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cutting through complexity

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Transfer pricing provisions – Specified Domestic Transactions

October 2012

Are you prepared for the change....

Transfer Pricing Trends

Global Trends

- Transfer Pricing is one of the foremost international tax issues faced by Multi-National Corporations
- Transfer Pricing adjustments lead to economic double taxation
- At least 45 countries have specific transfer pricing legislation and regulations
- Increased focus on enforcement in audits
  - Requirement for "contemporaneous" documentation
  - Greater assessment of penalties if documentation does not exist

Indian Trends

- Legislation introduced in India with effect from 1 April 2001
- Indian regulations are generally in line with OECD principles
- Detailed documentation requirements - Steep penalties up to 4% of the value of transaction in case of non-compliances
- Denial of tax incentives for Transfer Pricing adjustments made
- Since introduction of Transfer Pricing regulations in India in 2001, the Directorate of Transfer Pricing has made adjustments of approximately US $ 20 billion of which US $ 10 billion was made in the last audit cycle itself i.e. adjustment for FY 2007-08 is equal to the adjustment made for FYs 2001-02 to 2006-07

Five ASPAC countries on TP Week's Top Ten Toughest Tax Authorities for Transfer Pricing*

1	Japan
2	**India**
3	China
4	Canada
5	United States
6	France
7	Germany
8	Australia
9	Korea
10	United Kingdom

****Source: TP Week, 16 June 2010***

Finance Act 2012 – what has changed?

- Scope of TP regulations expanded to include ‘specified domestic transactions’ (‘SDT’)
  - Any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (b) of sub-section (2) of section 40A of Income Tax Act, 1961 (‘the Act’)
  - Transactions between undertakings of same taxpayer or transactions by taxpayer with closely connected persons for the purpose of Chapter VI-A of the Act (which includes tax holiday provisions like 80IA of the Act) and Section 10AA of the Act
- SDT regime applicable from FY 2012-13 where value of SDTs in aggregate exceeds INR 5 crores annually
- Preparation of Form No 3CEB and TP study report mandatory even for the SDT – hence onus of identifying and reporting all covered transactions on the tax payers
- Non-compliance with reporting requirements would now result in onerous additional penalties

SDT – Payments to related parties [Sec 40A(2)(b) of the Act]

Section 40A(2)(b) of the Act – only expenditure covered

- Refers only to 'expenditure' incurred in respect of payments made or to be made to persons specified under Section 40A(2)(b) of the Act
- Does not refer to any 'income'
- Expenditure by one group entity is income for another group entity – arm's length analysis may consider both transacting parties
- Only the entity incurring the expense will need to complete the prescribed compliances.

Capital expenditure – debatable

Who are the specified persons - Section 40A(2)(b) of the Act

Section 40A(2)(b) of the Act - list of persons/ entities to be treated as related parties/ specified persons

- Specified persons having substantial interest (i.e. more than 20% voting power or share in profits) in taxpayer's business and vice-versa covered
- Scope expanded to include sister concerns

Illustrative list of entities/ persons that may be included for a corporate taxpayer (not an exhaustive list):

