

Domestic Transfer Pricing

Understand the impact

Plan your action



CA N.C. Hegde and CA Rakesh Alshi

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Agenda

- Transfer Pricing - The Journey so far
- Specified Domestic Transactions – An introduction
- Specified Domestic Transactions – what it includes?
- Eligible business covered
- Concept of Arm's length price
- Fair Market Price Vs. Arm's Length Price
- Transfer Pricing Documentation
- New Form 3CEB
- Tax burden and related Penalty



Transfer Pricing
The Journey So Far



Significance of Transfer Pricing

- Transfer pricing is consistently cited by tax managers/CFOs as their number one tax issue in Asia Pacific
- The number of countries with transfer pricing rules and documentation requirements has grown
- Transfer pricing rules are actively enforced
- Aggressive positions being taken by tax authorities lead to risks for MNEs, including:
 - The potential for double taxation
 - Non-deductible penalties and interest



Trend Of Adjustments Over The Years

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

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

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

Specified Domestic Transactions
Applicable for FYE 31 March 2013



Prologue to the Introduction of SDT



Glaxo Smithkline Asia (P) Ltd.

- The issue of applying transfer pricing provisions to SDT was first discussed by the Supreme Court of India while delivering its judgment in the case of Glaxo Smithkline

Court's Observations

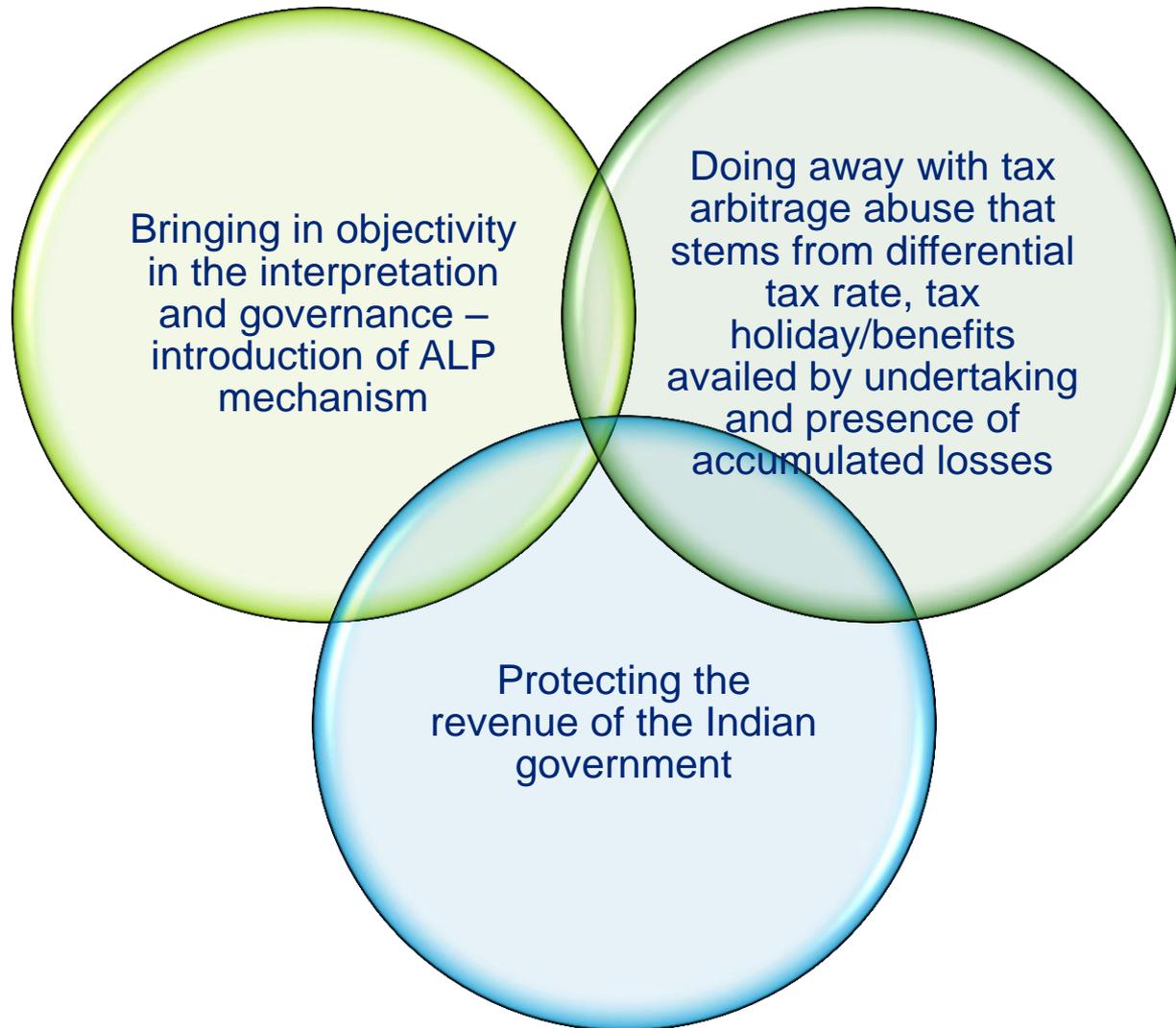
- The court observed that in the case of domestic related party transactions, under-invoicing of sales and over-invoicing of expenses typically would be revenue neutral in nature, except in the following two circumstances:
 - If one of the related companies is a loss making company, and the other is a profit making company and the profit is shifted to the loss making concern; and
 - If there are different rates for the two related units and if the profit is diverted towards the unit enjoying tax benefit.
- Hence, after examining the complications which arose while determining FMV or Market value to transactions between the domestic related parties, the Supreme Court of India suggested that the Ministry of Finance should consider appropriate provisions in law to make transfer pricing provisions applicable to the Domestic RPT.

