

DIRECT TAX REFRESHER COURSE (DTRC 2016)

TRANSFER PRICING & APPLICABILITY TO DOMESTIC TRANSACTIONS

C.A. T. P. Ostwal
T. P. Ostwal & Associates

Transfer Pricing

What is Transfer Pricing?

It is the **price** at which goods and/ or services are sold between controlled (or related) legal entities.

For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the **transfer price**.

Why are Transfer Pricing regulations required?

To make sure that the Transfer Price is at Arm's Length i.e. as if such transaction took place between unrelated entities.

If there were no regulations, entities could shift profits to their lower or no tax related entities and reduce their tax liabilities significantly.

Evolution of TP Provisions

- ❑ Indian TP provisions were introduced under **“Chapter X : Special Provisions Relating to Avoidance of Tax”**
 - **Chapter X, Section 92** of the Income Tax Act (1961) and **Rule 10A-E** of the Income Tax Rules (1962)
 - TP regime introduced via Finance Bill 2001 w.e.f April 1st 2001.
 - Covered only International Transactions
 - In other words, India is a relatively new entrant to the TP vortex!

- ❑ Domestic transactions were covered by Section 40A(2).
- ❑ Expenditure or payments to certain related parties considered to be “unreasonable” or “excessive” having regard to fair market value of such goods or services could be disallowed.

Evolution of TP Provisions

- ❑ In 2010, while hearing the case of Glaxo SmithKline v/s CIT, the SC stated the need to extend existing TP provisions to domestic transactions.
- ❑ Finance Act, 2012 amended the Income Tax Act to extended TP provisions to Specified Domestic Transactions (SDTs).
- ❑ The following transactions were covered:
 - Expenditure under section 40A(2)
 - Transfer of goods and services between the tax holiday undertaking and other undertakings of the taxpayer
 - Business transacted between the tax holiday undertaking and other 'closely connected entities'
 - Any other notified transaction

Provided that aggregate value of such SDTs exceed Rs. 20 crore [Rs. 5 crore upto A.Y. 2015-16]

Domestic Transfer Pricing Provisions – Intent of the Law

Bringing in objectivity in the interpretation and governance – introduction of ALP mechanism

Doing away with tax arbitrage abuse that stems from differential tax rate, tax holiday/ benefits availed by undertaking and presence of accumulated losses

Protecting the revenue of the Indian Government

Indian Domestic TP Provisions

Sections & Rules	
92	Computation of income having regards to ALP
92BA	Meaning of specified domestic transaction
92C	Computation of arm's length price (Rule 10B, 10C, 10CA)
92CA	Reference to Transfer Pricing Officer
92D	Documents and Information to be maintained (Rule 10D)
92E	Report from an Accountant (Rule 10E, Form 3CEB)
92F	Definitions of certain terms relevant to computation of ALP (Rule 10A)

Section 92 – When does ALP have to be calculated?

ALP shall have to be calculated for following transactions:

- ❑ When two or more Associated Enterprises mutually agree or arrange to allocate/ apportion/ or contribute to any cost/ expense in connection with a benefit/ service or facility provided or to be provided to any one or more of such enterprises
- ❑ Any allowance for an expenditure or interest or allocation of any cost or expense or **any income** in relation to the specified domestic transaction

The ALP shall be ignored if it reduces income chargeable to tax or increases the loss.

Sec 92BA – What is a Specified Domestic Transaction?

Any of the following transactions will be considered as an SDT:

- 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
- any transaction referred to in section 80A
- any transfer of goods or services referred to sub-section (8) of sec. 80-IA
- any business transacted between assessee and other person as referred to in sec. 80-IA(10)
- any transaction, referred to under Chapter VI-A or section 10AA, to which provisions of section 80-IA(8) or 80-IA(10) are applicable
- any other transaction as may be prescribed

and the aggregate such transactions entered into by the assessee exceeds **Rs. 20 Crore** [Rs. 5 crore up to A.Y. 2015-16]

Specified Persons as per 40A(2)(b)

