Overview

Transfer pricing (referred to as TP) regulations introduced in India in 2001, previously covered only cross border related party transactions. The Indian Transfer Pricing Regulations (Indian TP Regulations) comprise of Sections 92 to 92F of the Income-tax Act, 1961 (Act) and Rules 10A to 10T of the Income Tax Rules, 1962 (Rules) which guide computation of the transfer price and suggest detailed documentation procedures.

The Finance Act, 2012 has extended its scope to cover certain domestic transactions with related parties within India, defined as ‘Specified Domestic Transactions’ (referred to as SDT) by insertion of section 92BA in the Act. The Indian TP Regulations are applicable to SDTs from 1st April 2012.

By extending TP provisions to SDT, pricing of these transactions will need to be determined with regard to arm’s length principles using methods prescribed under Indian TP regulations.

The ICAI has issued a ‘Guidance note on report under section 92E of the Act (Transfer Pricing)’ last revised in August 2013. The said Guidance note analyses the provisions of SDT of the Act. This article discusses the contents of the Guidance note and related issues.

Section 92BA of the Act provides the transactions which will be covered within the ambit of SDT if the aggregate value of such transactions exceeds a threshold of Rs 5 crore in aggregate during a financial year:

i. Any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A;

ii. Any transaction referred to in section 80A;

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

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

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; or

vi. Any other transaction as may be prescribed

Threshold Limit

✓ Threshold not applicable internally for each limb of the definition

All the transactions covered under the six limbs will be considered as SDT only if the aggregate value of all transactions exceeds threshold of Rs 5 crore. If the threshold limit is crossed, the taxpayer will be required to comply with TP requirements with reference to all the transactions regardless of the fact that the value of transactions under one of the limbs may be less than Rs. 5 Crores.

✓ Computation of threshold limit

The threshold limit is required to be examined by adopting values as reported by the assessee on the basis of entries in his books of account.

The method of accounting regularly followed by the assessee would determine the basis of computing the threshold. If the assessee is availing credit of indirect taxes, the threshold limit for SDT can be computed on net basis (i.e. without including indirect tax levies like service tax, VAT, etc.). However, if the assessee is not availing
credit of indirect taxes, the threshold limit can be computed on gross basis.

✓ Comparison with threshold limit required to be done on a year on year basis

The comparison with threshold is required to be done on a year on year basis. It is possible that SDT may not apply in a particular year since the aggregate value of all transactions does not exceed Rs 5 crore whereas it may apply in subsequent year on account of crossing the threshold limit.

✓ Expenditure in respect of payments made to persons referred to in section 40A(2)(b) of the Act

Section 40A(2)(a) of the Act states the following:

‘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 this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the 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 there from, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction.’

The following proviso has been inserted in sub-section (2)(a) of section 40A by the Finance Act, 2012, w.e.f. 1-4-2013:

‘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.’

✓ Transactions in the nature of ‘income’ not covered?

This provision includes only the expenditure side and would not have any impact in the hands of the recipients of such payments. The persons/ entities receiving such income will not be subject to SDT under this provision.

Therefore, only the persons/ entities incurring such expenditure would be subject to SDT and would be required to comply with the relevant transfer pricing provisions.

✓ Expenditure claimed as deduction under ‘income from other sources’ also covered

Section 58(2) of the Act states that provisions of section 40A of the Act are also applicable for computation of taxable income under ‘income from other sources’.

Section 58 (2) of the Act states the following:

The provisions of section 40A shall, so far as may be, apply in computing the income chargeable under the head ‘Income from other sources’ as they apply in computing the income chargeable under the head ‘Profits and gains of business or profession’.

Hence, the said provisions are applicable to expenditure claimed as deduction under the head ‘income from other sources’ on account of specific direction in section 58(2) of the Act.

✓ Only certain types of capital expenditure covered

The said provisions are applicable only to that capital expenditure which has been fully claimed as deduction under other provisions.