Introduction

- Transfer Pricing was earlier limited to ‘International Transactions’
- The Finance Act 2012, extended the scope of Transfer Pricing provision to ‘Specified Domestic Transactions’
- The Specified Domestic Transactions would include the following:
 - Expenditure for which payment is made or to be made to domestic related parties
 - Tax Holiday/ Deductions claimed by the taxpayer
 - Transfer of goods or services between various businesses of same taxpayer
 - More than ordinary profits derived from transactions with closely connected persons

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

Specified Domestic Transactions – Intent of the Law



Specified Domestic Transactions – Intent of the Law

Domestic Tariff Area (DTA)

Scenario 1

Particulars	Co. A	Co. B
Taxes in India	33%	33%
Income from Related Party (RP)	100	-
Other Income	200	400
Expenses to RP	-	100
Other expenses	400	200
Profit/ Loss	(100)	100
Tax	-	33
Total Tax for the Group		33

Scenario 2

Particulars	Co. A	Co. B
Taxes in India	33%	33%
Income from RP	150	-
Other Income	200	400
Expenses to RP	-	150
Other expenses	400	200
Profit/ Loss	(50)	50
Tax	-	17
Total Tax for the Group		17

- By shifting of expenses from a loss making company to a profit making company, the group could reduce its tax liability by 16 for the current year, though the impact will be reversed in future years given carry forward of losses.
- To avoid such tax arbitrage cases and even though there is no erosion of tax base, SDT has been introduced.

Specified Domestic Transactions – Intent of the Law

DTA and Tax Holiday Unit

Scenario 1

Particulars	Co. A	Co. B
Taxed in India	0%	33%
Income from Related Party	150	-
Other Income	300	600
Expenses to RP	-	150
Other expenses	300	300
Profit/ Loss	150	150
Tax	-	50
Total Tax for the Group		50