Assessee	Person is a related party if
Individual	<ul style="list-style-type: none"> • Relative of Individual • Assessee or his relative has substantial interest in the business or profession of such person.
Company	<ul style="list-style-type: none"> • Director or his Relative • A person in whose business or profession the Assessee or any director (or his relative) has substantial interest
Firm	<ul style="list-style-type: none"> • Partner or his Relative • A person in whose business or profession the Assessee or any partner (or his relative) has substantial interest
AOP or HUF	<ul style="list-style-type: none"> • Member or his Relative • A person in whose business or profession the Assessee or any members (or their relative) has substantial interest
Any Assessee	Individual (or his relative) who has substantial interest in assessee's business or profession
	<ul style="list-style-type: none"> ▪ Company/ Firm/ AOP/ HUF having substantial interest in business or profession of assessee ▪ Any director/ partner/ member of the above (or their relative) ▪ Any other company carrying on business or profession in which the first mentioned company has substantial interest.
	<ul style="list-style-type: none"> ▪ Company/ Firm/ AOP/ HUF whose director/ partner/ member has a substantial interest in the business or profession of the assessee. ▪ Any director, partner or member of such company, firm, AOP or HUF ▪ Relative of director, partner or member.

Substantial Interest

A person is said to be substantially interested if:

- In case of company, any person who is the beneficial owner of shares carrying not less than 20% of the voting power; and
- In other case, any person who is beneficially entitled to not less than 20% of profits of such business or profession.
- The term beneficial owner of shares is nowhere defined in the Act.
- No mention of the words “**direct or indirect holding of shares**”.

Section	Taxpayers Covered	Sunset Clause As per Finance Act, 2016
10AA	Persons with income from SEZ units	No deduction Post 1 st April, 2021.
80-IA	Infrastructure developers	No deduction post 1 st April, 2017.
80-IAB	Developers of SEZ	
80-IAC	Eligible Start-ups [Introduced by Finance Act, 2016]	Incorporated on or after the 1 st day of April, 2016 but before the 1 st day of April, 2019.
80-IB	<ul style="list-style-type: none"> ▪ Small Scale industry engaged in operating cold storage plant ▪ Industrial undertaking in backward state (VIII Schedule) ▪ Company carrying on Scientific Research & Development ▪ Eligible Hospitals ▪ Eligible Housing Projects 	
	<ul style="list-style-type: none"> ▪ Eligible undertakings engaged in commercial production of Mineral oil/natural gas 	No deduction post 1 st April, 2017 for certain undertakings.

Section	Taxpayers Covered	Sunset Clause As per Finance Act, 2016
80-IBA	Eligible Housing Projects [Introduced by Finance Act, 2016]	Project should be approved after 1 st day of June, 2016, but on or before the 31 st day of March, 2019.
80-IC	Undertakings/ Enterprises in special category States	
80-ID	Business of Hotels & Convention Centres in specified areas	
80-IE	Undertakings in North - Eastern States	No deduction post 1 st April, 2017 [Pre-existing]
80LA	Offshore Banking Units & International Financial Service Centres	

Type of transactions covered

- Managerial Remuneration (Sitting Fees / Remuneration / Commission)
- Purchase / Sale of products
- Purchase / Sale of assets (Controversy)
- Purchase / sale of services
- Shared services / facilities
- Charge of Royalty for use of trade mark / trade name / knowhow
- Inter – unit transfer of goods / services (For Tax Holiday eligible units)
- Purchase / Sale of shares (if business)
- Financing (Interest expense)
- Corporate Guarantee charges
- Management cross charges
- Allocation of Corporate Overheads
- ESOPs / other benefits to KMP
- Transfer of goods / services between tax holiday eligible units and closely connected persons.

80-A(6) – MARKET VALUE OF GOODS/ SERVICES TO BE USED

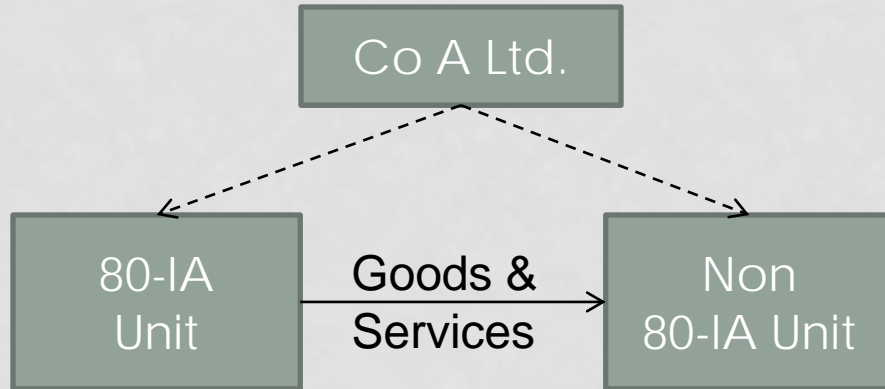
Section 80-A(6) provides for substitution of market value of goods and services in place of their recorded values, in case of internal transfer of goods and services between eligible units claiming deduction and other units of the assessee

