

## **ANALYSIS OF DOMESTIC TRANSFER PRICING PROVISIONS INTRODUCED BY THE FINANCE ACT, 2012**

- Kritika Sharma\*

### **1. INTRODUCTION**

Levying taxes is an integral part of revenue collection for any Government and an indispensable means for economic development. Thus, it is only natural for the Government to take all possible steps available to it under the law to levy tax and combat the ever-evolving tactics of tax evasion.

Tax evasion in its simplest form is just not paying your taxes. However in its more evolved and sophisticated form, it is an intricately connected web of complex transactions that on a casual glance appear completely genuine and unsuspecting and therefore would not ordinarily raise doubt or question.

The estimate is that illicit financial outflows from the developing world totalled a staggering US\$ 946.7 billion in 2011, with cumulative illicit financial outflows over the decade between 2002 and 2011 of US\$ 5.9 trillion. Some of this was on account of elusive profit allocation through innovative techniques adopted in international transactions.<sup>1</sup>

Such complexities in the international transactions lead to the formulation of 'Transfer Pricing Regulations' in 2001. This brought about transparency in international transactions leading to accrual of taxes.

Of late however, these complex transactions have taken on a domestic hue causing loss of revenue to the State. The impact of this new and

---

\* Student, Amity Law School, Noida

<sup>1</sup> Dev Kar, Joseph Spanjers, Illicit Financial Flows from Developing Countries: 2003-2012, available at <http://www.gfintegrity.org/wp-content/uploads/2014/12/Illicit-Financial-Flows-from-Developing-Countries-2003-2012.pdf> last updated in December, 2014.

unique form of financial jugglery at a domestic level is huge on the tax garnering measures by the Government. This step was taken for extending transfer-pricing regulations to domestic transactions through the Finance Act, 2012.

## 2. TRANSFER PRICING

To understand the concept of transfer pricing in its entirety, one has to go to its genesis, which is cross-border transactions.

Let us take an example of a domestic Indian company that is a subsidiary of an overseas parent company. The rates of taxation in the country of the parent company are lower than India. In this scenario, the subsidiary receives technical expertise and other necessary assistance from the parent company to assist it in the manufacture of a certain kind of product. The domestic subsidiary in turn, exports this manufactured product to the parent company at Rupees 100 per product. Similar products produced by independent comparable companies cost Rupees 150. Therefore, it can be said that the domestic Indian company undersells its product back to the parent company. It discloses far less profit as compared to other similar comparable products. Therefore, what really happens is that the Indian subsidiary company transfers its profits to the overseas parent company because the tax rates in the country of the parent company are lower than those in India.

If such a transaction is permitted at Rupees 100, the revenue earned through taxes in India would be far less when compared to similar products as this mechanism permits transfer of profits to the parent company overseas where the rates of taxation are less. Therefore, while this may not amount to tax evasion per se, it is certainly not the quantum of tax that ought to have been paid had the price of the product been calculated on the basis of comparable cost of similar products.

In order to rationalize this apparent anomaly, a method was introduced where the authorities, while assessing such transactions between the Indian subsidiary company and its parent company abroad, for the purpose of computing the income of the Indian company, take value of the sale price at Rupees 150, which is termed as “arm’s length price”, and thus make subsequent adjustments to the true income of the

assesse, which is the Indian subsidiary company. Adjustments, which are made to the controlled price by determining and calculating the arm's length, price of a transaction through different methods as listed and elaborately discussed under the Income Tax Rules, 1962.

This exercise of evaluating controlled transactions with similar uncontrolled transactions by finding comparable products and then subsequently making adjustments, if any, through these various methods of fixing arm's length price is known as "Transfer Pricing".

Therefore, in the year 2001 by means of the Finance Act, 2001, Section 92 was substituted by Sections 92 to 92F, thereby bringing into the Indian Income Tax Act, 1961 (hereinafter referred to as "1961 Act") provisions that dealt with transfer pricing.

These sections dealt with everything concerning such transactions ranging from definitions, methods of calculating the arm's length price of various international transactions, specifications regarding which transactions constituted international transactions under these provisions, specifications of who can come within the purview of being an associated enterprise, documentation required to be kept by the taxpayers to whom these provisions applied and the penalties they would face for non-compliance thereof.

Thus, in order to fall under the ambit of transfer pricing through these provisions, the following three essentials are required:

- (i) There has to be an 'international transaction',
- (ii) It has to take place between 'associated enterprises', and
- (iii) It has to be calculated at arm's length price.

With the introduction of the aforementioned Sections to the 1961 Act, provision was made to tax international transactions on their real value. This however left a vacuum for similar transactions that are domestic but which, as in the case of international transactions, do not portray the correct taxable value. Therefore, there arose a need to introduce provisions to cater for domestic transactions that are similar to those which are international in nature. Section 92BA was introduced through

---

<sup>2</sup> Sections 92-97, the Income Tax Act, 1961.

the Finance Act, 2012 to cater for this very situation.

