

# DOMESTIC TRANSFER PRICING

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12 October 2014



WIRC of ICAI: J B Nagar CPE Study Circle

# DOMESTIC TRANSFER PRICING

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# DOMESTIC TRANSFER PRICING

## Introduction

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# INTRODUCTION

## Background & Relevant Amendments

- TP provisions have been traditionally applied only to ‘international transactions’
- Taking cue from Supreme Court’s suggestion in case of **GlaxoSmithkline Asia (P) Ltd**, Finance Act 2012 has extended TP provisions to ‘Specified Domestic Transactions’ (SDTs), including:
  - **Payment to Related Parties**, covered under Section 40A(2)(b)
  - **Inter-unit transactions** by units covered under Section 80-IA, 80-IB, 80-IC, 80-ID, 80-IE, SEZ units and SEZ Developers
  - **Intra-group transactions** by taxpayers covered under Section 80-IA, 80-IB, 80-IC, 80-ID, 80-IE, SEZ units and SEZ Developers
  - Other prescribed transactions
- **TP Regulations apply if sum of above transactions exceed Rs. 5 Cr.**
- Corresponding amendments also carried out in relevant sections

# INTRODUCTION

## Tax Arbitrage Between Related Parties



Particulars	A Ltd.	B Pvt. Ltd.
Tax Rate	30%	30%
Sale to Related Party	1000	-
Sales to third parties	2000	4000
Purchase from Related Party	-	1000
Other Expenses	4000	2000
Profit/ Loss	-1000	1000
Tax	NIL	300
<b>Total Tax for the Group</b>	<b>300</b>	

Particulars	A Ltd.	B Pvt. Ltd.
Tax Rate	30%	30%
Sale to Related Party	1500	-
Sales to third parties	2000	4000
Purchase from Related Party	-	1500
Other Expenses	4000	2000
Profit/ Loss	-500	500
Tax	NIL	150
<b>Total Tax for the Group</b>	<b>150</b>	


# INTRODUCTION

## Tax Arbitrage for Tax Holiday Units



Particulars	Unit 1	Unit 2
Tax Rate	0%	30%
Sale to Ineligible Unit	1000	-
Sales to third parties	2000	4000
Purchase from Eligible Unit	-	1000
Other Expenses	4000	2000
Profit/ Loss	-1000	1000
Tax	NIL	300
<b>Total Tax for the Group</b>	<b>300</b>	

Particulars	Unit 1	Unit 2
Tax Rate	0%	30%
Sale to Ineligible Unit	2500	-
Sales to third parties	2000	4000
Purchase from Eligible Unit	-	2500
Other Expenses	4000	2000
Profit/ Loss	500	-500
Tax	NIL	NIL
<b>Total Tax for the Group</b>	<b>NIL</b>	



# DOMESTIC TRANSFER PRICING

## Coverage & Implications

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# DOMESTIC TRANSFER PRICING

## Coverage

- All payments to Specified Persons as per Section 40A(2)
  - Purchase of goods / services
  - Management fees / royalties
  - Interest payments on loans taken from Related Parties / guarantee fees paid to related parties
  - Purely domestic transactions - Managerial Remuneration, payment of rent, equipment hire etc.
  - Cost allocations
- Specific Transactions for Tax Holiday Taxpayers
  - Transfer of goods and services between tax holiday unit and another unit
  - Any business transacted with any person, where such business produces more than ordinary profits eligible for tax holiday; owing to 'close connection' or any other reason



# DOMESTIC TRANSFER PRICING

## Implications

- Compliance requirements
  - Documentation and Form 3CEB
  - Burden of Proof on the Taxpayer
- Transfer Pricing Benchmarking
  - Any of the 6 methods can be used, provided it is Most Appropriate Method
- Scrutiny by TPO
- Corresponding Adjustments may not be allowed
  - Poor Transfer Pricing would lead to additional tax cost
- Deadlines for compliances and scrutiny

# DOMESTIC TRANSFER PRICING

## Differences between pre and post amendment scenarios

Area of Difference	Pre-Amendment	Post-Amendment
Concept	Fair Value / FMV	Arm's Length Price
Nature	Open / flexible	Systematic / static
Ad-hoc adjustments	Commonly being made	Should be avoided
Burden of Proof	Revenue	Taxpayer
Approach of Taxpayer	Reactive	Proactive
Compliance Burden	Basic Reporting in TAR	Onerous

# DOMESTIC TRANSFER PRICING

## Differences between pre and post amendment scenarios

Area of Difference	Pre-Amendment	Post-Amendment
Cost based analysis	Accepted / not accepted	Accepted
Tax Evasion	Relevant	Not Relevant
Managerial Remuneration	Broad Justification	Justification of amounts
High Interest Paid	Nexus with loan given	Nexus not required
Tax Holiday Units	ALP not relevant	ALP specifically applied
AE as Comparables	Allowed / not allowed	Not allowed

# DOMESTIC TRANSFER PRICING


## Differences between International & Domestic Transfer Pricing

Area of Difference	International	Domestic
International Guidance	Available	Not Available
APA	Available	Not Available
Managerial Remn / Rent	Not Applicable	Applicable
Threshold for compliance	NIL	INR 5 Crores
Tested Party	Preferably Taxpayer	Taxpayer or other party
Revenue Loss to Govt.	Generally Relevant	Not Always Relevant

# DOMESTIC TRANSFER PRICING

## Differences between International & Domestic Transfer Pricing

Area of Difference	International	Domestic
Applicability	Associated Enterprises	Related Parties
Ownership Threshold	26%	20%
Transactions Covered	All Transactions	Limited Transactions
ALP Options for Interest	LIBOR / Eurobor / Rupee	Only Rupee Denomination
Forex Fluctuations	Relevant	Not Applicable
Reporting / Form 3CEB	Practically easier	Needs modification