In order to apply this provision, the conditions to be satisfied :

- There should be either of the following transfers :
 - Transfer of goods and services, from eligible unit to any other business carried on by the assessee
 - Transfer of goods and services, from other businesses of the assessee to the eligible unit

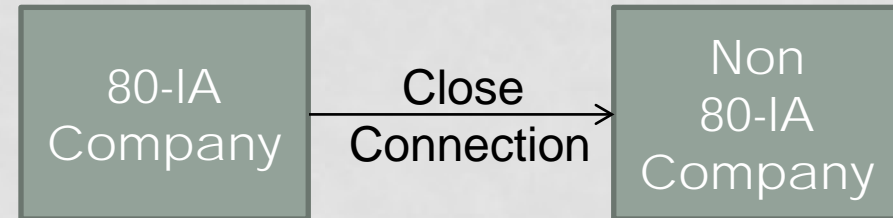
- The consideration for transfer does not correspond to market value of goods and services on the date of transfer

TRANSACTIONS U/S 80-IA(8) & 80-IA(10)



Section 80-IA(8)

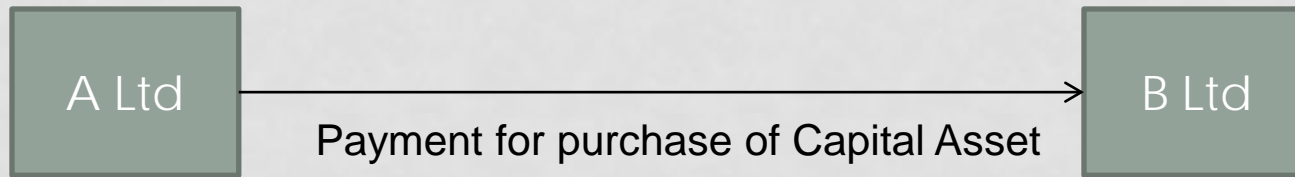
- Sale of Goods at Rs. 1200
- ALP is Rs. 1000
- Deduction u/s 80-IA will consider selling prices as Rs. 1000 since profit is being shifted to lower tax rate unit



Section 80-IA(10)

- Operating Margin 40% (Extraordinary Profits)
- ALP is 10%
- Deduction u/s 80-IA will be computed at 10% since more than ordinary profits are being generated owing to close connection

Case Study 1 – Revenue v/s Capital Expenditure



Will payment for purchasing a capital asset made to a related party covered u/s 40A(2)(b) be a SDT? (or any expenditure which is Capital Expenditure)

- Sec. 92BA(i) refers only to **expenditure** for which payment is made to a related party.
- There is no provision in Chapter X restricting or limiting applicability to only **Revenue** expenditure
- What is important is whether payment towards expenditure is made to person specified u/s 40A(2)(b)