The provisions introduced in 2012 include certain specified domestic transactions under the transfer pricing provisions of the 1961 Act, provided that:

- (i) there must be a 'specified domestic transaction',
- (ii) it must be between 'related parties', and
- (iii) It must therefore be calculated at arm's length price.

The provisions for penalties in lieu of failure of such documentation and compliance have thus effectively been extended to include these specified domestic transactions.

In order to explain domestic transfer pricing, let us take another example of Company A, which is owned by the same person who owns Company B. Company B, unlike company A, enjoys no tax benefits as a result of which the owner shifts his profit from company B to Company A by selling raw material from Company A to Company B at prices substantially higher than those usually accounted for in similar transactions. The authorities shall thus assess this transaction at its arm's length price and accordingly make adjustments to Company B's income. This would qualify as domestic transfer pricing.

### **3. NEED FOR PROVISIONS FOR DOMESTIC TRANSFER PRICING**

The visible need for specific provisions that would stipulate conditions to keep a check on the practices related to domestic transfer pricing was envisaged in *CIT v. Glaxo Smithkline Asia Pvt. Ltd.*<sup>3</sup>, wherein the Supreme Court expressed the need to put into place a mechanism to consider the fair market value of domestic transactions where the tax authorities had reasons to suspect a transfer of profit. Consequently, of the need expressed by the Supreme Court, the Government amended the existing legislation to include domestic transfer pricing.

---

<sup>3</sup>*CIT v. Glaxo Smithkline Asia Pvt. Ltd.*, 12 SOT 221 (Del).

It is pertinent to note that the reason International transactions were originally brought within the purview of Transfer Pricing Regulations was due to the rise in the trend of transferring profits from an enterprise situated in country with higher tax rates to its Associated enterprise situated in another country with lower tax rates, thus decreasing the net profit paid by the main enterprise. This thereby resulted in decreased revenue in the country where the Assessee company was situated.

Thus, Transfer Pricing Regulations were adopted to combat this developing masked method of evading taxes.

If this were to happen between domestic enterprises, one would not consider it an evasion of taxes since if one company were to transfer its profits to another for had better organize its taxes, the result would ordinarily be revenue neutral though this does not always hold true.

In order to appreciate the reason for this, one has to examine certain fundamental terms that are taken into consideration to assess the true value of transactions.

### ***3.1. Comparable***

This term relates to data with respect to the value of a transaction between unrelated parties in an uncontrolled transaction used as a comparison with the value of an international or specified domestic controlled transaction, wherein the two transactions in essence are similar to each other.

### ***3.2. Revenue Neutral***

This term is used to describe the situation where the amount of revenue or tax collected by the Government remains the same irrespective of there being various changes vis-a-vis increase for revenue from one source and decrease in another. For example, X the owner of Company A shifts his profits to another Company he owns, Company B, both of which do not enjoy any benefit of deductions via a Tax Holiday. In this scenario, the tax levied, although varied, shall be the same had such a transaction not occurred. This kind of situation, which provides the Government with the same value of tax that it is entitled to receive, had the transaction not occurred, is termed Revenue Neutral in nature.

### ***3.3. Controlled v. Uncontrolled transaction***

A controlled transaction is a transaction between associated enterprises; these could be resident or non-resident, for instance, a transaction between Company Y and its subsidiary Company YZ or a transaction between two companies both owned by Mr. A.

An uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident<sup>4</sup>, therefore being determined by the forces of market conditions.

The Apex Court, in *CIT v. Glaxo Smithkline Asia Pvt. Ltd.*<sup>5</sup>, observed that in the case of a domestic transaction, under-invoicing of sales and over-invoicing of expenses would ordinarily be tax neutral. However, it creates tax arbitrage like situation.

This usually happens in the following two cases:

- (i) If one of the related Companies is loss making and the other is profit making and profit is shifted to the loss making concern, and
- (ii) If there are different rates for two related units (because of different status, area based incentives, nature of activity, etc.) and if profit is diverted towards the unit on the lower side of tax arbitrage.

For example, it includes sale of goods or services from a non-SEZ area (taxable division) to a SEZ unit (Non-taxable unit) at a price below the market price so that the taxable division will have less profit taxable and non-taxable division will have a higher profit exemption.<sup>6</sup>

### ***3.4. Tax Arbitrage***

A tax arbitrage takes place when there are certain Tax Holidays, deductions, or investment programs that offer a tax reduction and elimination to certain businesses. As a result of the presence of these tax holidays and deductions, it becomes possible to transfer profit from ‘an

---

<sup>4</sup>Rule IOA [inserted by the Income Tax (Twenty-First Amendment) Rules, 2001 w.e.f. 21-8-2001)].

<sup>5</sup>*CIT v. Glaxo Smithkline Asia Pvt. Ltd.*, 12 SOT 221 (Del).

