Domestic Transfer Pricing Overview

Transfer pricing over past several years has been limited to international transactions. With the huge success of Tax Authorities imposing scrupulous tax burden on the tax payers, Finance Minister in the Finance Act, 2012 added a pinch of salt to the wound by extending the provisions of transfer pricing even to the domestic transactions between the related parties.

LEGISLATION PRIOR TO FINANCE ACT, 2012

Section 40A of the Income-tax Act, 1961 ('Act') empowers the Assessing Officer to disallow unreasonable expenditure incurred between related parties. Related parties have been specifically defined under clause (b) of section 40A(2) of the Act. A chart has been annexed herewith showing a diagrammatic representation of the related parties.

The existing provisions of clause (a) of sub-section (2) of 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**.

Further, under the provisions of section **80-IA** of the Act, the Assessing Officer is empowered to re-compute on a reasonable basis the profits and gains of the undertaking having regard to the market value of the goods or services transferred. The said provisions are made applicable even to the **SEZ units**.

As can be seen from the aforesaid provisions, there is no method or procedure prescribed for determining the market value to benchmark the expenditure incurred by an entity. On the other hand, transfer pricing provisions under section 92 of the Act provide a mechanism to deal with taxability of transactions of an entity in India with its overseas kin. These provisions lay down several methods for determining arm's length price which acts as a benchmark for the transactions of an entity with its associates and any excessive/ unreasonable expenditure is checked with regard to such benchmarks.

SUPEREME COURT DECISION IN THE CASE OF GLAXO SMITHKLINE

In the case of **CIT Vs. Glaxo SmithKline Asia (P) Ltd. (195 Taxman 35) (SC)**, Hon'ble Supreme Court observed that the Assessing Officer is constrained by non-maintenance of the relevant documents or getting specific transfer pricing audit in respect of domestic transactions between the related parties and that there is no guidance/methodology available for computing the market value. The Apex Court

suggested that transfer pricing provisions should be applicable even to domestic transactions in order to mitigate litigation.

FINANCE ACT, 2012

Based on the recommendations of Supreme Court in the aforesaid case, Finance Minister introduced transfer pricing regulations applicable to specified domestic transactions in Finance Act, 2012.

Transactions covered under the ambit of domestic transfer pricing (section 92BA):

- Any expenditure in respect of which payment is made or is to be made to a person referred to in Section 40A(2)(b) of the IT Act (transactions with related parties);
- Any transaction that is referred to in Section 80A (general section for deductions);
- Any transfer of goods or services referred to in Section 80-IA(8) (i.e. applicable to companies operating as industrial undertaking or enterprises engaged in infrastructure development);
- Any business transacted between the assessee and other person as referred to in section 80-IA(10) (i.e. transactions of an unit eligible for benefits under section 80-IA with any other entity where there is a close connection between the two entities);
- Any transaction, referred to in any other section under Chapter VI-A or section 10AA (i.e. SEZ units), to which provisions of sub-section (8) or sub-section (10) of section 80-IA are applicable;
- Any other transaction, as may be prescribed by the board.

Monetary limit

The transfer pricing regulations shall be applicable to the aforesaid specified domestic transactions only if the aggregate value of all the specified domestic transactions exceeds Rs 5 crores *(section 92BA)*.

SPECIFIED DOMESTIC TRANSACTIONS

Section 40A(2)

As discussed above, section 40A(2) provides for disallowance of any unreasonable or excessive expenditure incurred in relation to payment made to any related party having regard to the fair market value of the goods, services or facilities for which the payment is made.

With effect from AY 2013-14, the fair market value shall be arm's length price as computed in accordance with provisions of section 92C and section 92F. The concept of arm's length price is discussed in the ensuing paragraphs.

Section 80-IA

Section 80-IA provides for 100% deductions to the industrial undertakings engaged in infrastructure development, telecommunication services, industrial parks, power generation.

As per sub-section (8), where any goods or services are transferred by an eligible unit to a non-eligible unit or vice versa at a price other than the market value of such goods or services, the Assessing Officer has the power to recompute the profits and gains of such business having regard to the market price of such goods and services. The market value prior to Finance Act, 2012 meant the price that such goods or services would ordinarily fetch in the open market.

With effect from AY 2013-14, the definition of market value has been amended to mean either the price that such goods or services would ordinarily fetch in the open market **or** the arm's length price as defined in the provisions of section 92F.

As per sub-section (10), where there is a close connection between the assessee's eligible business and other third party and the course of business between them is arranged in a manner which produces extra-ordinary profits to the assessee, the Assessing Officer has the power to recompute such profits and gains of the eligible business.

With effect from AY 2013-14, the arm's length price under section 92F would be required to be followed by the Assessing Officer while recomputing the profits and gains of the eligible business.