# DOMESTIC TRANSFER PRICING

## Documentation & Certification

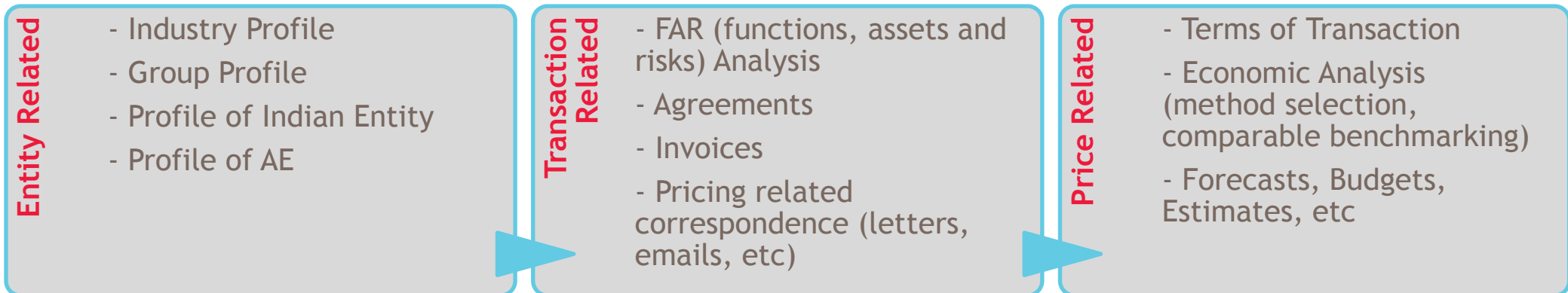
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# TRANSFER PRICING DOCUMENTATION

## Regulatory Requirement

- Section 92D of the IT Act r.w. Rule 10D of the IT Rules casts an obligation on the Taxpayer to maintain contemporaneous documentation with respect to the International Transactions and/or Specified Domestic Transactions:



- Section 92BA of the Income Tax Act exempts the taxpayer from any compliance with regards Specified Domestic Transactions where the aggregate value of such transactions do not exceed Rs. 5 Cr.
- Documentation is to be maintained for a period of 8 years from end of Assessment Year and ought to be produced before the Tax Office within 30/60 days from date of receipt of notice

# TRANSFER PRICING DOCUMENTATION

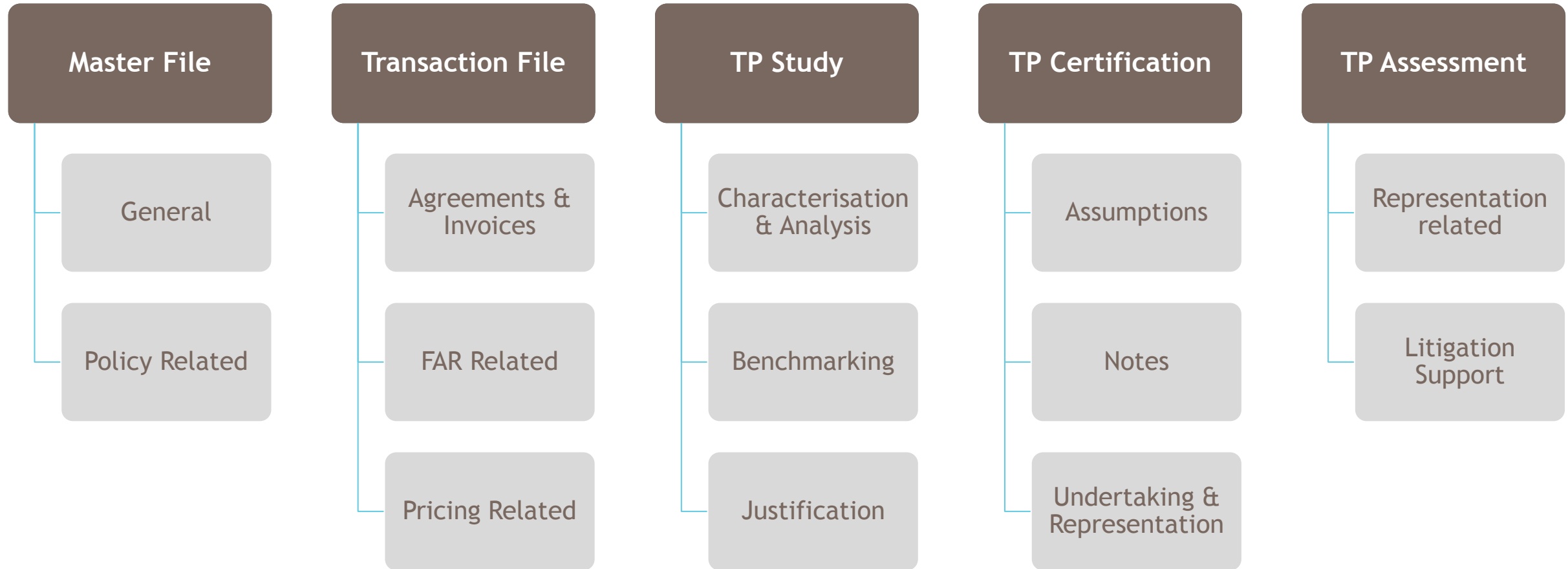
## Contemporaneous Documentation

- Rule 10D(4) of IT Rules requires that the information & documentation specified under the Rule 10D should as far as possible be contemporaneous and should exist latest by the due date of filing of the Return of Income
- The word ‘contemporaneous’ has not been defined under the IT Act
- Random House Webster’s Unabridged Dictionary defines the word Contemporaneous as “living or occurring during the same period of time”, "Concurrent", "Consistent", "Simultaneous".
- From the above it can be inferred that the documentation should be present or should be created at the time the Taxpayer is entering into an International Transaction or Specified Domestic Transaction with an AE
- Contemporaneous Documentation Issues
  - Availability of data while entering into controlled transaction / due date of filing of Return of Income (Extended due date for Transfer Pricing Cases)
  - Use of earlier years data
  - Use of multiple years data
  - Updation of Databases - Fresh Search by TPO
  - Restatement of Financials
  - Difference in financial year