<sup>6</sup>*Durga Rice & Gen Mills v. Assessing Officer Village Ajrawar Ward 3, Kaithal/Ismaillabad, ITA No. 360/Chd/2012.*

industry without such benefits' to 'one that has a tax holiday' thereby considerably reducing the taxpayer's burden and at the same time depriving the Authorities from collecting the amount of taxes they are legally entitled to.

This is a situation where taxpayers, through domestic transactions between related domestic parties utilize the benefits accruing to one of them and accordingly transfer their profits to the lesser tax-paying unit, via expenditure, etc., thus resulting in a different and less amount of revenue to the authorities.

### ***3.5. Tax Holiday***

A Tax Holiday is a Government investment plan or program that offers a tax reduction or in various cases, a tax elimination to businesses. Generally, we use it as a method to reduce sales tax by local governments.

The Governments of developing countries, in order to stimulate foreign investment, also use the concept and mechanism of Tax Holidays. Developing countries adopt this method to increase their GDP (Gross Domestic Product).

## **4. POSITION PRIOR TO THE FINANCE ACT, 2012**

Before amendment to the Finance Act, 2012, cases of domestic transfer pricing were dealt with under Section 40A(2)<sup>7</sup> of the 1961 Act, which provided that unreasonable or excess payment made to a related party or group companies be disallowed. Such a method was upheld in judgments delivered catena of cases like *KR Motilal v. CIT*<sup>8</sup>, *Mangal Chand Tubes Pvt. Ltd. v. CIT*<sup>9</sup>.

The problem that arises here is that the provision enabled the Assessing Officer to disallow that expenditure, or part thereof, that was unreasonable or in excess without defining the terms.

It is pertinent to note that the provisions do not per se dictate 'what'

---

<sup>7</sup> Sec. 40, Income Tax Act, 1961.

<sup>8</sup> *KR Motilal v. CIT*, (1999) 240 ITR 810 (Mad).

<sup>9</sup> *Mangal Chand Tubes Pvt. Ltd. v. CIT*, (1994) 208 ITR 729 (Raj).

constitute reasonable expenditure. This, as in the case of any term left ambiguous under the provisions of law, leads to great tribulations and allows various degrees of arbitrariness that is exercised on the victims of interpretation of such ambiguous provisions. In this case, the recipient of this arbitrary exercise is the assessee, and this effectively causes an obstruction of justice. Apart from opening the door for various Revenue authorities to use their discretion without bounded parameters or limit, whether in or against the interest of various principles of equity, natural justice and fair play, it also gives the assessee ample opportunity to question the use of such discretion at each stage thus leading to unaccountable amounts of litigation crowding an already overburdened judicial mechanism.

Thus, well-defined provisions were required to give better credibility to the disallowances and adjustments made under the provisions relating to Domestic Transfer Pricing. Therefore, the need clearly arose for putting a proper mechanism in place for determining the reasonable or fair value of certain kinds of expenditure. This subsequently led to the amendments brought in by the Finance Act, 2012 that extends the application of Arm's Length Price to certain specified transactions.

Apart from unreasonable expenditure made to related parties as under Section 40A(2), the concept of Domestic Transfer Pricing, prior to the Finance Act, 2012, was also covered under Sections 801A<sup>10</sup> and 801B, which dealt with the transfer of goods and services under various circumstances.

## **5. TRANSFER PRICING PROVISIONS EXTENDED TO SPECIFIED DOMESTIC PROVISIONS THROUGH THE FINANCE ACT, 2012<sup>11</sup>**

The Finance Act, 2012 brought various changes relating to the type of transactions that would fall under the gambit of Transfer Pricing provisions, the documentation statutorily required to be maintained by the perpetrators of such transactions and the relation between the parties transacting in order for these provisions to apply.

Soon after the *Glaxo Smithkline* case, the provisions of transfer pricing

---

<sup>10</sup> M/s Tweezerman India Pvt Ltd v. Addl. CIT, 2010-TII-4S-ITAT-MAD-TP.

<sup>11</sup> CIT v. Discovery Estates Pvt. Ltd., ITA 1089/2011.



were extended to certain specified domestic transactions between related parties in terms of Section 92BA, which is the main provision that defines the concept of “Specified Domestic Transactions”.

### ***5.1. Amendments made by the Finance Act 2012 in relation to Domestic transfer pricing***

Apart from the insertion of Section 92BA<sup>12</sup>, the other amendments made in relation to Domestic Transfer Pricing include<sup>13</sup>:

- (i) The proviso to section 40A(2)(a) which adds payment to relative or close associates to the list of specified domestic transactions to be taken at Arm's Length Price,
- (ii) Extension of the meaning of related parties in Section 40A(2)(b) to include any other company carrying out business or profession in which the first mentioned company has substantial interest,
- (iii) Explanation to Section 44AB stating that the due date for furnishing a report in the case of an international transaction or specified domestic transaction being undertaken is to be 30<sup>th</sup> November,
- (iv) Amendment to Section 80A(6) extending the applicability of Section 92BA to the deductions under 10AA or 80IA to 80RRB,
- (v) Provisions of Section 80IA(8) and 80IA(10) now stating that the transactions under these sections are to be treated as Specified Domestic Transactions and are to be taken at arm's length price, and (vi) Section 90(2) and 90A(2) which extend the applicability of the provisions of Chapter X-A of this Act even in situations where they are not beneficial to the Assessee.