Nature of expenditure IRRELEVANT

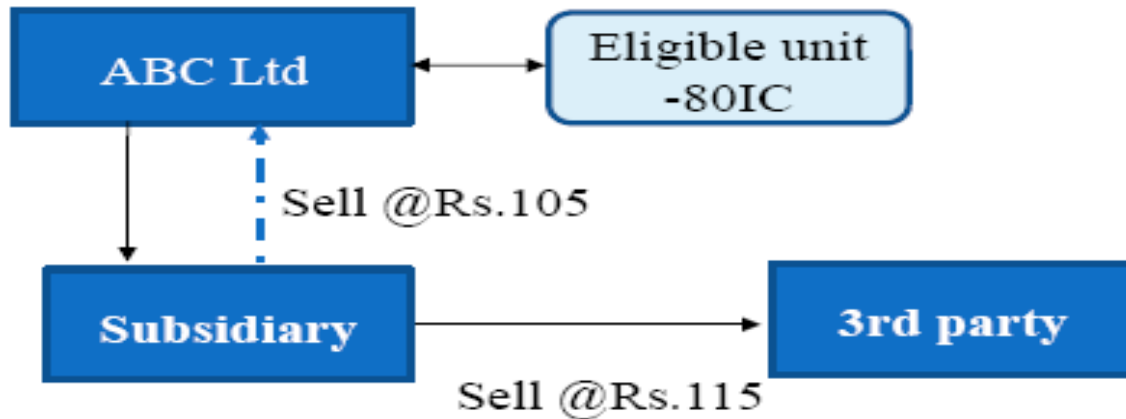
Case Study 2

- The assessee has 9 units & is engaged in manufacturing and trading of yarn, hosiery goods and knitted cloth;
- The assessee claimed deduction u/s 80-IC for 2 units
- Various admin expenses including Director's Remuneration debited in HO
- No expenses allocated to the tax-holiday units;
- No re-allocation of expenses was made in any of earlier years ;
- Separate books of accounts for each unit and for the Head Office

Issues

- Whether common costs have to allocated to eligible units?
- Whether provisions of 80-IA(8) & 80-IA(10) will be applicable?
- Whether allocation of common costs meets ALP principle?
- Only manufacturing business is eligible for deduction u/s 80IC. Within the same unit both Mfg. & Selling & Distribution activities are undertaken
 - Do the eligible & non-eligible activities have to be segregated
 - Does notional transfer of goods from the eligible to non-eligible business have to be assumed to determine profits of eligible business?

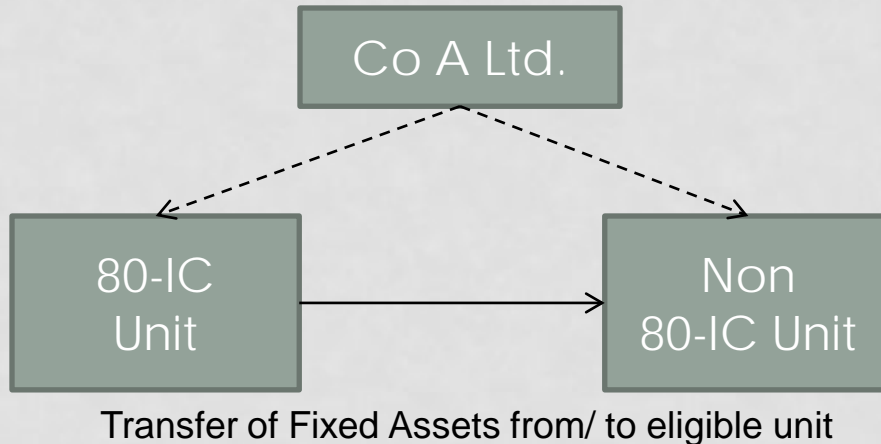
Case Study 3



Issue:

From point of view of deduction u/s 80IC, the price charged by the subsidiary is less than the market price and consequently, the profits of the 80IC unit is inflated by Rs. 10 (i.e. the difference between the supply price to third parties of Rs. 115 and the supply price to the assessee of Rs. 105)?

Case Study 4



- Does the transfer of Fixed Assets from/ to eligible unit fall within the definition of SDT?
- If yes, does Market Value of such transfer have to be established based on TP principles?
- What method will be applied to calculate ALP

Case Study 5



- A and B are related parties u/s 40A(2)(b)
- ALP Interest Rate is 10% p.a.