For example –

i. Deduction claimed under section 35(2AB) of the Act on expenditure on know-how;

ii. Deduction claimed under section 35 of the Act on expenditure on scientific research;

iii. Deduction claimed under section 35AD of the Act on expenditure on Specified business.
What is substantial interest?

The explanation to section 40A(2)(b) of the Act states that a person shall be deemed to have a substantial interest in a business or profession, if,—

(a) in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent of the voting power; and

(b) in any other case, such person is, at any time during the previous year, beneficially entitled to not less than twenty percent of the profits of such business or profession.

Based on the above, the threshold for substantial interest to qualify as ‘specified persons is twenty per cent or more. However, as per section 92A(2) of the Act, the term associated entities is clearly defined to include an enterprise holding directly or indirectly shares carrying not less than twenty six per cent of the voting power in the other enterprise.

Accordingly, if I Co1 purchases goods from I Co2 in which it has a 24% equity stake at any time during the previous year, such an expenditure transaction will qualify as a specified domestic transaction. I Co1 would be subject to SDT and would be required to comply with the relevant transfer pricing compliances.

Exclusion of international transaction from scope of SDT does not imply that all transactions with non-residents are not subject to SDT

The Guidance note does not specifically discuss this issue. There could be a SDT which may be cross border and either or both parties to the transaction could be a non-resident as the threshold trigger for SDT and international transfer pricing differs.

For example – I Co an Indian company may make payment to F Co, a foreign company, which holds 21% in I Co. I Co and F Co are not associated enterprises as threshold of 26% is not met. However, payment by I Co to F Co is covered under section 40A(2)(b) of the Act and would be subject to SDT provisions.

Indirect subsidiaries also to be considered?

The phrase ‘directly or indirectly’ is not used in Section 40A(2)(b) of the Act as mentioned in section 92A(2)(a) and (b), which defines the term ‘associated enterprise’ for the purposes of international transactions.

In this regard, reference should be made to the Central Board of Direct Taxes (CBDT) Circular number 6-P dated 6 July 1968 explaining the then newly inserted provisions in section 40A(2) of the Act. The circular sets out the categories of the persons and payments to which specified persons would be covered within the provisions of section 40A(2). It states that such persons would include inter alia —“(c) persons in whose business or profession the taxpayer has a substantial interest directly or indirectly”.

However, Explanation to Section 40A(2) of the Act deems a person to have substantial interest if such person is ‘beneficial owner’ of shares carrying not less than twenty per cent of voting power.

The term ‘beneficial ownership’ is not defined in the Act. It is to be construed in contrast to ‘legal owner’ and not in context of determining indirect ownership of shares. Therefore, the emphasis is on covering the real owner of the shares and not the nominal owner. This proposition is also supported by legal jurisprudence which states that in a multi-tier structure, a parent cannot be regarded as the beneficial owner of shares in a downstream subsidiary merely because it owns the shares of the intermediate subsidiary companies. It is important to respect the fact that the entities are separate legal entities.
Transactions covered under Section 80A of the Act

The second limb of section 92BA of the Act covers all the transactions referred under section 80A of the Act. Though the reference is given for the transactions referred in section 80A of the Act, on examining it in detail, it covers only those transactions which are referred under Section 80A sub section (6) and not to other sub sections. The other sub sections do not deal with the fair pricing mechanism.

It is pertinent to note that section 40A(2)(b) covers only expenditure transactions. However, the provisions of section 80A(6) covers both income as well as expenditure transactions of the eligible unit.

The same is also supported by the corresponding amendment made in the Explanation of expression ‘market value’ of the said section in Finance Act, 2012, which states that in case of the specified domestic transactions, the market value shall be computed at Arm’s Length Price as defined under section 92F sub clause (ii) of the Act.

As per Section 80A(6) of the Act, any transfer of goods or services from an eligible undertaking or unit or enterprise to any other business of the assessee or vice versa should be done at market value as on the date of transfer.

Also, if the value of transaction does not cross the threshold limit of Rs 5 crore, the same will still be governed by unamended provisions of Section 80A(6) of the Act and fair market value will be determined on general principles.