### ***5.2. Jurisdiction***

Unlike transfer pricing provisions related only to international transactions, the amended provisions extend to specified domestic transactions. Therefore, if proceedings were held under the premises that a ‘specified domestic transaction’ is being undertaken, then the

---

<sup>12</sup>CIT v. Discovery Estates Pvt. Ltd ITA 1089/2011.

<sup>13</sup>Chapter X-A, the Income Tax Act, 1961.

subsequent jurisdiction would pertain to transactions within the domestic territory only. In addition, the aggregate of these transactions being assessed has to exceed Rupees Five crores; only then will it evoke the jurisdiction of these provisions. However, there are some circumstances under which domestic transfer pricing provisions are not restricted to resident entities, for example, in the case of a Company paying remuneration to its non-resident director, the transaction although cross-border would still be considered as a domestic transaction.

## 6. CONCEPT OF DOMESTIC TRANSFER PRICING

The concept of domestic transfer pricing works on the same principle of transfer pricing in general but instead involves specified domestic transactions, as defined under Sections 40A(2)(b), 80IA(8), 80IA(10) and 10AA, between related parties defined under Section 40A (2)(a)(i).

Section 92BA<sup>14</sup> states that the transfer pricing provisions shall apply to certain domestic transactions and then goes on to define these transactions.

To understand intricately as to what transactions this provision extends to, that is, what transactions come within the purview of being a 'specified domestic transaction', each of the six categories of eligible transactions are dealt with separately.

The first being expenditures that have been or are supposed to be paid to the related parties as listed as under Section 40A(2)(b). This would refer to expenditures such as that on buying goods, on procurement of services, expenditure on interest payments, expenditure on salary, training services, marketing expenses, expenditure on purchase of tangible and intangible property, etc.

The second category deals with Section 80A under Chapter VI-A. This chapter deals with various deductions that the assessee is allowed to make while computation of his gross income for the purpose of assessment. We are concerned, however, with specified domestic

---

<sup>14</sup>Meaning of Specified Domestic Transactions, Sec. 92BA, Income Tax Act, 1961 (wef. 01/03/2013).

transactions, more specifically with Section 80A(6) which states the when goods and services are transferred between related parties; the consideration for said transaction has to be taken at arm's length price.

The third category of transactions deals extends the applicability of specified domestic transactions to transfer of goods and services as under Section 80IA(8) if it is observed by the Assessing Officer that they are not fair market value or at arm's length price. These would include inter unit transfers and extraordinary profits earned by units availing Tax Holidays or other tax deductions and exemptions.

The fourth category of transactions refers to Section 80IA(10) when it appears to the Assessing Officer that the assessee is accruing extraordinary profits in relation to its transactions with business, etc., and these profits accrue either due to close relations of the assessee with the other party or otherwise, then while considering the same for deductions as under the provisions of Chapter-VI, the value of these profits shall be taken at arm's length price as defined under Section 92F.

The fifth limb of Section 92BA further extends the meaning of specified domestic transactions to cover transactions under any other provisions of Chapter-VI-A or Section IO-AA, thereby including Section 80IAB, 80IB, 80IC, 80ID, 80IE, etc.

Lastly, the section also keeps the door open for various CBDT orders to add other categories of transactions to the existing list.

Not only does this provision define a specified domestic transaction but it also declares a threshold limit for these transactions. It is only after crossing this limit would such transactions come under the purview of a specified domestic transaction as per this Act and accordingly take at arm's length price. Thus, according to these provisions specified domestic transactions would, effectively yet not exhaustively, include transactions like payment for purchase of semi- furnished goods, transfer of machinery, technology, transfer of interest, royalty, transfer of goods and services in certain cases, rent, payment made to personnel and in various cases to relatives.

### ***6.1. Related Parties***

Now the question that arises is between whom such a specified domestic transfer would have to take place in order for it to invoke the

domestic transfer pricing regulations under this Act. To answer this question, Section 40A of the Act<sup>15</sup> must be read.

The term 'related parties' has effectively been defined under Section 40A (2) (b). This can be systematically analysed to cover both individuals and juristic persons and, under certain circumstances, a combination of the two. As far as individuals are concerned, the Act<sup>16</sup> provides that the ambit of related parties is to cover their various relatives. It also states specifically that when the assessee is a juristic person, that is, a company, an association of persons, a firm or a Hindu undivided family, the term related parties would take within its definition any director of the company, partner of the firm or any member of the association or Hindu undivided family and any relative of such director, partner or member. It further includes persons both natural as in the case of individuals and juristic, who have a substantial interest in the business and profession of the assessee and various persons related to such persons.