Scenario 2

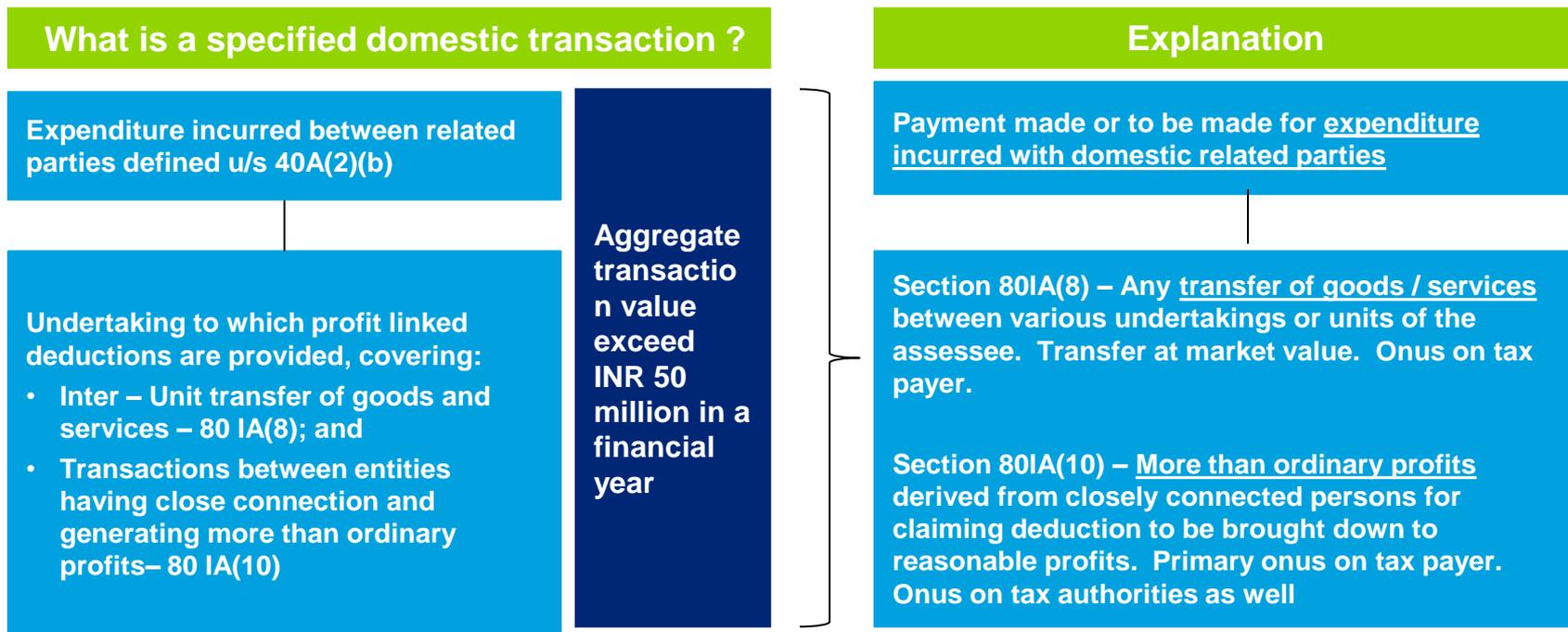
Particulars	Co. A	Co. B
Taxed in India	0%	33%
Income from Related Party	225	-
Other Income	300	600
Expenses to RP	-	225
Other expenses	300	300
Profit/ Loss	225	75
Tax	-	25
Total Tax for the Group		25

- By shifting of expenses from a tax holiday unit (Power) to a unit in the Domestic Tariff Area, the group could reduce its tax liability by 25.
- To avoid such cases Domestic TP has been introduced.

Specified Domestic Transactions

What it includes?

“Specified domestic transaction” in case of an assessee means any of the following transactions, not being an international transaction, namely:



Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the Specified Domestic Transaction shall be computed having regard to the arm's length price

40A(2)(b) – Expenditure between related parties

APPENDIX XVIII [PARA 39.1]

**Chart of persons specified in
Section 40A(2)(b) - (Refer Paragraph 39.1)**

<i>Individual</i>	<i>Firm</i>	<i>Association of persons</i>	<i>HUF</i>	<i>Company</i>	<i>Where person having substantial interest in the business of profession of the assessee is</i>			
<i>His relatives</i>	<i>Its partners</i>	<i>Its members</i>	<i>Its members</i>	<i>Its directors</i>	<i>Individual</i>	<i>Association of persons</i>	<i>HUF</i>	<i>Company</i>
	<i>Their relatives</i>	<i>Their relatives</i>	<i>Their relatives</i>	<i>Their relatives</i>	<i>His relatives</i>	<i>Its members</i>	<i>Its members</i>	<i>Its directors</i>
						<i>Their relatives</i>	<i>Their relatives</i>	<i>Their relatives</i>

Note: Where one or more of the persons falling in any of the above categories (i.e. individual and his relatives, firm, its partners and their relatives, etc.) have substantial interest in the business or profession carried on by any person – that person is also covered under section 40A(2)(b)

