowance under Section 40A(2).

EXTENT OF COMPARABILITY

In the case of *Deep-raj Minerals*[20], it was held that transactions purported to be used for determining fair market value for Section 40A (2) purposes need to be comparable to the transactions under consideration, and not necessarily be identical.

Even under the arm's length principle, it is accepted that finding exact comparables could be challenging (especially finding external comparables for the CUP Method). Accordingly, the relevance of other methods which do not require such strict comparability requirements as CUP Method has been emphasised.

COMPARABILITY CONSIDERATION FOR INTEREST ON LOANS

In the case of *Shiv Agrevo*[21], it was held that interest on short term and long term funds can be different and cannot be compared for disallowing expense under Section 40A (2).

Even under the arm's length principle, although sometimes in a different context, it has been held that interest on loans with different characteristics cannot be compared.[22]

GEOGRAPHICAL DIFFERENCES

In the case of *West Coast Paper Mills*[23], the taxpayer had a paper unit and few power units in the state of Karnataka, from which power was supplied to the paper unit. It also had windmills in the state of Tamil Nadu, from which power was supplied to the Tamil Nadu State Electricity Board (TNSEB). For determining the fair value of supply of electricity to the paper unit for Section 80IA (8), the Mumbai Tribunal observed that the cost of production of power was different in the states of Karnataka and Tamil Nadu. Accordingly, it rejected that rate at which the taxpayer sold power to TNSEB, and adopted the rate paid by the taxpayer to Karnataka State Electricity Board for power purchased. It was further held that an adjustment needed to be made to exclude extraneous charges such as electricity duty etc., which were not connected with the taxpayer's business.

Use of appropriate allocation keys for cost allocation

In various cases involving tax holiday units, an appropriate cost allocation for shared resources becomes important, to determine the exact amount of profits available for the tax holiday. Courts have had the occasion to pass judgement on the question of appropriateness of the allocation key used.

In the case of *EHPT India Pvt. Ltd.*[24], the Delhi High Court held that headcount was an acceptable allocation key in the facts and circumstances of the case. In another case of *Controls & Switchgear Co. Ltd.*[25], turnover was held to be an appropriate

The Indian transfer pricing regulations clearly stipulate that corresponding adjustments would not be permitted in the context of 'international transactions'.

[17] *Supra*
[18] Also refer *CIT vs. Computer Graphics Ltd. [2006] 155 TAXMAN 612 (MAD)*
[19] *Hive Communication (P.) Ltd. vs. CIT [2011] 201 TAXMAN 99 (DELHI)*
[20] *Deep-raj Minerals vs. ACIT [2009] 31 SOT 144 (MUM)*
[21] *ACIT vs. Shiv Agrevo Ltd. [2009] 34 SOT 1 (Jp.) (uro)*
[22] For instance, refer *ITO vs. Maharishi Solar Technology Pvt. Ltd. [ITA No. 4561/Del/2009]*, wherein, size, and terms and conditions of the loan were held to be important comparability considerations. Similarly, in *Aithent Technologies Pvt. Ltd. vs. ITO [2012] 134 ITD 521 (DELHI)*, the Delhi Income Tax Appellate Tribunal (Tribunal) observed several comparability considerations for loans, including period of loan amount, currency, interest rate basis etc.
[23] *West Coast Paper Mills Ltd. vs. ACIT [2006] 103 ITD 19 (MUM)*
[24] *CIT vs. EHPT India (P.) Ltd. [2012] 204 TAXMAN 639 (DELHI)*
[25] Controls & Switchgear Co. Ltd. vs. DCIT [2012] 204 TAXMAN 53 (DELHI) (MAG)

Any mispricing in the case of international transaction has the potential to cause revenue loss for the Government. However, specified domestic transactions need not always result in a revenue loss to the Government.

allocation key for allocation of indirect expenses. It would not be out of place to mention that, although in a different context[26], even under the transfer pricing regime, turnover and headcount have been held to be acceptable allocation keys.[27]

Differences between pre and post-amendment scenarios

There are several important differences between the way payments to domestic related parties was examined until now and how such payments would be looked at going forward. The key areas of differences are highlighted below.

Concept

Under the pre-amendment scenario, the valuation of all payments to related parties was required to be justified using 'fair market value'. Similarly, in respect of tax holiday units, inter-unit transfers of goods or services were required to be carried out at 'market value'. Intra-group transactions by taxpayers having tax holiday units were required not to result in 'more than the ordinary profits' for the taxpayer. However, these terms have not been defined under the Act. Divergent interpretations of these terms by taxpayers as well as revenue and judicial authorities have resulted in significant litigation.