It is important to note that for a person, both natural and juristic, to be shown to have a substantial interest in the business or profession of the company, etc., such person must be beneficially entitled to not less than twenty percent of the shares of said company, etc.

## ***6.2. Computation of Arm's Length Price***

Section 92F(ii) defines "arm's length price" as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled transactions.

The computation of arm's length price is in essence a factual exercise committed to establishing that the conditions that are imposed in financial or commercial transactions between associated enterprises are astute to and in harmony with the arm's length principle. Financial or commercial uncontrolled transactions between unrelated or independent enterprises, the market forces impose various conditions and the market forces and conditions dictate these transactions. However, it is not so in controlled transactions and while a company in dealing with its related branch or other such related party might try and duplicate market conditions, the assumption is that these companies through their various

---

<sup>15</sup> Section 40A, the Income Tax Act, 1961.

<sup>16</sup>Section 40A(2)(b), *ibid*.

related parties manipulate and distribute their respective incomes in order to achieve a more favourable tax assessment. This assumption can effectively be refuted by computation of arm's length price and showing how the transaction has taken place at the same value as any uncontrolled transaction of a similar kind. Thus, the company must choose the most appropriate method of computing the arm's length price of the international or specified domestic transaction undertaken by it. Which of the five, now effectively six, methods is most appropriate for that particular transaction depends essentially on the facts and circumstances specific to the company and transaction.

Section 92C<sup>17</sup> clearly prescribes five distinct methods of determining the arm's length price of a transaction and states a sixth method being any other method as prescribed by the board. The ambiguous 'other method' contained in this provision has been given a more concrete form via the insertion of Rule 10AB to the Income Tax Rules, 1962.

Further, Rule 10B in considerable detail lists these methods. Recently in the *LG* case<sup>18</sup>, a new method named the bright line test method was used even though it is not listed as a method as under the Income Tax Act, 1961 and Income Tax Rules, 1962<sup>19</sup>. This has been a highly debated topic, discussed in several cases including *Ford India P. Ltd. v. DC IT*<sup>20</sup> and *CIT v. Glaxo Smithkline Asia Pvt. Ltd.*<sup>21</sup>.

### ***6.3. Applicability of new domestic transfer pricing provisions (w.e.f 2012-13)***

In order to fit the criteria for subsequent compliance and proceeding, three basic elements are required before an assessee can be brought under the newly inserted domestic transfer pricing provisions.

*Firstly*, the assessee must have undertaken a specified domestic transaction as defined under the Act.

*Secondly*, the said transaction must be between related parties as also defined and stated under the provisions of the Finance Act 2012.

---

<sup>17</sup>Section 92C, Computation of Arm's Length Price, Income Tax Act, 1961.

<sup>18</sup>*L.G. Electronics India (P.) Ltd. v. ACIT*, [2013] 29 taxmann.com 300 (Delhi-Trib.).

<sup>19</sup>*Pereftti Van Melle India Pvt. Ltd. v. Assessee*, ITA NO.58971DEL12012.

<sup>20</sup>*Ford India P. Ltd. v. DC IT*, (2013) 25 ITR 456 (Chennai-Trib.).

<sup>21</sup> *CIT v. Glaxo Smithkline Asia Pvt. Ltd.*, 12 SOT 221 (Del).

*Lastly*, the aggregate of the transactions undertaken by the assessee in the financial year<sup>22</sup> that qualify as specified domestic transactions should be more than five crores.

Thus only after all these three conditions are fulfilled can the authorities regard the assessee as subject to the provisions for specified domestic transactions, which in turn subject it to all the transfer pricing provisions that first only applied to international transactions.

## **7. IMPLICATIONS OF THE FINANCE ACT, 2012 WITH RESPECT TO DOMESTIC TRANSFER PRICING PROVISIONS**

### ***7.1. General Implications***

The implications of these amendments are cohesive with the purpose of their employment, that is:

- (i) To empower Revenue to adjust the income as portrayed by the assessee giving value to the arm's length price of the transaction, and
- (ii) To make detailed documentation of various transactions undertaken by the employee mandatory and subject to statutory compliance under these provisions.

### ***7.2. Less ambiguity***

It thus renders the provisions aimed at curbing the craft of domestic transfer pricing relatively unambiguous and sets down a comparatively standardized method of evaluation and assessment for combating these situations. In addition, the type of transactions that fall under scrutiny are clearly defined and listed. The specific relationship required to render to parties eligible for qualifying as related parties is detailed. The question of reasonableness, which is the root from which this amendment originated is also resolved by the mechanism of calculating the arm's length price through the various methods listed in Section 10B of the Income Tax Rules 1962. This decreases the scope of arbitrariness in the exercise of

---

<sup>22</sup>Income of the previous year is chargeable to tax and thus for the purpose of the Income Tax Act, previous year is the Financial year [F. No. 205/4/90-IT.A-II, dt. 22-05-1990 from CBDT].

discretion by the concerned authorities.