40A(2)(b) – Expenditure between related parties

PART III

<i>Director</i>	<i>Partner</i>	<i>Member of AOP</i>	<i>Member of HUF</i>
Companies in which he is a member	Firms in which he is a partner	AOP of which he is a	
Director			
All other Directors of such AOP	All other partners of such firms	All other members of such	
Companies	All other members of such HUF		
Their relatives	Their relatives	Their relatives	Their relatives

Notes:

1. Relative is defined in section 2(41) as including husband, wife, brother, sister or any lineal ascendant or descendent of the individual.
2. "Person having a substantial interest" is explained in section 40-A as under:
 - i. In the case of company - the person concerned 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 20% of the voting power.
 - ii. In other cases - such person is at any time during the previous year, beneficially entitled to not less than 20% of the profits of such business or profession.

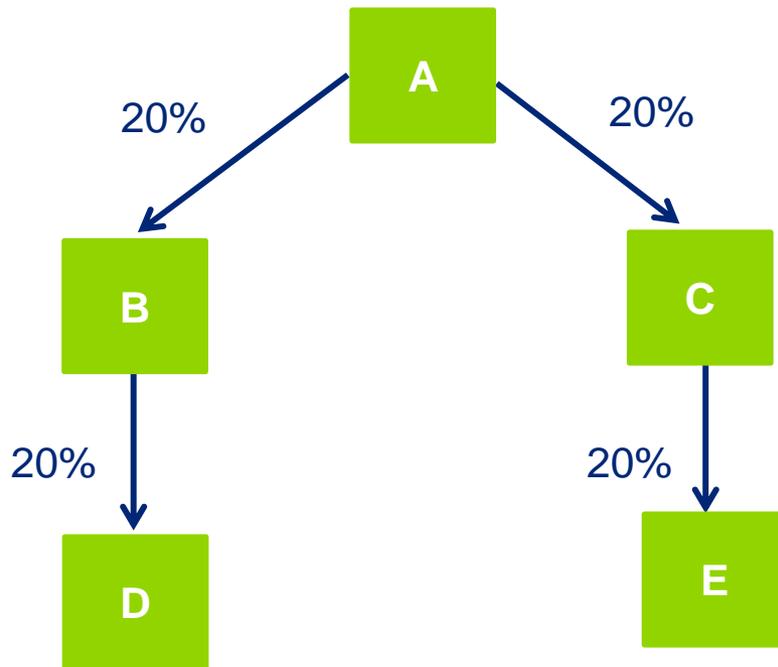
40A(2)(b) – Expenditure between related parties

- Expenditure paid or to be paid to related parties will require to be at arm's length
- Examples of related parties under section 40A(2)(b)

Payer	Receiver of Payment
Individual	<ul style="list-style-type: none">• Relative of individual
Company	<ul style="list-style-type: none">• Director of company or relative of the director
AoP/ HUF	<ul style="list-style-type: none">• Member of AoP / HUF or relative of such member
Any taxpayer	<ul style="list-style-type: none">• Payment to a person who has substantial interest in me• Payment to a director / partner / member / relatives of a person who has substantial interest in me• Payment to a company in which my parent (more than 20% holding) has substantial interest• Payment to a person whose director/ partner/ member has substantial interest in me• Payment to a director/ partner/ member/ relatives of a person whose director/ partner/ member has substantial interest in me• Payment to a person in which I have substantial interest• Payment to a person in which my director/ partner/ member/ relatives have substantial interest• Payment to any of my director/ partner/ member/ relatives

Substantial Interest means beneficial ownership of shares with at least 20% voting right for company or beneficial entitlement of at least 20% of the profits for other than company at any time during the year