Issues

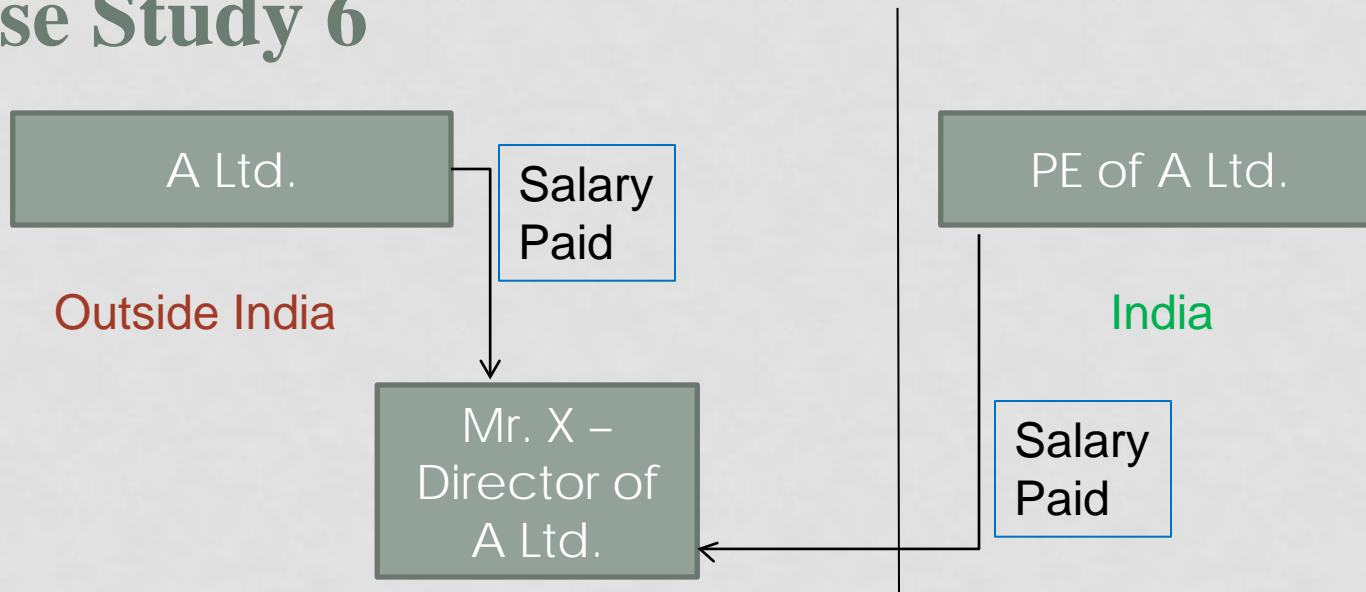
- Income transactions from related parties are not covered u/s 40A(2)(b) – therefore no impact on A
- Where interest is paid at 18% p.a., the same being an expense, is covered u/s 40A(2) – B, is liable to Domestic TP Provisions.
- When, no interest is paid by B provisions of s. 40A(2) r.w.s. 92BA are not applicable as no expenditure is incurred – Domestic TP will not apply.

Even if interest paid by B is deducted while computing income under the head “Income from Other Sources” and not with respect to Business Income, the provisions of s. 40A shall apply by virtue of section 58(2).

Domestic TP not restricted to transaction with residents

- SDT does not mean that transaction should not be cross border neither does it mean that both parties to the transaction need to be resident.
- SDT may be cross border and either or both parties to the transaction could be non-resident.
- Examples:
 - Remuneration paid by an Indian company to a non -resident director
 - Remuneration paid by a FC having PE to non resident director
 - Payment by Indian Co to Foreign Co. where Foreign Co. holds 20% to < 26% in Indian Co.

Case Study 6



Issue

Mr. X and PE of A Ltd. are not AEs, therefore no International transaction in terms of S. 92B r.w.s S. 92A.

But

- Mr. X and PE of A Ltd. are related parties as per s. 40A(2)(b)
- Therefore, payment of salary to Mr. X is an SDT and therefore ALP will have to be determined.
- Further ALP can be benchmarked based on their work, experience and qualification, limits specified under Companies Act, 2013. However there is no streamlined process for this.

SDT can be applicable to transactions with/ between non-residents

Other Issues

Applicability of SDT provisions in case of Loss making eligible units

- Eligible unit incurs losses, tax holiday claimed is “NIL”;
- Possibility of shifting profits is absent;

But, losses are c/f and set-off against future profits or set-off against profits of other eligible units, therefore Domestic TP provisions will apply.

Allocation of interest expenses

- Loan taken for setting up eligible unit and other unit, and interest costs allocated only to other unit;
- Notional interest on borrowed funds in case of inter-unit financing;
- Borrowings at entity level, disbursements to units out of both borrowed funds and own funds, whether interest cost is to be apportioned;

Disallowance if Payment exceeds ALP

- S. 40A(2) empowers AO to disallow excessive/unreasonable expenditure if such transactions are not at ALP as per section 92F(ii)
- Further even ALP compliant, it can still be disallowed if AO is of the opinion that it is not legitimate to the needs of Business or Profession.