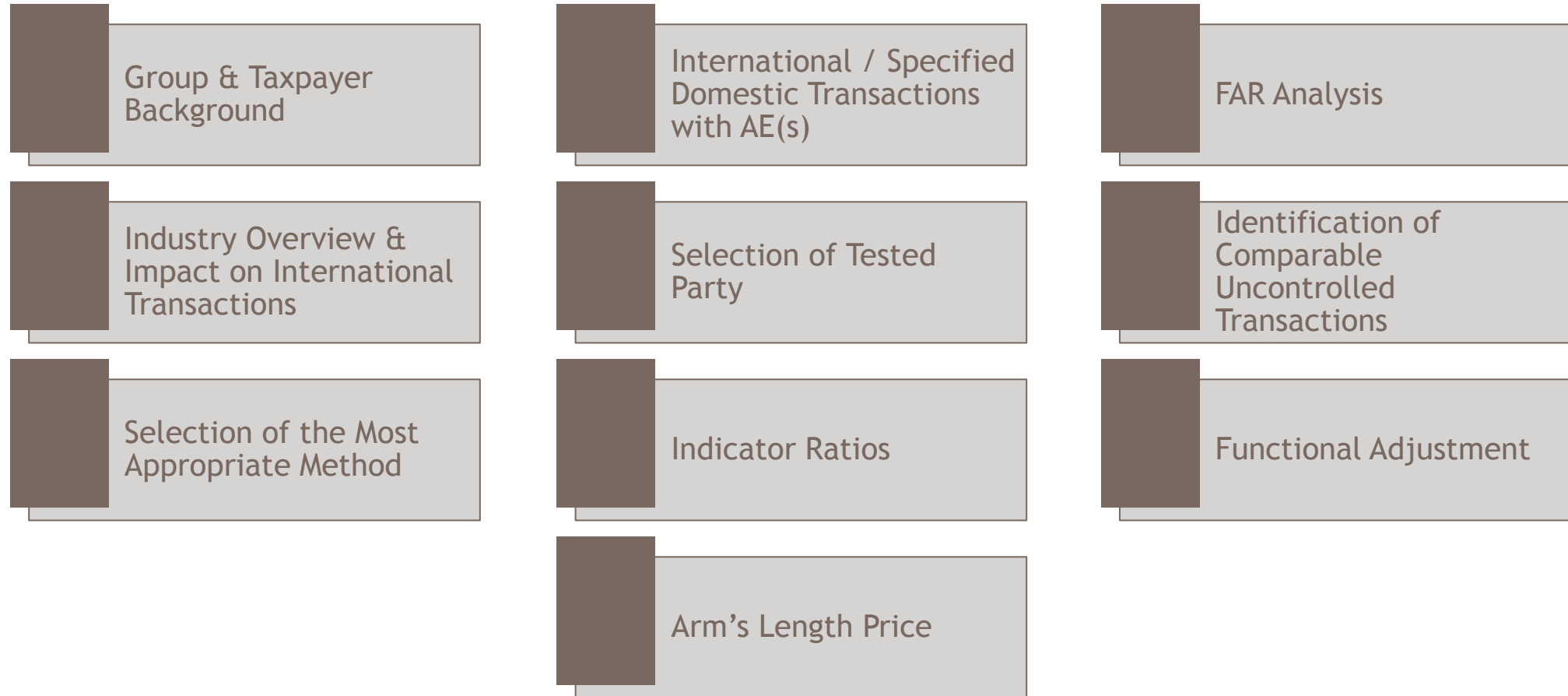
# TRANSFER PRICING DOCUMENTATION

## Best Practices - Documentation



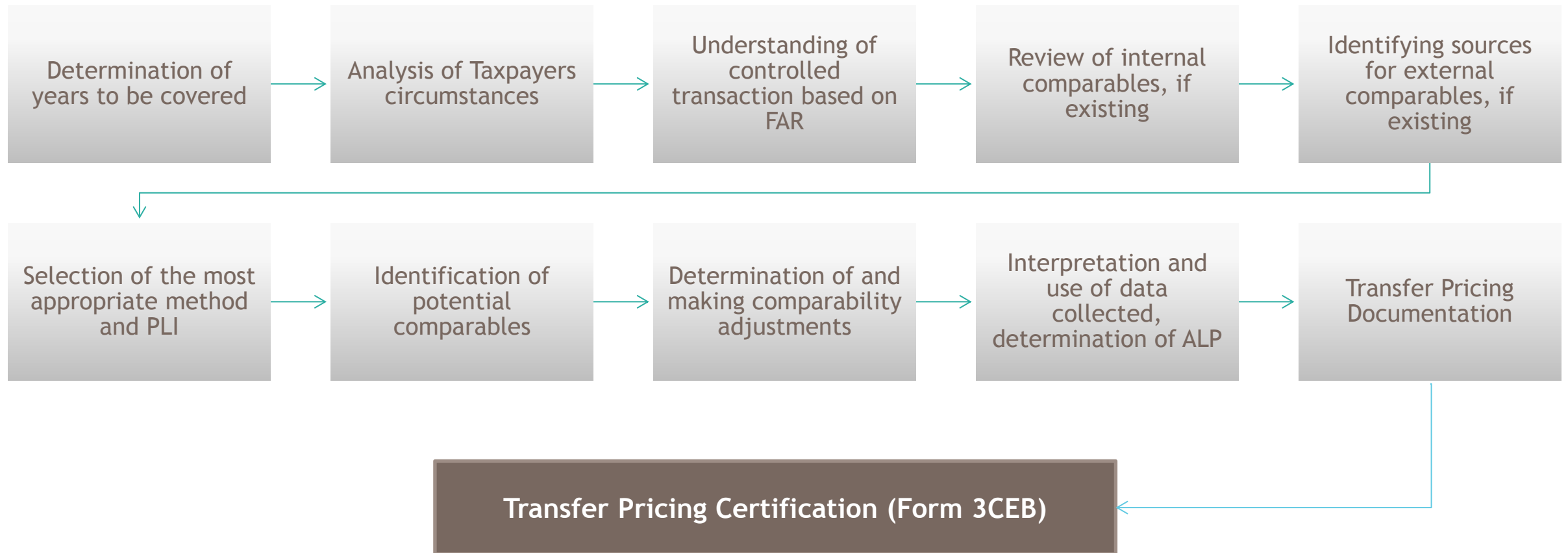
# TRANSFER PRICING DOCUMENTATION

## Best Practices - Transfer Pricing Study



# TRANSFER PRICING CERTIFICATION

## The Process



# TRANSFER PRICING CERTIFICATION

## Form No 3CEB

- Section 92E of the Income Tax Act requires every person who has entered into an international transaction or a specified domestic transaction to obtain a report from an accountant
- Rule 10E prescribes the requisite report to be furnished in Form No. 3CEB

### Form No 3CEB

Examination of accounts & records

Maintenance of prescribed information & documents

Factual accuracy of contents mentioned in annexure to form 3CEB

### Annexure to Form No 3CEB

Part A: General Information

Part B: International Transactions

Part C: Specified Domestic Transactions

- While certifying in the Report consider the following
  - Make appropriate disclosure of judicial pronouncement relied upon
  - Follow Accounting Standard, ICAI Guidance Notes & Standards on Auditing issued by ICAI
  - Obtain written representation for positions and assumptions

# TRANSFER PRICING CERTIFICATION

## Annexure to Form 3CEB

### Part C - Specified Domestic Transactions

21. List of associated enterprises with whom the assessee has entered into specified domestic transactions
  - Name, Address and PAN of the associated enterprise
  - Relationship with associated enterprise
  - Brief description of the business of associated enterprise
22. Transactions in the nature of payment for any expenditure to persons referred to in section 40A(2)(b)
23. Transfer or acquisition of any goods or services to/from eligible business of the same assessee
24. Any business transacted by an eligible business
25. Any other transaction

# TRANSFER PRICING CERTIFICATION

## Check Points for the TP Auditor and Taxpayer

### Coverage of Relationships

- Check for completeness and correctness
- Check points
  - Previous year's form 3CEB
  - Financial Statements
  - Notes to Accounts - AS 18 disclosures
  - Form 3CD - Sec. 40A(2)(b) disclosures
  - Cost Audit Report of the company
  - Company / group website
  - Register under Section 301 of Companies Act
  - Management discussion and representation
  - Relevant Income tax forms