After the amendments, the concept used for justification of the fair valuation would be that of arm's length price. Arm's length price has been defined[28] as:

> *"A price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions."*

The arm's length price is required to be computed using any of the six[29] specified methods, which is the most appropriate method under the facts of the case.

The concept of ALP is more structured as compared to fair market value, and provides some degree of certainty and guidance regarding the computation of the fair valuation of the transaction at hand.

Ad-hoc adjustments

Fair market value being a flexible concept, often resulted in arbitrariness and ad-hoc adjustments without any reasonable basis.

The case of Hinduja Group[30] is a case in point. In this case, the revenue authorities had provided an ad-hoc adjustment to the taxpayer in relation to rent paid by it to its related party, and reduced the amount of disallowance which could have been made otherwise. In a subsequent year, the Mumbai Tribunal, deciding in favour of the taxpayer, insisted that such ad-hoc adjustment should be continued to be provided to the taxpayer, and deleted the disallowance made by the revenue authorities.

There have also been several cases wherein, the Revenue Authorities have disallowed expenses on an ad-hoc basis, and such disallowances have been deleted by the Judicial Authorities[31].

The room for making ad-hoc adjustments appears to be restricted now, given the application of arm's length principle to specified domestic transactions.

Burden of proof

Section 40A (2) reads:

> *"...and the **Assessing Officer is of opinion** that such expenditure is excessive or unreasonable..."* (Emphasis supplied)

Accordingly, it would appear that until now, the burden of proof was placed on the Revenue Authorities for cases involving payments to related parties.[32]

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[26] Cost contribution allocation for centrally provided services

[27] See *Dresser-Rand India (P.) Ltd. vs. Addl. CIT [2011] 47 SOT 423 (MUM)*

[28] Section 92F(ii)

[29] Refer Section 92C read with Rule 10B and 10AB for details of prescribed methods.

[30] *DCIT vs. Hinduja Group India Ltd. [2008] 22 SOT 237 (MUM)*

[31] For instance, refer *Emersons Process Management India (P.) Ltd. vs. Addl CIT [2011] 47 SOT 157 (MUM) (URO); Gujarat Guardian Ltd. JCIT [2008] 174 TAXMAN 151 (CHD)(MAG)*

[32] Decisions of various Courts have also upheld this view. For instance, refer *DCIT vs. Choice Sanitaryware Industries [2011] 9 taxmann.com 120 (RAJKOT); Mittal Metal vs. ITO [2008] 21 SOT 186 (DELHI) (SMC); Marghabhai Kishabhai Patel & Co. vs. CIT [1977] 108 ITR 54 (GUJ.); DCIT vs. Lab India Instruments (P.) Ltd. (supra)*. However, in *CIT vs. Shatrunjay Diamonds [2003] 128 TAXMAN 759 (Bom)*, the burden of proof in cases involving Section 40A(2) was held to be shifted to the taxpayer.

However, after the amendment made by the Finance Act, 2012, the documentation and compliance requirements for specified domestic transactions are in line with international transactions. Accordingly, the burden of proof is placed on the taxpayer for determining the fair transfer price of specified domestic transactions.

Based on the above, it can be said that the obligation is now cast on the taxpayer, to ensure that specified domestic transactions are compliant with the arm's length standards, rather than mere basic reporting requirements prior to the amendment.

Managerial Remuneration

In several cases, payment of a certain amount of managerial remuneration, or increase in managerial remuneration as compared to the last year(s) has been justified considering the increase in sales and profitability of the taxpayer.[33]

However, under the arm's length principle, the amount of remuneration would also need to be justified based on an appropriate comparable benchmark, rather than only qualitatively justifying the validity of payment or increase in the amount of the remuneration.

Interest paid to related parties – nexus with loans given

The approach to determine the fair market value of interest paid on loans taken from related parties in several cases has been that high interest paid to related parties cannot be disallowed if the nexus of such related party loan with a low interest-bearing loan given by the taxpayer cannot be proved.[34]

Under the arm's length principle, the stress is on the comparability of comparable interest rates, rather than on the nexus between loans taken and loans given by the taxpayer.[35]

Use of related party/AE as comparables

There have been divergent Court Rulings in the context of whether payments to other related parties/group companies can be used as valid indicators of the fair market value of the goods/services in consideration.