REFERENCE TO TPO

– INSTRUCTION NO. 3/2016

Instruction No. 3/2003 was issued to guide TPOs/ AOs on TP provisions & to ensure procedural uniformity. Updated instructions were issued via Instruction No. 15/2015. However, queries & comments led to replacement by Instruction No. 3/2016.

The following are the important new instructions:

- Reference to TPO to determine ALP only where AO considers it necessary and expedient (circumstances have been laid out to ensure consistency).
- If TP risk is one of the reasons for which case is selected for scrutiny, then mandatorily reference to TPO has to be made.
- If a case is selected for scrutiny, but has no TP risk parameters, then it can be referred to TPO only in certain circumstances.
- Scrutiny Cases on other than TP risk parameters where reference has to be made:
 - Accountant's report u/s 92E not filed or International Transaction (IT)/ SDT or both are not disclosed in the Accountant's report.
 - TP adjustment of Rs. 10 crore or more in any past year has been upheld on appeal
 - Search & seizure has been carried out and AO/ Investigation Wing has recorded finding with regards TP issues in connection with SDT or IT.

REFERENCE TO TPO

– INSTRUCTION NO. 3/2016

- Additionally in a case where a TP adjustment for a previous year has been fully or partially set aside by ITAT/ HC or SC, the case “*shall invariably be referred to the TPO for determination of the ALP*”.
- In the following cases AO must, as a jurisdictional requirement, record his satisfaction that there is income/ potential income which is being affected by ALP determination of an IT or SDT and take approval of PCIT/ CIT
 - Accountant’s report u/s 92E not filed and AO discovers IT or SDT
 - IT or SDT has not been disclosed in Accountant’s report and AO discovers the same
 - IT or SDT have been declared in the Accountant's report but assessee has made qualifying remark that the same is not an IT or SDT or that they do not affect his income
- However, prior to recording such satisfaction, assessee must be given the opportunity to be heard and raise any objection.
- AO must then pass a speaking order considering such objections raised by the taxpayer and decide whether reference to TPO has to be made.

REFERENCE TO TPO

– INSTRUCTION NO. 3/2016

- Although AO has power to determine ALP by virtue of Section 92C but such power will not be exercised if the case is not referred to the TPO. Instead, the AO must record in the assessment order that TP issue has not been examined under instructions of the CBDT.
- TPO's role is limited to determining ALP in cases referred to him by AO.
- He is however, empowered to determine ALP for such ITs which comes to his notice during proceedings before him.
- However, TPO can only determine ALP for SDT referred to him by the AO and not if new SDT is discovered by him during proceedings.
- TPO's order must contain details of data used, reasons for arriving at a certain price and applicability of method used. Further, such order is subject to judicial scrutiny.
- AO has to use the ALP determined by the TPO.
- Any previous references made to TPO under old Instructions which do not conform with new Instructions may be withdrawn by the concerned PCIT/ CIT.

ALP METHODS

Six methods prescribed

Transactional Methods

- CUP
- Cost – Plus Method
- Resale Price Method

- Sixth “method” – Any other method (Rule 10AB) – Indian discovery

- **TNMM** and **Cost Plus** rule the roost in practice

- Income Tax Rules (Rule 10B, Rule 10AB, **Rule 10CA**) prescribe the machinery of these methods

- No hierarchy on methods in Indian TP

- Most Appropriate Method (MAM) to be applied

- MAM v/s Best Method

Profit Based Methods

- TNMM
- Profit Split Method

ALP METHODS

- ALP is calculated using the **range concept** or **arithmetic mean** of comparable prices as applicable
- Use of multiple year data (permitted as per Finance Act, 2014)
- **Prowess™, CapitalLine™ & AceTP** company databases are used for TP reports by all parties including Revenue Dept.
- **High volume of transfer pricing litigation today**; most TP litigations have not reached High Courts/Apex Court
 - **“Litigation loop”** – many cases remanded back to AO/TPO