  - Shareholding pattern as per Members Register and Annual Return

### Coverage of Transactions

- Reconciliation with disclosures
  - Notes to Accounts [AS-18]
  - Tax Audit Report [Section 40A(2)(b)]
  - Cost Audit Report
  - Register under Section 301 of Companies Act
- Ledger scrutiny
  - Ledger of Party Concerned
  - Transaction Ledger
- Reconciliation with amounts as per Financial Statements
- Management discussion and representation
- Details of foreign exchange transactions as provided in the audited accounts

# TRANSFER PRICING CERTIFICATION

## Roles and Responsibilities

### Taxpayer

- Recognition of parties and transactions where transfer pricing applies
- Determination of the most appropriate transfer pricing methodology
  - Recognizing comparable transactions / entities, as much as is relevant from TP perspective
  - Providing relevant industry-level and market-level information, such as key markets, major customers, competitors etc.
  - Providing insight into price-setting mechanism
- Determination of Arm's Length Price
- Compilation of relevant documents as proof of Arm's Length Price on real time basis
- Maintenance of transfer pricing documentation (as per section 92D r.w. Rule 10D)

### Auditor

- Independence in Audit work
- Clearly defined Scope of examination
  - Importance of signed engagement Letter
- Management Representation Letter
- Communication with outgoing auditor
- Adherence to Code of Conduct
- Adherence to Guidance Note
- Quality control and peer review
- Timely issuance of the Accountant's Report (Form 3CEB) to client
- Maintenance of client file and documentation
- Disclaimer in Documentation

# TRANSFER PRICING CERTIFICATION

## Practical Issues

- Availability of contemporaneous data
- Comparability differences
  - Cyclical Issues
  - Geographical differences
  - Quantity differences
  - Differences in terms of transaction
  - Currency of transactions
- Aggregation or standalone evaluation of transactions
- Lack of clarity regarding nature of transaction
  - Services v Cost allocation
  - Mutual agreement v Business restructuring
- Lack of Information available with client
  - Lack of records maintained
  - Transactions undertaken in absence of agreements
  - Confidential Agreements
- Reliance on previous year's benchmarking and analysis