Transfers referred to in section 80-IA(8) of the Act

The third limb of section 92BA covers all such transfers of goods or services as referred under Section 80-IA(8) of the Act.

This section provides that any transfer of goods or services from one eligible unit to another unit or vice versa of the same assessee, shall be done at market value.

The Finance Act, 2012, amended the explanation to section 80-IA(8) defining ‘market value’. Market value shall be computed at arm’s length price as defined under section 92F sub clause (ii) of the Act for all the transactions fall under the purview of SDT.

Transactions between two eligible units covered

The Guidance Note is silent on this issue. The transactions between both the profit linked holiday qualifying units are covered under section 80A(6) and/or section 80-IA (8) of the Act and will fall within the ambit of SDT. The AO is allowed to make TP adjustments to determine the quantum of deduction available in respect of profits of each of the qualifying units. The conservative view is to voluntarily benchmark the transaction at arm’s length price and report such transactions.

Transfers referred to in section 80-IA(10) of the Act

The forth limb of Section 92BA covers all the transactions between the assessee carrying on eligible business under the said section and any other person owing to ‘close connection’.

The term ‘close connection’ is not defined under the Act.
Arm’s Length Price

Section 92C(1) of the Act stipulates that the arm’s length price is to be determined by adopting any one of the following methods, being the most appropriate method:

- Comparable Uncontrolled Price method (CUP method)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)

Other Method (OM) as prescribed by the Board and provided in Rule 10AB and 10B

Selection of most suitable method

Rule 10C(1) states that the method to be selected shall be the one that suits the best as per the facts and circumstances of each transaction and that provides the most reliable measure of the arm’s length price. Rule 10C(2) lists the specific factors that should be taken into account in the process of selecting the most appropriate method.

Maintenance of information and documents

Rule 10D(1) lays down thirteen different types of information and documents that a person has to keep and maintain.

This information is broadly classified into three types:

a) Enterprise-wise documents
b) Transaction-specific documents
c) Computation related documents

Report under Section 92E

Every person who has entered into international or specified domestic transaction during a previous year shall obtain a report in Form 3CEB and furnish such report on or before 30th November of the relevant year. The form is required to be duly signed and verified in the prescribed manner by the accountant and setting forth such particulars as may be prescribed.

Penalties for non-compliances of Domestic Transfer Pricing provisions

<table>
<thead>
<tr>
<th>Section</th>
<th>Trigger</th>
<th>Quantum of penalty</th>
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</thead>
<tbody>
<tr>
<td>271(1)c</td>
<td>In case of an adjustment post assessment, if regarded as concealment of income</td>
<td>100-300% of the tax leviable on the amount of adjustments</td>
</tr>
<tr>
<td>271AA</td>
<td>Failure to maintain TP documentation, failure to report the transaction, maintenance or furnishing of incorrect information/document</td>
<td>2% of the value of the transactions</td>
</tr>
<tr>
<td>271BA</td>
<td>Failure to furnish Form 3CEB</td>
<td>INR 100,000</td>
</tr>
<tr>
<td>271G</td>
<td>Failure to furnish TP documentation with the tax officer</td>
<td>2% of the value of the transactions</td>
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</tbody>
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Conclusion

SDT will not be limited to large groups. Many mid-sized groups, partnership firms, HUFs and even individuals in smaller cities will now have to adhere to the TP laws. Certain expenses, transfer of goods and services between related parties, extraordinary profits and profits earned by SEZs / tax holiday units will now be liable for scrutiny by TPO’s. This will lead to an increase in the administrative and compliance burden for the taxpayer in respect of such transactions. While the Advance Pricing Agreement (APA) regime has been introduced with respect to international transactions, the same benefit has not been extended for domestic transactions.

I thank the Chamber for giving me the opportunity to draw the attention of the members to some finer points related to SDT. My thanks are also due to CA Ms. Akshata Kapadia and CA Kushal Shah for helping me in the research required to be done for this article.