Illustration – Expenditure u/s 40A



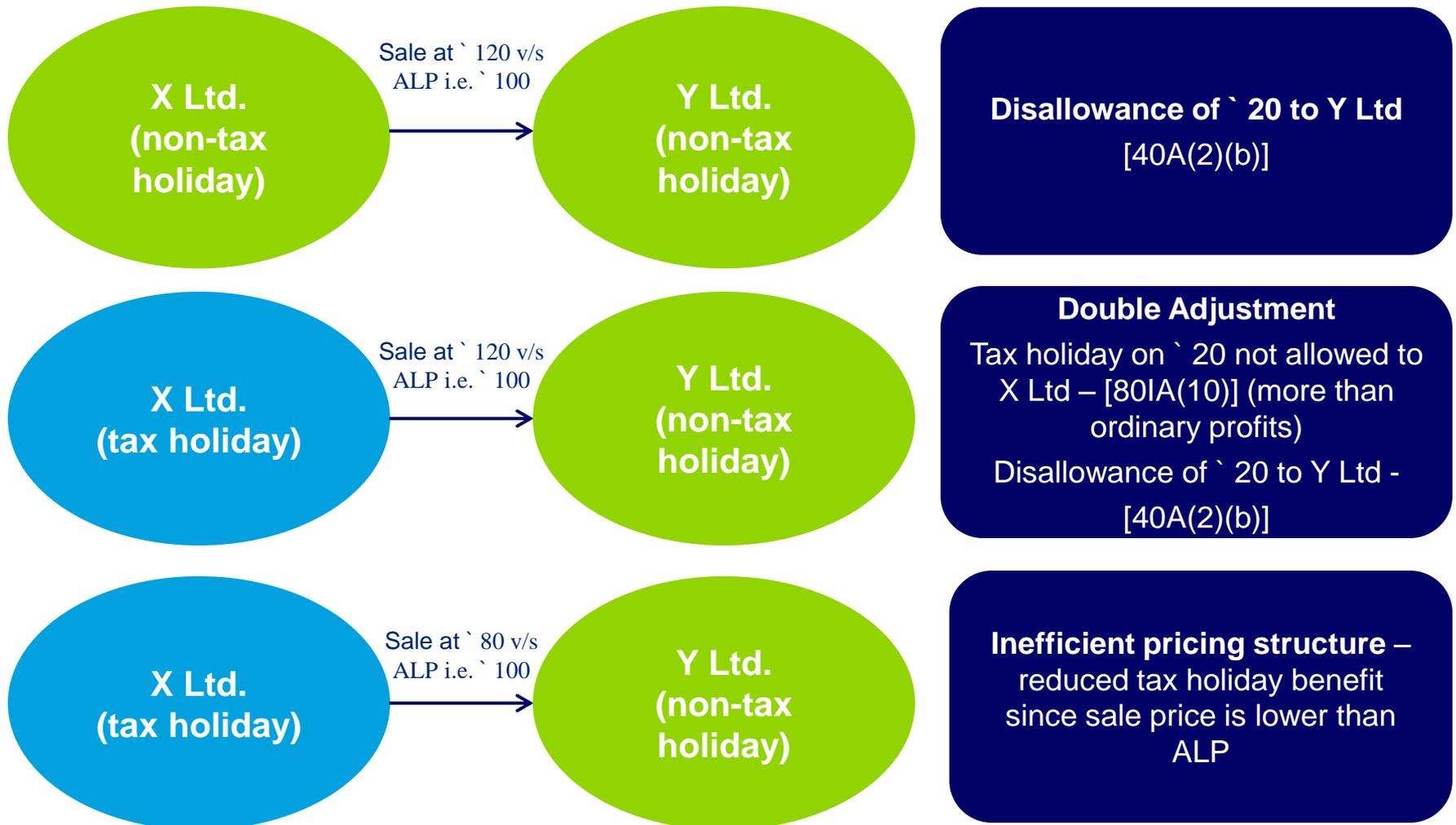
Transactions covered ?

A & B	→	Yes
A & C	→	Yes
A & D	→	No
A & E	→	No
B & C	→	Yes*
D & E	→	No

* Post Budget 2012 amendment under section 40A

Requirement to justify that expenditure not excessive or unreasonable and meets the arm's length criteria