# DOMESTIC TRANSFER PRICING

## Issues & Case Studies

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# DOMESTIC TRANSFER PRICING

## Relationships Covered u/s 40A(2)

### Any Taxpayer

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

### Tax Holiday Taxpayer

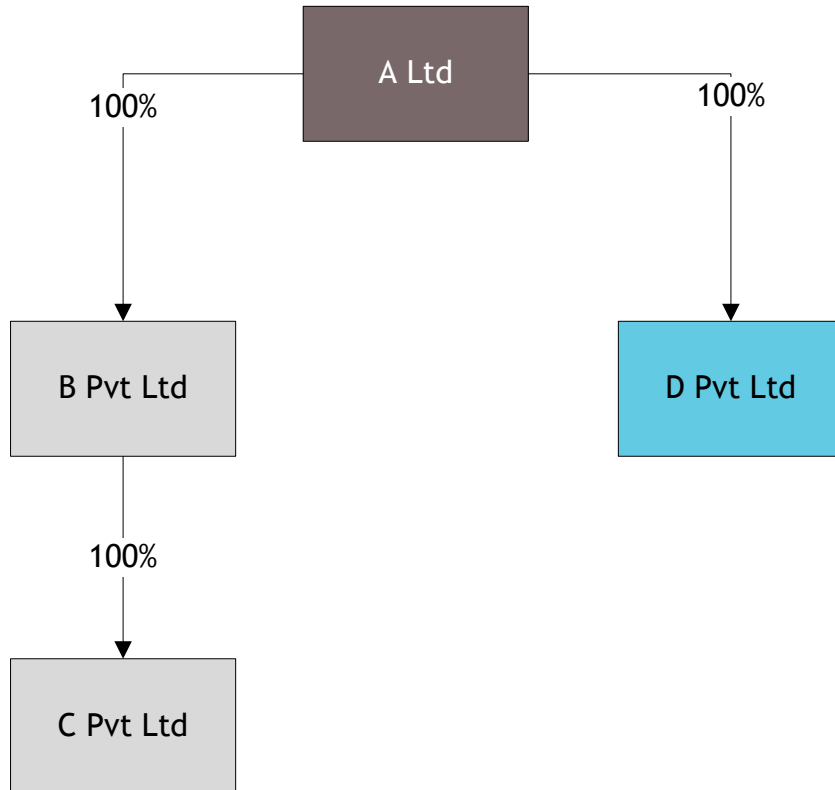
- Any other eligible or non-eligible unit of the same Taxpayer

### Tax Holiday Taxpayer

- Any person with whom the course of business is so arranged, which results in excess profits in the tax holiday unit - either due to close connection or any other reason

# DOMESTIC TRANSFER PRICING

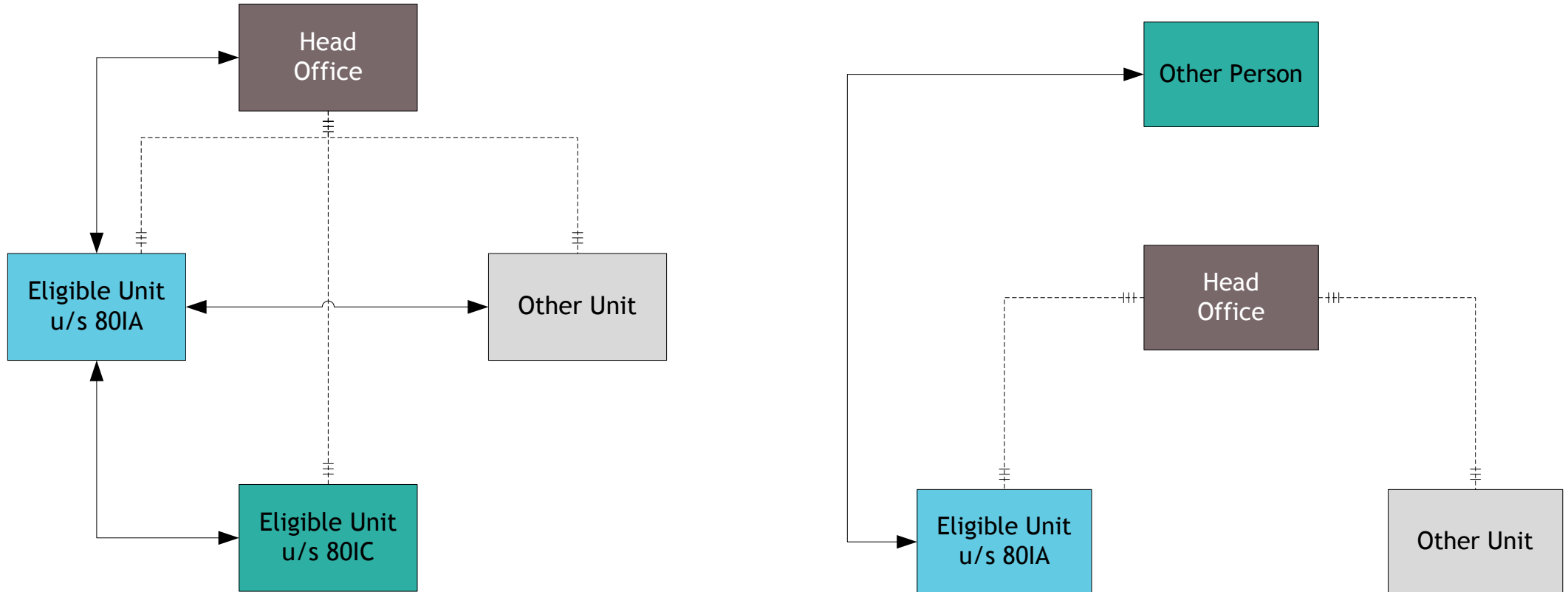
## Relationships Covered u/s 40A(2)



- Is Domestic TP applicable in case where there is payment of expenditure by:
  - B to A?
  - C to A?
  - D to B?
  - B to C?
  - D to A?
  - D to C?
  - A to B?