### ***7.3. Shift from Fair Market Value to Arm's Length Price***

Post Finance Act, 2012, we witness a generic change and effective shift for fair market value to arm's length price. While fair market value is calculated with basic market values and reports, arm's length price can be calculated through specific methods like cost plus method, etc. Fair market value can be taken at any pricing point of a market while Arm's Length Price is the arithmetic mean of comparable prices. While for fair market value even the one particular value is enough for comparison, the calculation of arm's length price requires a much larger sample size of comparables.

### ***7.4. Domestic Transactions to be at Arm's Length Price***

The Companies, enterprises, Hindu Undivided Families, or various other persons being the assessee, if purported to be undertaking's 'specified domestic transactions' have to show vis-à-vis detailed documentation and records that these transactions and the various considerations and the like are valued at arm's length price.

### ***7.5. Documentation***

Due to changes that are laid down in this Act that made, transfer pricing provisions applicable to these specific domestic transactions, Assesseees with no international transactions or link whatsoever also have to comply with the stringent requirements for the maintenance of detailed documents relating to these transactions.

### ***7.6. Double Taxation Conundrum***

It is to be noted that while there are provisions under this Act to make adjustments or disallow expenses at the hands of a taxpayer, corresponding adjustment is not allowed to the recipient of such income. This thus leads to circumstances where the fatiguing concept of double taxation surfaces yet again. Thus, relative adjustments are not made under these provisions. For example, if rent paid by A to a related party B worth Rupees 50 Crores is considered excessive under Section 40(A) (2) and is added to the income of A, a subsequent decrease in the income of B will not be made. In other words, the provisions only take into consideration of expenditure and not income.

### ***7.7. Transfer Pricing Adjustment***

In case it is observed that the transaction is not at arm's length price, then accordingly an adjustment shall be made with respect to the difference in the value of the transaction and the arm's length price. This adjustment in the form of a disallowance shall naturally result in enhancement of income and subsequent levy of tax or interest.

### ***7.8. Impact on the Assessee***

These provisions may have adverse implications on the taxpayer and will thus effectively make it extremely difficult for the taxpayer to organize his affairs in a manner that will benefit him in terms of taxes paid. It also includes individuals within the ambit of transfer pricing and thus adds the burden of excessive documentation and compliance on various individual taxpayers as well as the others that fall under these provisions.

### ***7.9. Impact on E-Businesses***

Under the existing regulations for foreign direct investment in India, companies with foreign investment are not permitted to carry B2C (Business to customers, for example eBay) e-commerce. Thus, in order to achieve this, such companies with foreign investment have created various models (the distinct company model, marketplace model and the private model), usually involving more than one company, both of which are invariably related to each other. These shall now come under scrutiny, given the new domestic transfer provisions, thus adversely affecting such companies.

### ***7.10. Reference to the Transfer Pricing Officer***

Section 92CA stipulates that where the assessee undertakes an international transaction or a specified domestic transaction, the assessing officer may, with the prior approval of the Commissioner, refer the computation of arm's length price under Section 92C to the Transfer Pricing Officer in relation to the said international or specified domestic transaction, if he finds it expedient and necessary to do so. Section 92CA(2) further stipulates that the Transfer Pricing Officer, after receiving a reference via the assessing officer regarding the international or specified domestic transactions undertaken by the assessee, must serve a notice to the assessee requiring him to produce, on a date specified therein, any such evidence that have may have relied on in support of his computation of the arm's



length price of the international or specified domestic transactions that have accordingly been referred to the Transfer Pricing Officer.

### ***7.11. Powers of the Transfer Pricing Officer***

Earlier, it was understood that the reference to the Transfer Pricing Officer is transaction and enterprise specific. However, in view of the insertion of sub-section (2A) and (2B) a fresh question arose as to whether the Transfer Pricing Officer, to whom a reference has been made, concerning certain international or specified domestic transactions, can in fact, consider other such international or specified domestic transactions that have not been expressly referred to him.

The answer to this question, as given the provisions of sub-clauses (2A) and (2B) of Section 92CA, is in the affirmative. The Transfer Pricing Officer can now take into consideration international or specified domestic transactions not expressly referred to him. This view was upheld in *Vodafone India Service Pvt. Ltd. v. Union of India*<sup>23</sup> and *Reebok India Co. v. ACIT*<sup>24</sup>.

### ***7.12. Section 92CA (7)***

Also, as per section 92CA(7), the Transfer Pricing Officer while calculating the arm's length price may exercise the powers of an assessing officer under Section 131(1) and Section 133(6). These are powers for summoning or calling for details for the purpose to investigation and enquiry into the matter.