Other Specified Domestic Transactions

Sub-sections (8) and (10) of section 80-IA have been referred in the following deductions/ exemptions and therefore, the transfer pricing regulations are also made applicable to such sections:

- Section 10AA - Income from newly established units in SEZ
- Section 80IAB - Income of an undertaking or enterprise engaged in the development of SEZ
- Section 80IB - Income from certain industrial undertakings and housing projects

PROVISIONS APPLICABLE TO SPECIFIED DOMESTIC TRANSACTIONS

Section 92

Section 92 provides that any income arising from an international transaction shall be computed having regard to the arm's length price. With effect from AY 2013-14, the same is applicable even in relation to specified domestic transactions.

Section 92C : Methods of computation of arm's length price

Following methods as applicable to the international transfer pricing are now made applicable to specified domestic transactions for determining arm's length price:

a) Comparable uncontrolled price method (CUP Method):

- The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for the property or services transferred in comparable circumstances.
- Such price is adjusted to account for differences in the nature of functions, characteristics of property or contractual terms or geographical indices, etc.
- Such adjusted price is considered to be an arm's length price in respect of the property transferred or services provided.

b) Resale price method (RPM):

- RPM is a method based on the price at which a product that has been purchased from a related party is resold to an unrelated enterprise.
- The resale price is reduced by the resale price margin/ gross profit margin.
- This is further reduced by the expenses incurred in connection with the purchase of product or obtaining of services.
- The price so arrived at is adjusted to take into account the functional and other differences between the domestic transaction and the comparable uncontrolled transaction which could materially affect the amount of gross profit margin in the open market. This adjusted price is considered as the arm's length price.

c) Cost plus method (CPM):

- CPM uses the costs incurred by the supplier of the property (or services) in a controlled transaction.
- Direct and indirect costs of production incurred by the enterprise in respect of the property or service to a related party are determined.
- A gross profit mark up in the same or similar comparable uncontrolled transaction by the enterprise or an unrelated enterprise is added.
- The price so arrived at is then adjusted to take into account the functional and other differences between the domestic transaction and comparable uncontrolled transaction affecting the gross profit margin in the open market.
- Such adjusted price is considered to be an arm's length price in respect of the property transferred or services provided.

d) Profit split method (PSM):

- PSM first identifies the combined profit of the related parties arising from the domestic transaction in which they are engaged
- The relative contribution made by each related party is then evaluated on the basis of the functions performed, assets employed and risks assumed by each party.
- The combined profit is then split amongst the parties in proportion to their respective contributions

- The profit thus apportioned to the assessee is taken into account to arrive at arm's length price in relation to the domestic transaction.

e) Transaction net margin method (TNMM):

Under TNMM, arm's length price is determined by comparing the net profit margin computed on an appropriate base (eg: costs, sales, assets, etc) that the manufacturer or service provider earns from the controlled transaction with net profit margin computed on the same base from comparable uncontrolled transactions.

Section 92CA

The Assessing Officer may refer the computation of arm's length price to the Transfer Pricing Officer with respect to the specified domestic transactions. The order of the Transfer Pricing Officer is binding on the Assessing Officer.

Section 92D: Documentation

As per section 92D, every person who has entered into Specified Domestic Transaction shall keep and maintain such information and documents in respect thereof, as prescribed in Rule 10D. Documentation as prescribed under Rule 10D comprises of the following broad categories:

- ***Entity related:***

  - Profile of industry
  - Profile of group
  - Profile of the entity
  - Profile of the related parties

- ***Pricing related:***

  - Transaction terms
  - FAR analysis (functions performed, assets employed and risks assumed)
  - Economic analysis (method selection, comparable benchmarking)
  - Forecasts, budgets, estimates

- ***Transaction related:***

  - Agreements
  - Invoices
  - Pricing related correspondence (for example: letters, e-mails, etc)

Section 92E

As per section 92E, an assessee entering into international transactions has to obtain report from a Chartered Accountant in form No. 3CEB before the due date for filing the return of income. This requirement is now extended to specified domestic transactions from the AY 2013-14.

PENAL CONSEQUENCES IN CASE OF NON-COMPLIANCE

Nature of Penalty	Quantum of Penalty	Section
Failure to maintain set of documents	2% of value of transactions	271AAA
Failure to report any transaction in Accountant's report	2% of value of transactions	271AAA
Furnishing incorrect information	2% of value of transactions	271AAA
Failure to furnish Form 3CEB before due date	Rs 100,000	271BA
Failure to furnish documentation with the tax officer	2% of value of transactions	271G

ILLUSTRATIONS FOR APPLYING TRANSFER PRICING METHODS IN SPECIFIC SCENARIOS

Few illustrations of specified domestic transactions and the benchmarking method to be followed:

Nature of transaction	Method of benchmarking
Rent paid to a related party covered under section 40A(2)(b)	Internal comparables: Rent charged can be benchmarked with the rent earned by the related party from third party tenants External Comparables: Market rates per sq ft prevailing during the relevant period for similar properties in the same area.
Loans taken from related parties. Payment of interest covered under section 40A(2)(b)	Internal comparables: CUP method could be followed. Interest charged by the related party from other third parties on similar terms to be compared External Comparables: Prevailing rate of interest charged by the banks on loans given on similar terms could be used as a benchmark
Payment for integral (business) services	TNMM is the most appropriate method. Return on capital employed or return on operating costs could be used as the Profit Level Indicator. Functional comparability of the companies to be considered in conjunction with the risk and return profile of the companies being selected for determining arm's length price.
Purchase of goods by SEZ unit from non-SEZ unit (related party or close connection)	Internal comparables: CUP method could be used whereby price charged by non-SEZ unit with respect to the same goods from third parties on similar terms.