# DOMESTIC TRANSFER PRICING

## Relationships Covered for Tax Holiday Units



# DOMESTIC TRANSFER PRICING

## Applicability to Trusts and co-operative societies

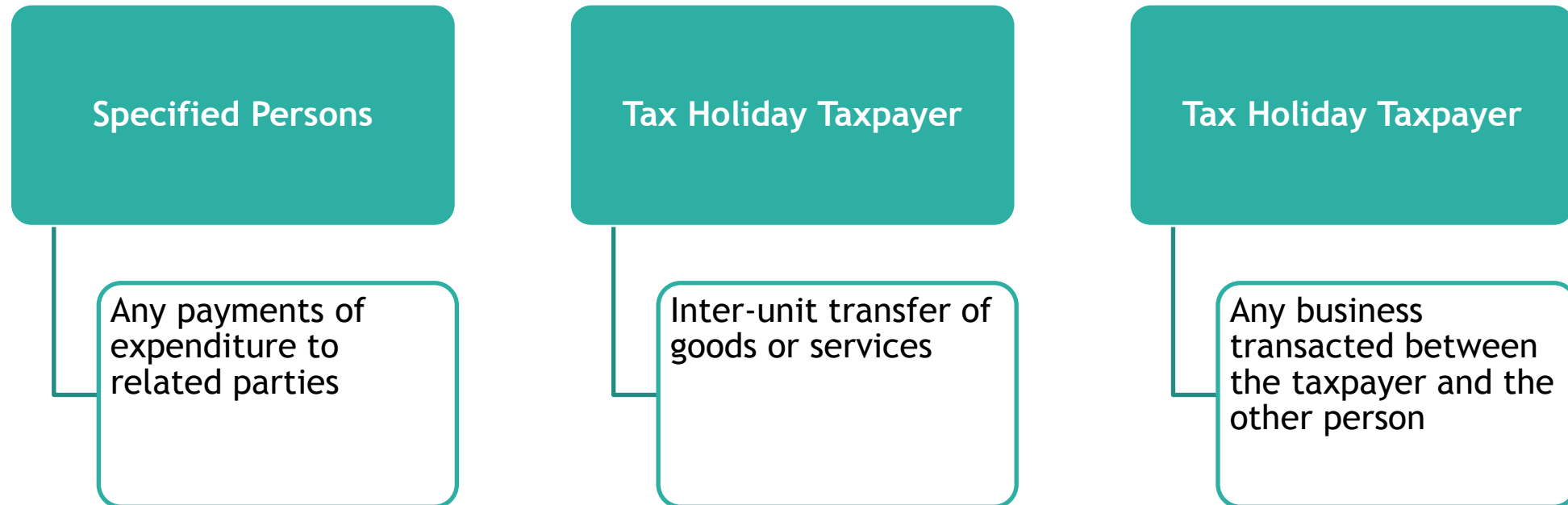
- Domestic Transfer Pricing applicable to all assesses under the Act
- Whether payments by a taxpayer to a trust or co-operative society covered?
- Few Court rulings have held trusts and co-operative societies to be outside the scope of 40A(2)(b)<sup>1</sup>
- However, Sub-clause (vi) of section 40A(2)(b) makes a reference to '*any person who carries on a business or profession*'.
- Therefore, in a case where a trust or co-operative society carries on '*Business or Profession*', whether payments made to such trust or co-operative society, in whose business the taxpayer has substantial interest, could said to be covered within the ambit of sub-clause (vi) of section 40A(2)(b)

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<sup>1</sup> See, *Shanker Trading (P.) Ltd. v. Commissioner of Income tax (2012) IT Appeal No. 53 of 2000 & Others (Delhi)*, *Commissioner of Income tax v. ManjaraShetkariSahakariSakharKarkhana Ltd. (2008) 166 Taxman 287 (Bom.)*

# DOMESTIC TRANSFER PRICING

## Transactions Covered



# DOMESTIC TRANSFER PRICING

## Transactions Covered

### Capital Expenditure

- Whether capital expenditure covered within the ambit of domestic transfer pricing
- Section 92BA(i) refers to '*any expenditure*', without making a specific exclusion for Capital Expenditure
- Inference may be drawn from other provisions of the Act where capital expenditure has been specifically excluded (For instance, Section 37)
- Whether assets acquired on merger/demerger, where consideration paid by issue of equity shares, covered under domestic transfer pricing?

### Expenses relating to 'Income from other sources'

- Provisions of domestic transfer pricing make reference to *persons* covered under 40A(2)(b) and not *expenditure* domestic transfer pricing
- Accordingly, provisions of domestic transfer pricing could apply to expenses incurred in relation to 'Income from other sources' also

# DOMESTIC TRANSFER PRICING

## Transactions Covered

### Allocation of corporate costs

- Whether allocation of corporate costs such as managerial remuneration between the eligible and non-eligible units of an assessee would be subject to domestic transfer pricing?
- One view is that the ‘goods or services’ transferred ought to have been held for the ‘purpose of the business’
- Another view is that legislative intention of introduction of domestic transfer pricing was to check tax evasion through mispricing of intra-unit transfer of goods or services and hence all intra-unit transactions ought to be covered including allocation of corporate costs