### ***7.13. Westminster Principle Effectively Inapplicable***

The Westminster<sup>25</sup> principle, which is the cardinal principle in English law, states, "given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance." It was speculated that the Ramsay Principle as held in *McDowell and Co. Ltd. case* overruled this principle. However, it was applied in *UOI v. AzadiBachaoAndolan*<sup>26</sup> after observing that it was

---

<sup>23</sup>*Vodafone India Service Pvt. Ltd. v. Union of India*, [2013] 37 taxmann 250 (Bom.).

<sup>24</sup>*Reebok India Co. v. ACIT*, [2013] 32 taxman 869 (Mumbai-Trib.).

<sup>25</sup> *IRC v. Duke of Westminster* 1935 ALL ER Rep 259.

<sup>26</sup> *UOI v. AzadiBachaoAndolan*, (2004) 10 SCC 1.

still being applied in England<sup>27</sup>.

This principle allows a man to organize his taxes in a manner that will be most profitable to him within the specified provisions of law. However, all such transactions can now be challenged under the Finance Act, 2012 which effectively makes it close to impossible for a person, both natural and juristic, to structure their incomes, profits and losses.

#### ***7.14. CBDT Notification (Notification No.41-10/06/2013)***

This CBDT Circular aims to facilitate the proper implementation of the amendments brought into the Indian transfer pricing provisions through the Finance Act, 2012. It extends the application of Rules 10A, 10AB, 10B, 10C, 10D and 10E to Specified Domestic transfer thus, amending these rules and replacing the words “international transaction” with “international transaction or specified domestic transaction”. It also amends Rule 1UA to include a definition of “Associated Enterprises” that applies specifically to Specified Domestic Transactions. The CBDT also amended Form 3CEB to accommodate Specified Domestic Transactions by adding Part-C that requires information regarding the Specified Domestic Transactions entered into by the assessee just as Part- B is to contain detailed information regarding International Transactions. The annexure attached to Form 3CEB was also amended to include various Specified Domestic Transactions.

#### ***7.15. Compliances under New Provisions***

Under the new provisions, taxpayers are now required to identify any Specified Domestic Transactions that they might have entered into. If any such transactions have been undertaken and identified and the aggregate value of these transactions exceeds five crores, then the taxpayer is required to analyse these transactions and subsequently report and obtain a certificate with respect to these transactions in the format of Form 3CEB.

---

<sup>27</sup>Craven v. White, 1988 3 ALL ER 495; Mcnaiven v. Westmoreland Investments Ltd., 2001 1 ALL ER 865 (HL).

### **7.16. Provisions of Law**

Under the new provisions specified, domestic transactions are also required to be recorded and documented under the same rules and provisions related to transfer pricing as international transactions. Thus the taxpayer is required to maintain information and documentation with respect to specified domestic transactions as mentioned in Sec 92D and further stipulated by Rule 10D and is according to Rule 10E required to furnish a report in the form of Form 3CEB as under section 92E.

### **7.17. Form 3CEB**

This certificate is to be furnished and subsequently approved by a chartered accountant in its proper format, which consists of three parts and an annexure of transactions. The CBDT notification 41/2013 amended Form 3CEB and inserted a third section to it as under 'Part-C', so as to include specified domestic transactions, and to facilitate the regulation of domestic transfer pricing as envisioned in the Finance Act 2012. Thus, part A of Form 3CEB contains information and particulars of the assessee; Part-B consists of details of International Transactions undertaken, if any; Part-C consists of details related to Specified domestic transactions. As of now, five categories of information regarding specified domestic transactions are to be mentioned in Form 3CEB, which are as follows:

- i. List of Associated Enterprises with respect to the specified domestic transactions and their details and particulars;
- ii. Particulars of transactions as under section 40A;
- iii. Particulars of transactions are under section 80 IA (8), Section 80A or Section 10-AA;
- iv. Particulars relating to transactions with businesses resulting in more than ordinary profits as under section 80 IA (6);
- v. Particular with respect to any other transactions.

In addition, the new Form 3CEB requires more details and particulars and is more thorough in nature, thus expressing the newly acquired enthusiasm of the tax authorities. Thus this, coupled with other

provisions related to default of furnishing such a report and other mandatory documentation, puts an onerous responsibility on the taxpayer and chartered accountant to handle the issue of reporting very meticulously and efficiently.

### ***7.18. Required categories of Information & Documentation:***

The documentation required to be furnished by the assessee can be broadly divided into three categories; entity related, price related and transaction related.

Entity related documentation includes the profiles of the industry, the group, the enterprise, and its associated enterprises. Price related documentation would include terms of transactions, FAR analysis (Functions, assets, and risks), method selection, comparable benchmarking, budget, and forecasts. Documentation related to transactions including pricing policies, agreements, pricing related correspondence (letters, emails, etc.), business plan, management's accounts, reports, etc. For example, if the transaction is the interest paid on a loan, then details of how the interest rate was determined, details of the loan agreement and the basis on which the rate of interest is higher than the standard value of interest and other such details shall be filed.