Tax burden, if transaction not at ALP



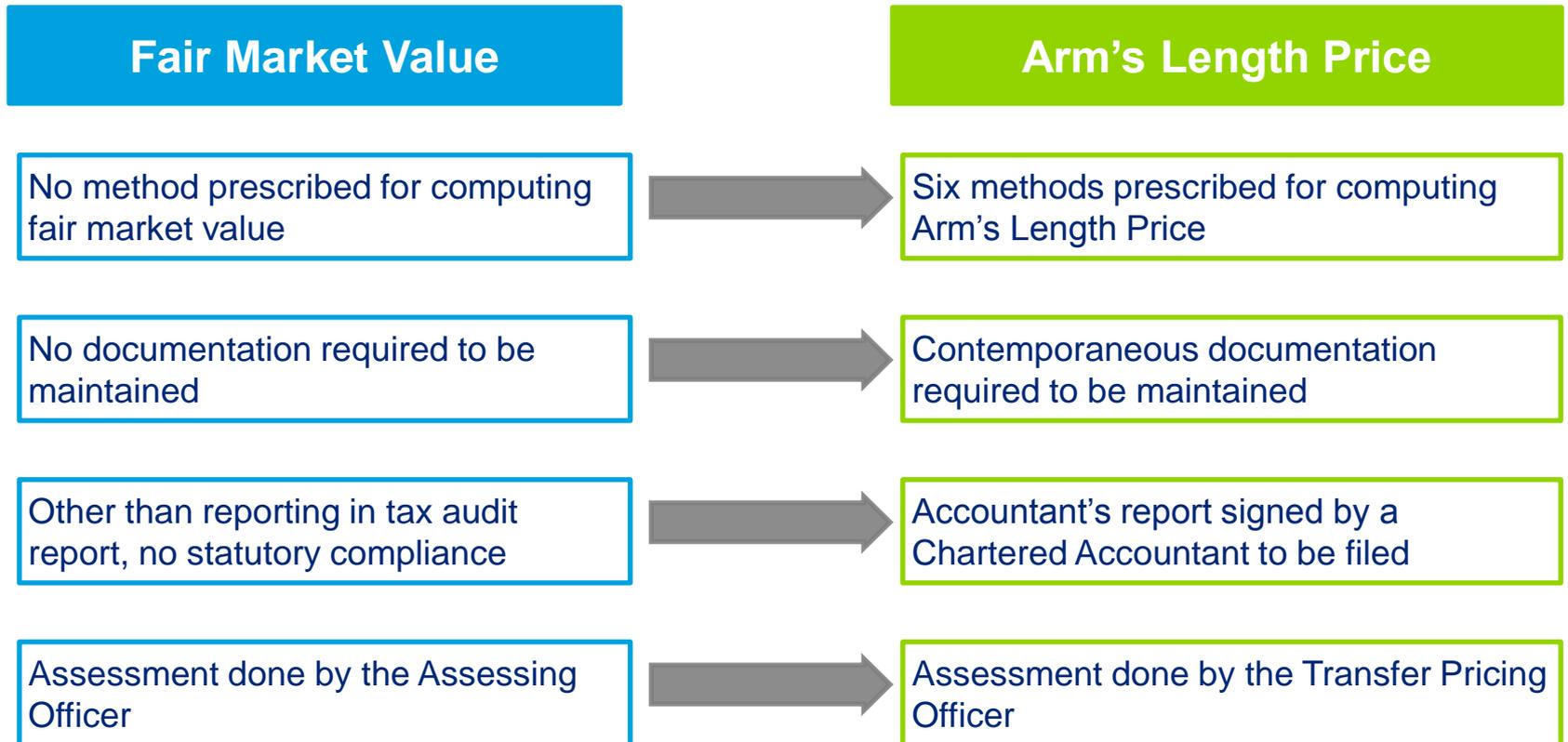
Eligible Business Covered

Section	Tax Payers covered	Deduction
10AA	Persons with income from Special Economic Zone (SEZ) units	<ul style="list-style-type: none"> • 100% for the first 5 years • 50% for the next 5 years • 50% of the profits or amount credited to SEZ re investment reserve, whichever is less for next 5 years
80-IA	Infrastructure developers	<ul style="list-style-type: none"> • 100% for a period of 10/15 years out of 15/20 years, as the case may be, from the date of commencement of operation
80-IA	Telecommunication service providers	<ul style="list-style-type: none"> • 100% for a period of 5 years • 30% for the next 5 years • out of 15 years from the date of commencement of operations
80-IA	Developers of Industrial park	<ul style="list-style-type: none"> • 100% for a period of 10 years out of 15 years from the date of commencement of operations
80-IA	Producers or distributors of power	<ul style="list-style-type: none"> • 100% for a period of 10 years out of 15 years from the date of commencement of operations
80-IAB	Developers of SEZ	<ul style="list-style-type: none"> • 100% for a period of 10 years out of 15 years from the date of commencement of operations
80-IB	Small scale industry engaged in operating Cold storage plant	<ul style="list-style-type: none"> • 30% of profits for the first 10 years
80-IB	Industrial undertaking in Industrially backward state as mentioned in VIII Schedule (ex: Jammu and Kashmir)	<ul style="list-style-type: none"> • 100% of profits for 5 years and • 30% for the next 5 years
80-IB	Multiplex theaters and convention centre	<ul style="list-style-type: none"> • 50% for the first 5 years