RANGE CONCEPT & MULTIPLE YEAR DATA

- ❑ October 2015, CBDT published **Notification No. 83/2015** releasing the final rules for the use of Range and multiple year data.
- ❑ Amendment to existing Rule 10B pertaining to the determination of ALP based on selection of the Most Appropriate Method (MAM)
- ❑ The word ‘financial year’ has been replaced by the term ‘current year’ in order to avoid disputes arising from the use of the term ‘financial year’.
- ❑ The above amendment will be applicable for only those international transactions or SDTs, entered into on or after 1 April 2014.
- ❑ Where RPM or Cost Plus Method or TNMM is used as MAM, comparability will be conducted based on
 - data relating to the current year; or
 - if current year data is unavailable, data of immediate previous year
 - However, if current year data subsequently becomes available during assessment proceedings, the same shall be considered

ALP Range Concept

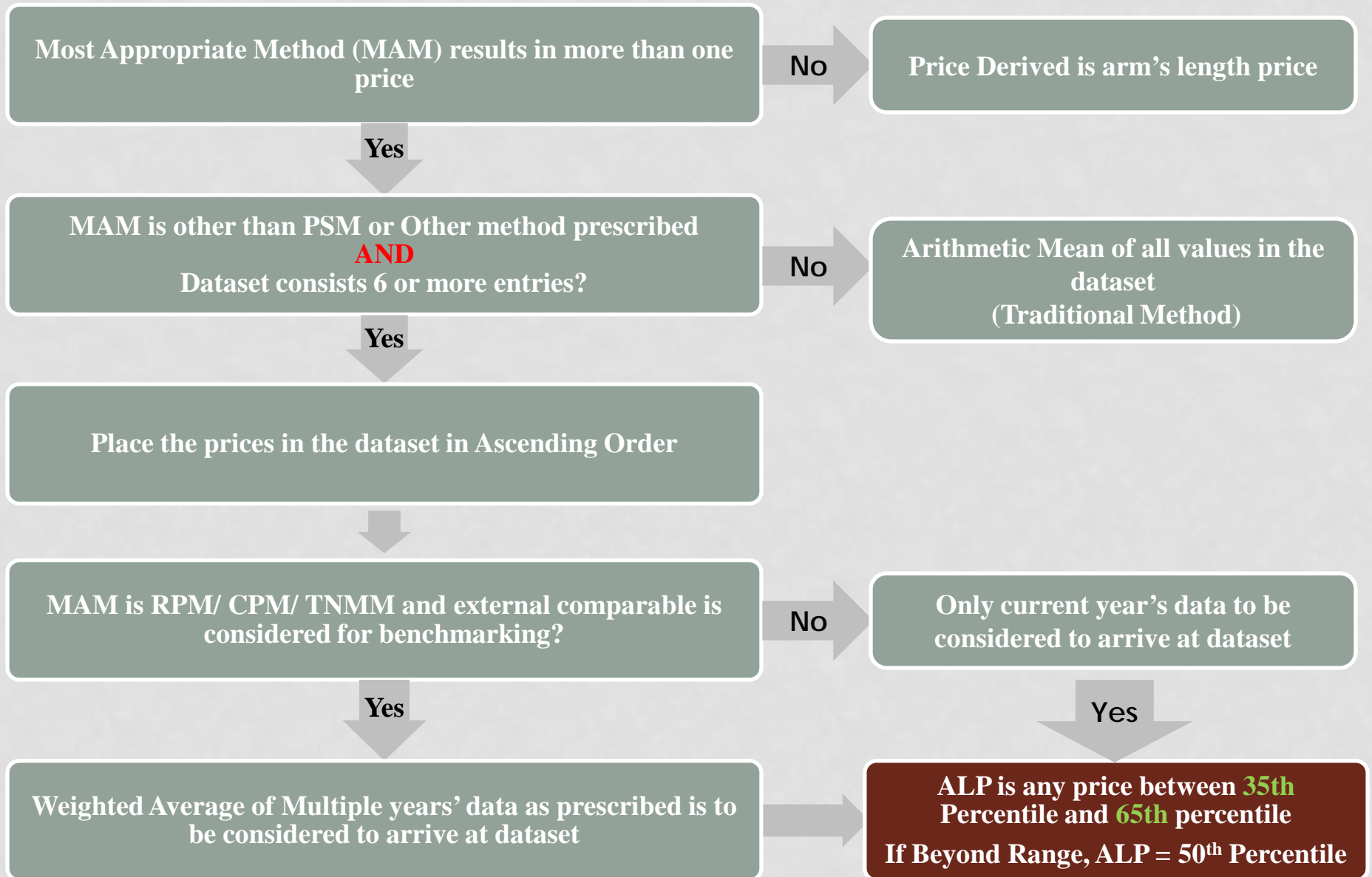
A minimum of six comparables would be required in the dataset for applying the concept of Range. Range from the 35th percentile to the 65th percentile of the ALP determined by the dataset will be considered.