	External Comparables: CUP or TNMM could be followed using external databases. Where TNMM is opted, Operating profit margins could be used as the Profit Level Indicator

ISSUES

- Payment of managerial remuneration

  It is impractical to benchmark payment of remuneration to the directors/ other payments to directors. Salary of directors is determined by the management based on several factors viz qualifications, experience which are individual traits and varies from company to company. Certain judicial precedents have accepted the view that if the managerial remuneration is within the limits prescribed in the Companies Act, 1956, the same is a reasonable expenditure under section 40A(2)(b).

- Corresponding adjustments

  Where there is an adjustment with regard to any specified domestic transaction, the same will result in increase in the profits of the tax-payer and resultant increase in tax liability. However, in the absence of any provision allowing corresponding adjustment in the related party's income, it leads to double taxation.

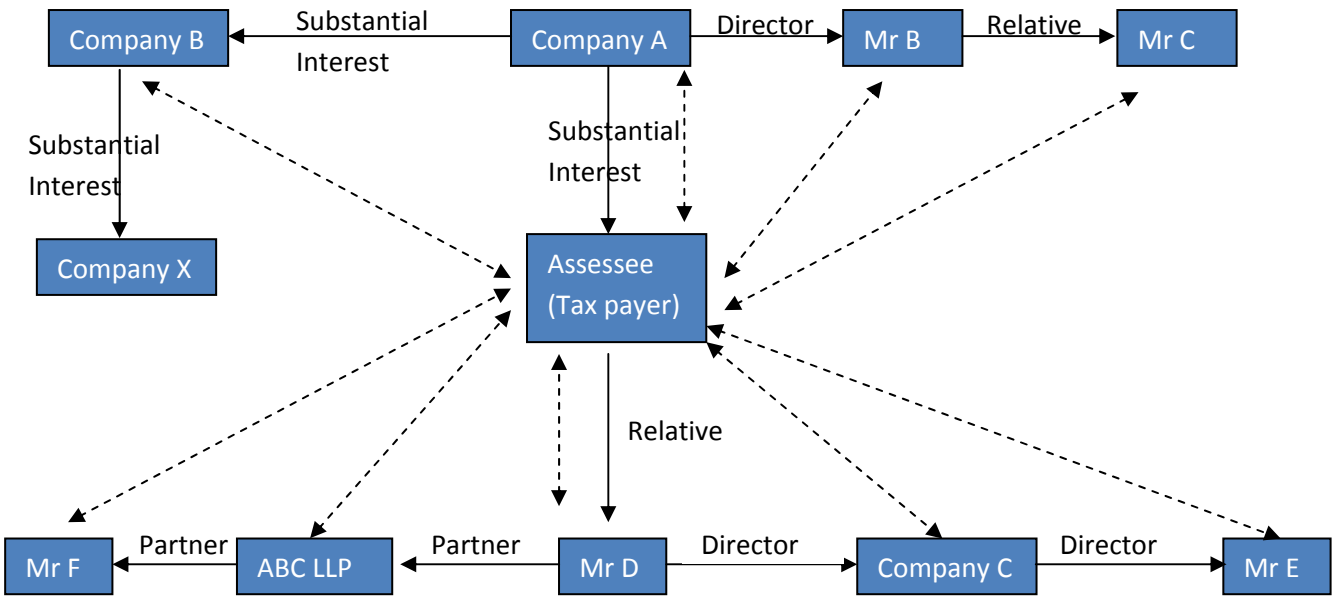
- Advance pricing agreements

  The concept of advance pricing agreement introduced by Finance Act, 2012 is not extended to specified domestic transactions.

- 'Close connection'

  Section 80-IA(10) provides for applicability of domestic transfer pricing provisions where there is a 'close connection' between the assessee's eligible business and other third party. However, the said term has not been defined in the provisions of the Act.

Annexure: Illustrative chart depicting Related parties under section 40A(2)(b)



Nature of relationship

Related party transactions u/s 40A(2)(b)

In the above chart, it is pertinent to note that indirect holding in Company X should not be covered within the definition of related party under section 40A(2)(b).

Please note that the above chart is only illustrative but covers significant portion of related party transactions stipulated under section 40A(2)(b).