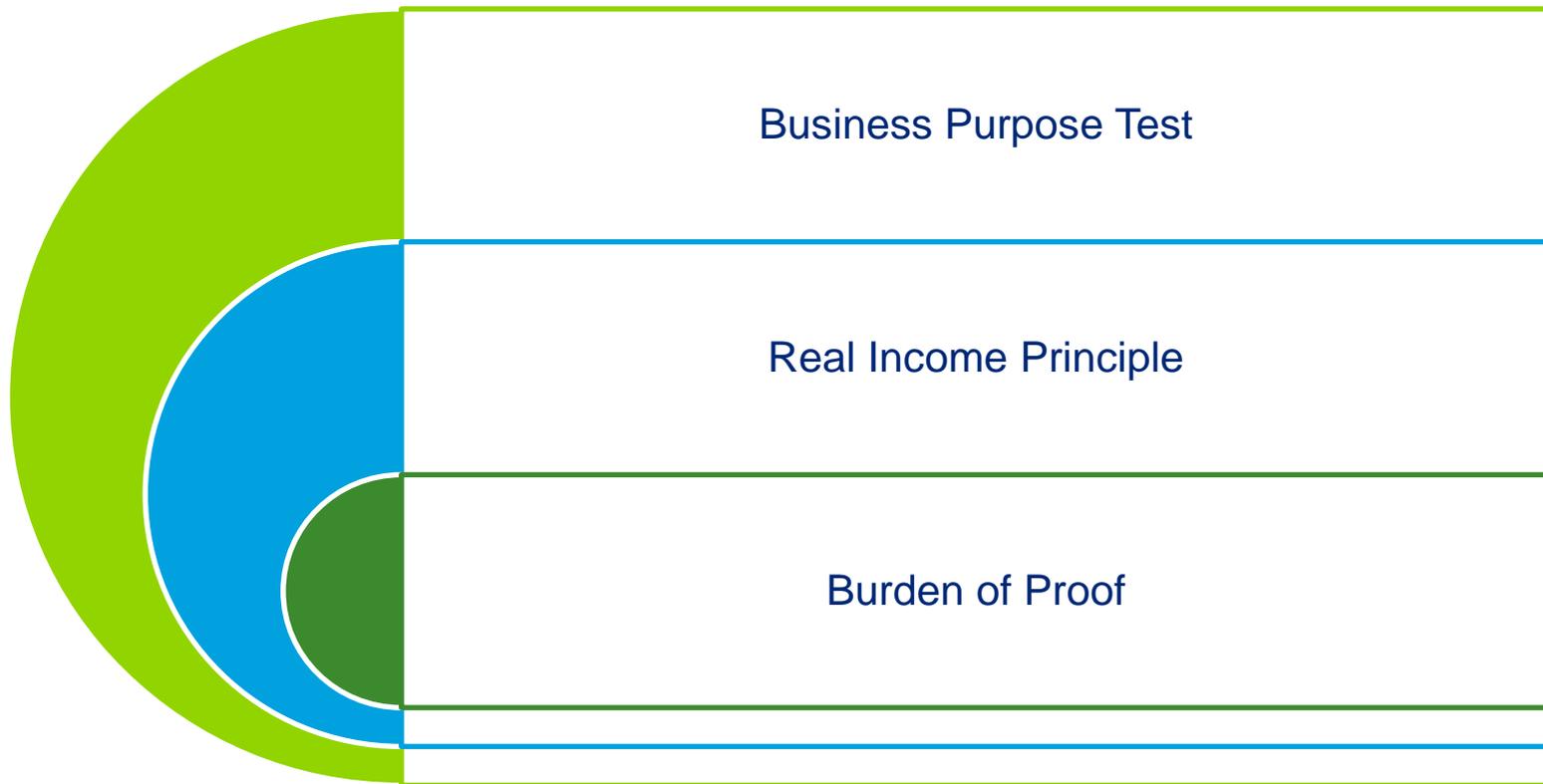
Eligible Business Covered (contd...)