The concept of range will not be applicable in cases where the MAM is Profit Split Method or 'Other Method'.

If the transfer price is within the 35th & 65th percentile of the dataset, the transaction shall be deemed to be at the ALP. If the transfer price falls outside the arm's length range the ALP of the transaction shall be taken to be the median of the dataset (i.e. the 50th percentile).

If the dataset consists of less than 6 comparables, or MAM is Profit Split Method or 'other method', ALP will be determined using arithmetic mean of all prices/data included in the dataset. Further, the benefit of 3% variation as available earlier, continues to be available.

RULE 10CA IN A NUSHELL



DOCUMENTATION UNDER INDIAN TP

- ❑ Maintenance of prescribed documentation to the extent contemporaneous (Section 92D r.w. Rule 10D)
- ❑ Obtaining and filing of Accountant's report (Form 3CEB) as prescribed under Section 92E read with Rule 10E is mandatory
- ❑ Stringent penal provisions in case of failure to maintain documentation

DOCUMENTATION - SECTION 92D R/W RULE 10D

ENTITY RELATED

- Profile of Group
- Profile of Indian entity
- Profile of AE's
- Profile of Industry

PRICE RELATED

- Terms of Transactions
- F.A.R analysis
(functions, assets & risks)
- Economic analysis
(comparable benchmarking, method selection)
- Forecasts, budgets, estimates

TRANSACTION RELATED

- Agreements
- Bills, Invoices
- Correspondence related to pricing
(emails, documents, letters etc.)

Particulars	Documents Required
Organizational Structure	Profile of Group Shareholder details Legal status, residential status, ownership links, country of tax residence of each of the enterprises
Nature of business & Market Conditions	Broad description of business of the taxpayer Industry overview Business of the AE
Controlled Transactions	Nature & terms of international transactions Details of services provided and/or property transferred Value and quantum of international transactions
Background Documents	Economic & Market analysis Budgets, estimates, forecasts and any financial data
Comparability – FAR analysis	Record of uncontrolled transactions Evaluation of comparability of transactions Description of functions performed, risks assumed and assets employed (F.A.R)

Particulars	Documents Required
Selection & Application of TP method	<ul style="list-style-type: none"> • Description of methods considered for determining ALP • Most Appropriate Method (MAM) selected along with reasons for selection • Actual working of ALP • Details of comparables and their PLI computation • Differences between comparable data & uncontrolled transactions • Method & mode of adjustments
Assumptions, strategies & Policies	Any assumptions or policies which have affected the determination of ALP
Supporting Information	<ul style="list-style-type: none"> • Publications, databases, annual reports, Governmental studies • Market research & technical publications • Correspondence of negotiation between AE's

Bottomline: Documentation requirements are onerous and burdensome for the Indian taxpayer

Indian TP v/s OECD Guidelines

Concepts	Indian regulations	OECD Guidelines
AE	Very wide definition	Restricted to controlled entities
Comparable range	Earlier (up to 31.3.14) used arithmetic mean of comparables & variation within $\pm 3\%$. Now (w.e.f. 01.04.14) ALP to be computed as per prescribed manner i.e. <i>range of comparable data subject to certain conditions</i>	Allows for range of comparable data
Multiple year data	Permitted (Finance Act, 2014)	Permitted
Foreign comparables	Not permitted in practice	Permitted
Priority of methods	“Most appropriate method” rule	Originally, a preference for “traditional” methods
Use of unspecified Method	A sixth method....allowing any other method as prescribed	Permitted
Documentation	Stringent	Prudent business principles
Intangibles	Definition added only in Finance Act 2012. Lack of guidelines/discussion on Intangibles	Definition, discussion, reports, guidance etc.
Secondary Adjustment	Not specifically provided in the Act. However, huge TP adjustments are made.	Permits secondary adjustments only where specifically provided under domestic law

THANK YOU