# DOMESTIC TRANSFER PRICING

## Transactions Not Covered



Tax Rate = 30%

### Scenario 1

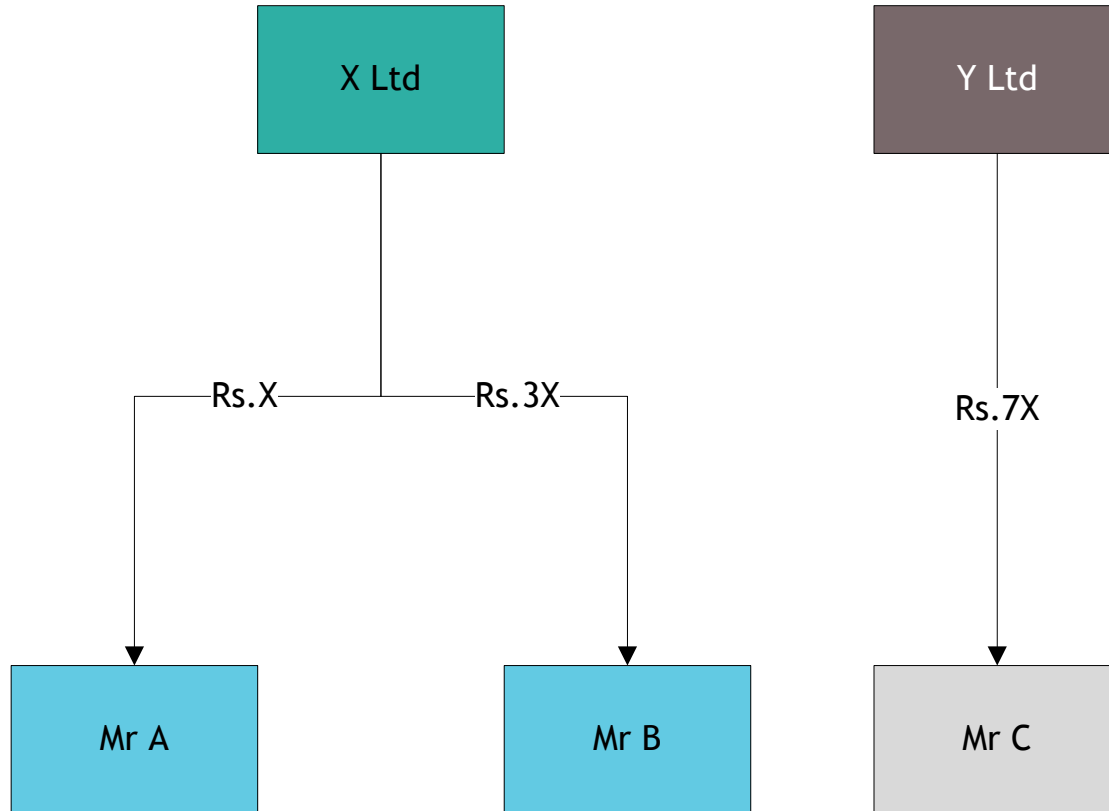
Particulars	A Ltd.	B Pvt. Ltd.
Sale to Related Party	3000	-
Sale to third parties	5000	4000
Purchase from Related Party	-	3000
Other Expenses	2000	3000
Profit/ Loss	6000	-2000
Tax	1800	NIL
<b>Total Tax for the Group</b>	<b>1800</b>	

### Scenario 2

Particulars	A Ltd.	B Pvt. Ltd.
Sale to Related Party	1000	-
Sale to third parties	5000	4000
Purchase from Related Party	-	1000
Other Expenses	2000	3000
Profit/ Loss	4000	NIL
Tax	1200	NIL
<b>Total Tax for the Group</b>	<b>1200</b>	

# DOMESTIC TRANSFER PRICING

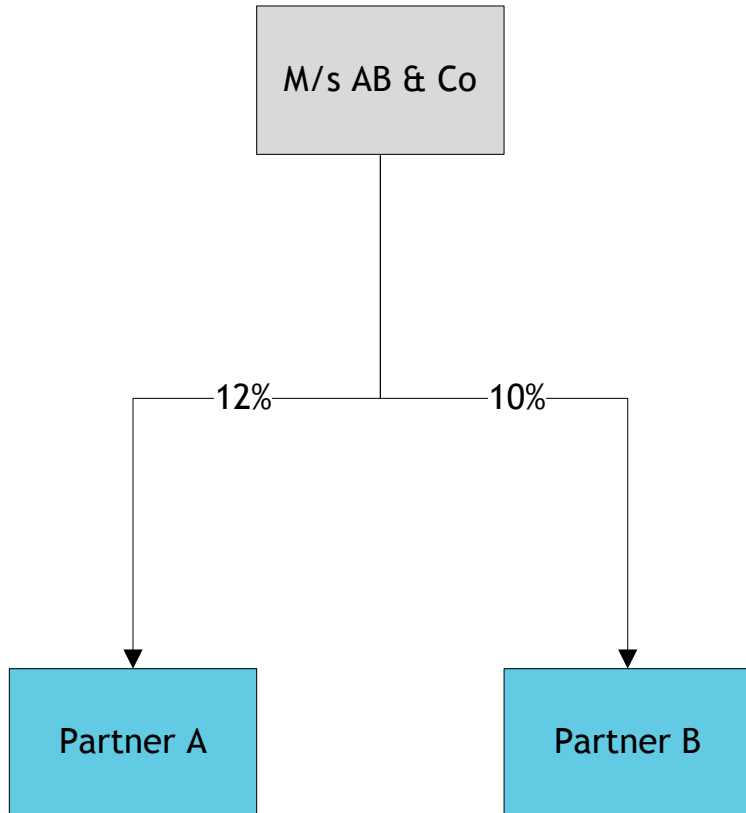
## Director's Remuneration



- Benchmarking of Director's Remuneration (Rs.3X paid to Director - Mr.B)
  - Rs.X paid to other Director - Mr.A?
  - Rs.7X paid by Y Ltd. to Director - Mr.C?
- Incase of increase in remuneration - previous years value comparable?
- What should be the approach for benchmarking Director's Remuneration?