For instance, in the case of *Diebold Systems*[36], payment to one related party was held as an indicator of fair market value, and used by the Revenue Authorities to make adjustments to the purchase price paid for the same products to other related party. This was also subsequently upheld by the Chennai Tribunal.

Conversely, in the case of *Van Oord Dredging*[37], payments made to one related party were held not to be an indicator of fair market value for making adjustments in prices paid to another related party.

Henceforth, in respect of specified domestic transactions, the stress would be on obtaining third party comparable data, either internal or external; and use of related party data for benchmarking arm's length nature of any payment would not be allowed.[38]

Applicability to tax holiday units/taxpayers

In relation to taxpayers enjoying profit-linked tax holidays, the concept of fair value has been applied to ensure that such taxpayers are not over-stating incomes or under-stating expenses, and thereby, claiming higher profit-linked tax deductions.

In cases where such tax holiday entities have been subjected to transfer pricing provisions, it has been held unanimously in various cases, that arm's length price determined by the Revenue Authorities as per the transfer pricing regulations cannot be considered as the fair market value for disallowing the profit-linked deduction.[39]

The kind of relationships covered by transfer pricing for international transactions, and that for specified domestic transactions are different.

[33] For instance, refer *Jagdamba Rollers Flour Mill Ltd. vs. ACIT [2009] 117 ITD 260 (NAG) (TM); Abbas Wazir (P.) Ltd vs. CIT [2003] 133 TAXMAN 702 (AL.)*.

[34] For instance, refer *Deputy Commissioner Vs. Shripal S. Morakhia [2006] 7 SOT 609 (MUM)*.

[35] Refer, for instance, *VVF Ltd. vs. DCIT [ITA No. 673/Mum/06]; Aithent Technologies Pvt. Ltd. vs. ITO (supra)*

[36] *Diebold Systems (P.) Ltd. vs. ACIT [2006] 8 SOT 585 (CHENNAI)*

[37] *Van Oord Dredging & Marine Contractors BV vs. DDIT [2007] 105 ITD 97 (MUM)*.

[38] In a slight departure from this position, the Mumbai Tribunal, in *Bayer Material Science (P.) Ltd. vs. Addl. CIT [2012] 134 ITD 582 (MUM)* has held that in cases where the type of transaction at hand normally occurs only between associated enterprises, a controlled transaction can also be used as a valid comparable for determining arm's length price, provided that such controlled transaction is at arm's length.

[39] Refer, for instance, *M/s Tweezerman (India) Private Limited vs. Addl. CIT [2010] 4 ITR(TRIB.) 130 (CHENNAI); M/s. Visual Graphics Computing Services (India) Pvt. Ltd. vs. ACIT [2012] 15 ITR(TRIB.) 393 (CHENNAI); Weston Knowledge Systems & Solutions (India) Pvt. Ltd. vs. ITO [2012] 23 taxmann.com 215 (Hyderabad – Trib.)*

However, the concept and definition of arm's length price have now been specifically imposed on the existing concept of fair market value in cases of such taxpayers. Accordingly, the above-mentioned Court Rulings will now be inapplicable in this context.

Way forward for taxpayers

Application of transfer pricing regulations to specified domestic transactions will certainly add to the compliance requirements of Indian taxpayers. This would significantly impact domestic business houses which have several group entities and multiple inter-company transactions.

However, rather than application of transfer pricing to specified domestic transactions, what really appears to have added to the compliance burden of taxpayers, is the shifting of onus of proof from the revenue authorities to the taxpayer.

While the deadline for reporting requirements for specified domestic transactions for Financial Year 2012-13 would be 30th November 2013, documentation for such transactions is required to be contemporaneous, and therefore, the documentation requirements have already triggered.

The approach of the taxpayers will now need to be proactive, and not reactive. Rather than waiting for the closure of accounts, it would be prudent on the part of taxpayers to review their transactional structures and pricing policies at the earliest, and amend such structures and policies to the extent required, in order to be compliant with the arm's length standards. A timely review would provide taxpayers with sufficient time to take corrective actions, if necessary, as well as guide them on the contemporaneous documentation requirements. ■

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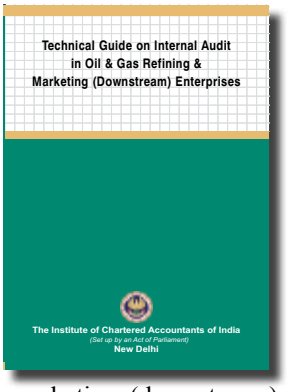

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