Section	Tax Payers covered	Deduction
80-IB	Company carrying on scientific research and development	<ul style="list-style-type: none"> • 100% of profits for first 10 years
80-IB	Eligible housing projects	<ul style="list-style-type: none"> • 100% of profits from such business
80-IB	Eligible hospitals	<ul style="list-style-type: none"> • 100% of profits for first 5 years
80-IC/80-IE	Persons with units in North-eastern states claiming deduction	<ul style="list-style-type: none"> • 100% for a period of first 10 years
80-ID	Hotels located in districts having World Heritage site	<ul style="list-style-type: none"> • 100% of profits for first 5 years of commencement of business

Implication post – budget 2012 for SDT



Arm's Length Price – What has changed?



Concept of Arm's Length Price

- Arm's length price" means a price which is applied or proposed to be applied in a transaction in uncontrolled conditions
- Arm's Length price is determined using the Most Appropriate Method out of the six transfer pricing methods prescribed by the Income Tax Rules:
 - Comparable Uncontrolled Price Method
 - Resale Price Method
 - Cost Plus Method
 - Profit Split Method
 - Transactional Net Margin Method
 - Other Method
- If more than one comparable price is obtained using above methods, then the arm's length price would be 'Arithmetic Mean' of comparable prices

Deviation of plus/ minus three percent is permitted from arm's length price

What documentation would be required?

Entity Related



- Profile of Industry
- Profile of group
- Profile of related parties

Price Related



- Transaction terms
- Functional Analysis (functions, assets and risks)
- Economic Analysis (method selection, comparable benchmarking)
- Forecasts, budgets, estimates

Transaction Related



- Agreements
- Invoices
- Pricing related correspondence (letters, e-mails, fax, etc.)

New Accountants Report – Form 3CEB

- The new Form 3CEB ('the Form') contains 25 clauses requiring disclosure of the details of the various international transactions and specified domestic transactions.
- The Form is broadly divided into 3 parts.
 - Part A deals with general information about the taxpayer
 - Part B is in relation to International transactions and
 - Part C deals with Specified domestic transactions
- This new Accountants Report has to be signed by a Chartered Accountant and submitted to the Tax Department before the due date of filing return of income



Adobe Acrobat
Document

**Issuance of Accountants Report in Form 3CEB :
Timeline is before 30 November 2013**

Penalty implications

	Impact	Quantum of Penalty
Penalty	<u>Sec 271AA</u> • Failure to keep and maintain Transfer Pricing documentation • Failure to report such transaction which is required to do so • Maintaining or furnishing incorrect information or documents	<ul style="list-style-type: none"> 2% of value of each international transaction
	<u>Section 271G</u> • Failure to furnish / submit any information / document to the transfer pricing officer	<ul style="list-style-type: none"> 2% of value of international transaction for each such failure
	<u>Section 271BA</u> • Failure to furnish accountant's report in Form No. 3CEB	<ul style="list-style-type: none"> INR 100,000
	<u>Section 271(1)(c)</u> • Transfer pricing adjustment – Concealment of income or furnishing inaccurate particulars of income	<ul style="list-style-type: none"> 100-300% of amount of tax sought to be evaded on concealment of particulars of income or furnishing inaccurate particulars of such income

Way Forward

Impact Analysis

- Identify transactions with related parties and tax holiday units
- Desktop analysis to determine whether the current way of carrying on transactions will comply with arm's length standard
- Identify major transactions which need correction

Planning (Forward Looking)

- FAR analysis of proposed specified domestic transaction
- Benchmarking the proposed transaction
- Recommend the pricing to be followed for specified domestic transaction

Documentation (Historic)

- Roll forward the planning study with the actual FAR
- Benchmark the actual transactions carried out during previous year
- Issue Form 3CEB
- Maintain documents to be produced before the tax authorities during assessment

Conclusion

- Now Transfer pricing will not be limited to just the large groups any more.
- Many mid-sized groups, partnership firms, Hindu Undivided Families ('HUFs') and even individuals in smaller cities will now have to adhere to the TP rules.
- SDT will largely increase the compliance burden for taxpayers having substantial domestic related party transactions.



Thank You