# DOMESTIC TRANSFER PRICING

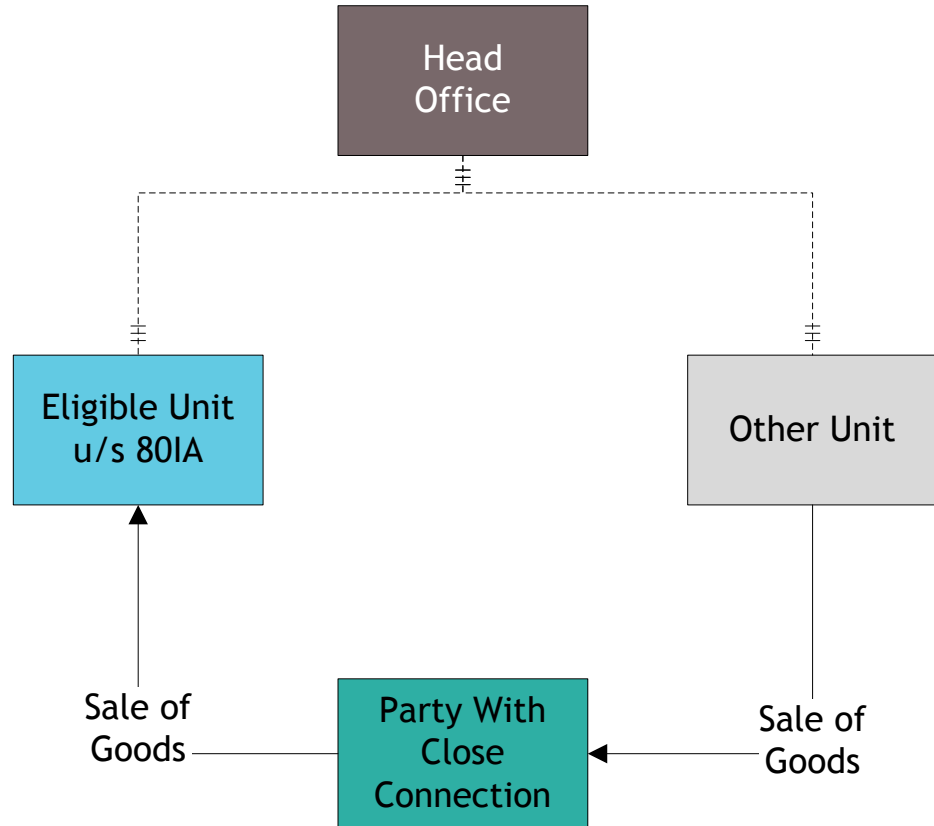
## Interest to Partners



- Benchmarking of payment of interest to partner - covered under section 40(b)
  - Is section 40A(2)/ transfer pricing applicable? Should ALP be determined?
  - Can 12% interest rate as provided by section 40(b), be considered as ALP?
  - Can payment of interest @ 15% be justified if ALP = 15% or more? Can section 40(b) disallowance be made to the extent of 3%?
  - If ALP = 9%, is section 40(b) still applicable? If interest is paid @ 12%, will 3% be disallowed?
  - What will be the scenario in case of remuneration?

# DOMESTIC TRANSFER PRICING

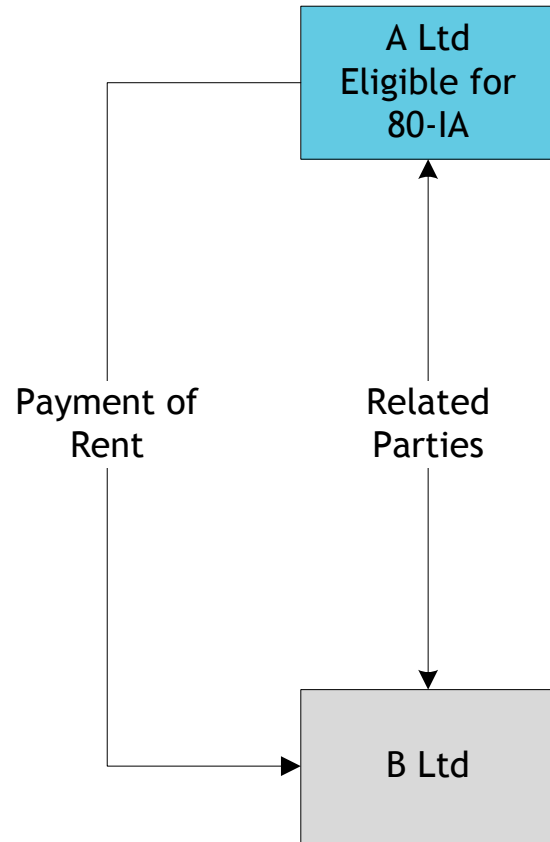
## Close Connection u/s 80-IA(10)



- Will Domestic TP be applicable to such a transaction structure?
- Close Connection under section 80-IA(10)
- What if the intermediary does not have a close connection with the taxpayer?
- “any other reason” - section 80-IA(10)
- Is the business transacted so arranged...?
- Practical issues in reporting in Form 3CEB / justification of arm’s length price?

# DOMESTIC TRANSFER PRICING

## Section 40A(2) Vs. Section 80-IA



- Assume, arm's length price of the rent paid is Rs. 100 Cr.
- What if the transaction price is Rs. 80 Cr.?
- What if the transaction price is Rs. 120 Cr.?
- Practical issues in price setting!

# DOMESTIC TRANSFER PRICING

## What When Benchmarking Is Not Feasible

- Exhaust all possible sources of benchmarking & documents
- Demonstrate due diligence
- Reliance on International Guidance
- Reliance on Expert Opinions
- Documentation for inter-company negotiations
- Documenting complete transactional profile
- Next best possible comparable (Lateral Comparable)
- Earlier/subsequent year's benchmark
- Group level transfer pricing policies
- Industry best practices
- Compile robust documentation for each stage





# KEY TAKEAWAYS

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# KEY TAKEAWAYS

## Mitigate Transfer Pricing Risks

- Expanded coverage
  - Expanded definition of AE and Enterprise
  - Capital transactions covered
  - Specified domestic transactions
  - Business Restructuring
- No provision for revision of Form 3CEB
- Increased penalty exposure
- Importance of
  - Management Representation Letter and its coverage
  - Disclaimers in Documentation
- **DOCUMENTATION IS THE KEY**





# THANK YOU

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