### ***7.19. Penalties for Non- Compliance of Provisions for Domestic Transfer Pricing***

The penalties for non-compliance are severe under Transfer pricing regulations. The provisions of the 1961 Act regarding penalties to be imposed that adhere strictly to transfer pricing are stated as u/sec. 271AA<sup>28</sup>, 271BA<sup>29</sup> & 271G<sup>30</sup>

Other general provisions for imposing penalties are provided under Section 271(1)(C) which states that where the Assessing Officer or Commissioner (Appeals) during the proceedings under these provisions is satisfied that a person has conceal the particulars of his

---

<sup>28</sup>Section 271AA, Penalty for failure to keep and maintain information and documents in respect of International transactions or specified domestic transactions, Income Tax Act, 1961.

<sup>29</sup>Section 271 BA: Penalty for failure to furnish report under section 92E, *ibid*.

<sup>30</sup>Section 271 G: Penalty for failure to furnish information or document under section 92D, *ibid*.

income or furnished incorrect particulars of such income then according to (iii) of Section 271(1)(c), he can direct him to pay by way of penalty, in addition to the tax payable by him, if any, a sum which shall not be less than the amount and not more than three times the amount of tax sought to be evaded by him by reason of concealment of the particulars of his income or failure to furnish particulars of such income. This provision thus imposes a 100-300% penalty on the taxpayer.

## 8. OECD GUIDELINES AND TRANSFER PRICING PROVISIONS

The challenges faced by the OECD and developing countries while trying to develop transfer-pricing provisions, is the same, that is, the conflict between trying to protect their tax base versus not creating situations of double taxation or the uncertainties that could hamper foreign direct investment and cross border trade.

According to the OECD's Multi-Country Analysis of Existing Transfer Pricing Simplification Report, the 18 countries<sup>31</sup> answered in affirmative to the question of whether in their country transactions among domestic related parties are also subject to arm's length price:

The following 11 countries<sup>32</sup> answered in negative that domestic transactions between related parties are not subject to the arm's length principle in their country:

The country of Switzerland has defined specific rules for interactional profit allocation between associated enterprises. However, these rules do not necessarily comply with the arm's length principle.

In Slovenia, transactions amongst domestic related parties are also subject to the arm's length principle, but the arm's length principle among these domestic related parties is only used in the following circumstances or situations:

---

<sup>31</sup> Austria, Czech Republic, Denmark, Estonia, Finland, France, Hungary, Ireland, Israel, Luxemburg, Mexico, Netherlands, Norway, Poland, Spain, Turkey, United Kingdom, United States.

<sup>32</sup> Argentina, Australia, Belgium, Canada, Chile, Italy, Japan, Korea, New Zealand, South Africa, Sweden.

- i. If one of the domestic related parties in the tax period for which revenue and expenses are established, discloses an uncovered tax loss carried forward from previous tax periods; or
- ii. If one of the domestic related parties pays tax at a zero per cent rate or at a special rate, lower than the general tax rate in CITA-2; or
- iii. If one of the domestic related parties is exempt from paying tax under CITA-2.

Thus, here the arm's length principle among domestic parties is more an anti avoidance issue rather than being a transfer pricing issue.

In Germany, transactions between domestic related parties are subject to the arm's length principle only in specific cases where the domestic transaction leads to a hidden profit distribution.

## **9. INTERPLAY BETWEEN THE FINANCE ACT, 2012 AND THE COMPANIES ACT, 2013**

There is a degree of interplay among the provisions related to domestic transfer pricing in the Finance Act, 2012 and Section 188 of the Companies Act, 2013 that deals with Related Party transactions. It stipulates that any transaction proposed to be undertaken with respect to a related party shall first be put before the Board for approval and only then shall it be entered into. In addition, it mentions certain figures relating to the threshold for such transactions and states that if the proposed transaction is beyond a certain amount as prescribed in the Act, then the question of whether it should be undertaken or not shall also be placed before the shareholders of the Company.

## **10. CONCLUSION**

In conclusion, the Finance Act, 2012 has opened the door to a much higher level of stringency where transfer pricing is concerned. It has altered the way transfer-pricing regulations were looked at in India, and

by bringing domestic transactions under the purview of such regulations, this Act has effectively pushed the tax evaders into a tight corner. However, it can be said that it is purely beneficial and has no adverse ramifications. The Act imposes an immensely arduous system of documentation and onerous reporting on taxpayers, though not all of whom may even be involved in conspicuous profit allocation activities, and levies heavy penalties in lieu of failure to maintain such documentation and reports. In addition, other challenges faced include the identification of accurate comparables as under this scheme of domestic transfer pricing. To conclude, through its wide ambit that brings individuals as well within the contours of transfer pricing regulations, this Act has widened the scope of the existing provisions and has put in place a rigorous scheme of documentation and penalties.