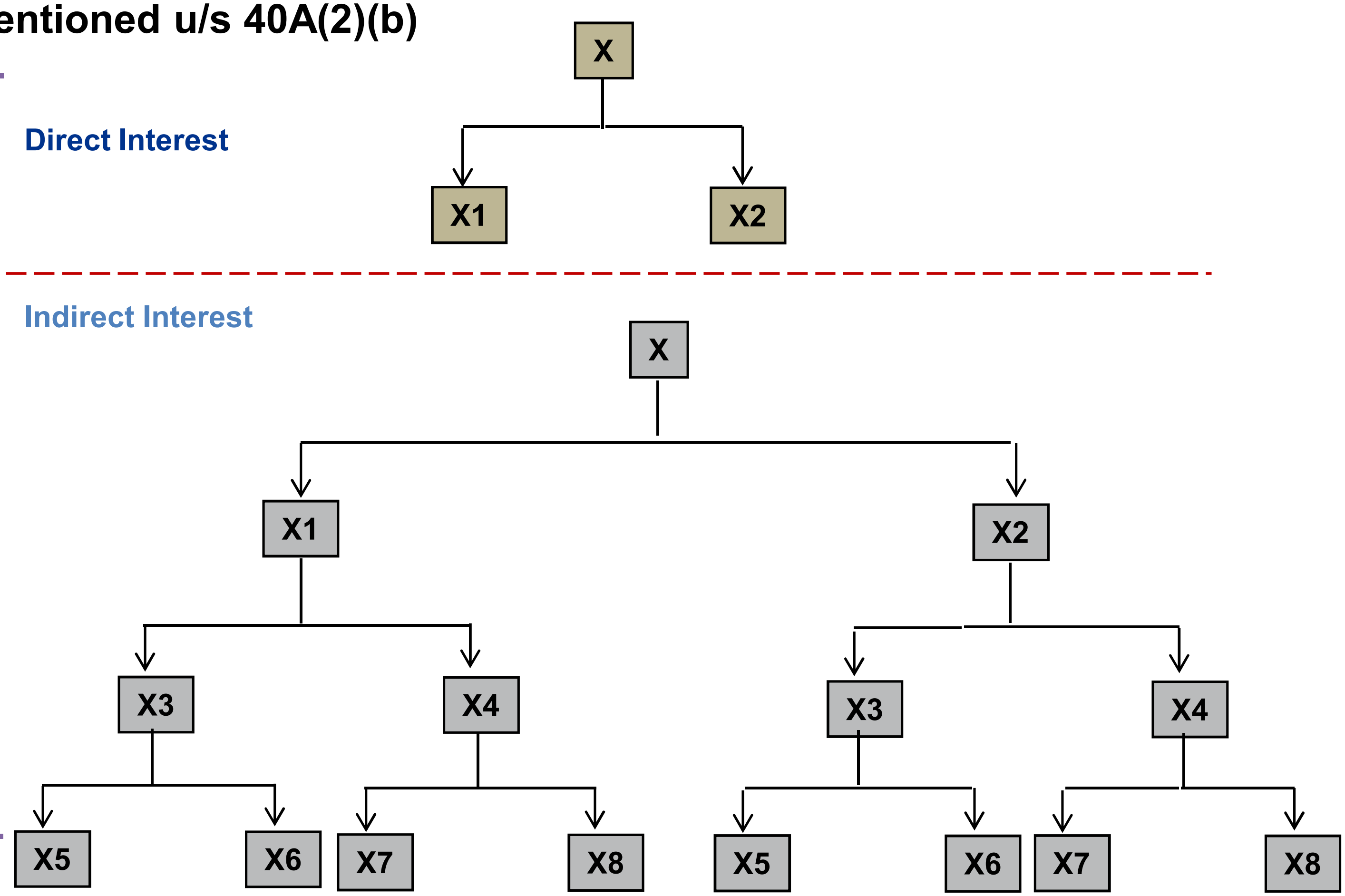
- those holding 20% or more equity in the tax payer;
- companies whose 20% or more shares are held by such a company that holds more than 20% equity in the tax payer;
- those companies in which the tax payer holds 20% or more equity;
- Directors of tax payer company, and relatives of such Directors;
- Directors of companies in category (a) above; and relatives of such Directors;
- If an individual holds 20% or more equity in the tax payer, then relatives of such an individual; all other companies where such individual is a Director; all other Directors of such a company, and relatives of all such Directors; etc

Indirect interest illustrated

Related parties as mentioned u/s 40A(2)(b)

Transactions between sister concerns now covered

Coverage - Substantial direct and indirect interest?



Key Aspects

- 40A(2)(b) covers only payments, but for tax holiday undertakings, both income and expenditure need to be at arm's length price (ALP)

Impact of certain transactions

- Transactions without consideration
- Capital expenditure

Non-conforming with ALP

- Economic Double taxation
- Penalty for non compliance

SDT –
units availing a tax holiday

Anti abuse conditions under tax holiday provisions

Sub-section (8) of section 80-IA (and similar such provisions in Chapter VI –A)

Tax holiday unit

Inter unit transfers (goods and services etc.)

Other unit

Not corresponding to market value (adherence to ALP proposed)
Appropriate allocation keys to be used to allocate costs and overheads for computation of tax holiday
Revenue will challenge use of ad-hoc allocation keys

Sub-section (10) of section 80-IA (and similar such provisions in Chapter VI –A)

Tax holiday company

Business transacted (wider than transfer of goods or services)

Other person having close connection

More than ordinary profits earned by business unit claiming deduction (adherence to ALP proposed)

Corresponding provisions to the above would be covered in Chapter VI-A and Section 10AA

Transactions to be reported in Accountant’s Report and their arms’ length nature to be substantiated in the TP Report

Possible Tax Leakages – If ALP Not Followed (Illustrations)

X Ltd.
(non-tax holiday)

Sale at 120 v/s ALP (i.e. 100)

Y Ltd.
(non-tax holiday)

Disallowance for X Ltd of INR 20

[40A(2)(b)]

X Ltd.
(non-tax holiday)

Sale at 120 v/s ALP (100)

Y Ltd.
(tax holiday)

Double Disallowance INR 40 (INR 20 for both companies)

[40A(2)(b) and excessive profit-Chapter VIA/10AA]

X Ltd.
(non-tax holiday)

Sale at 80 v/s ALP (100)

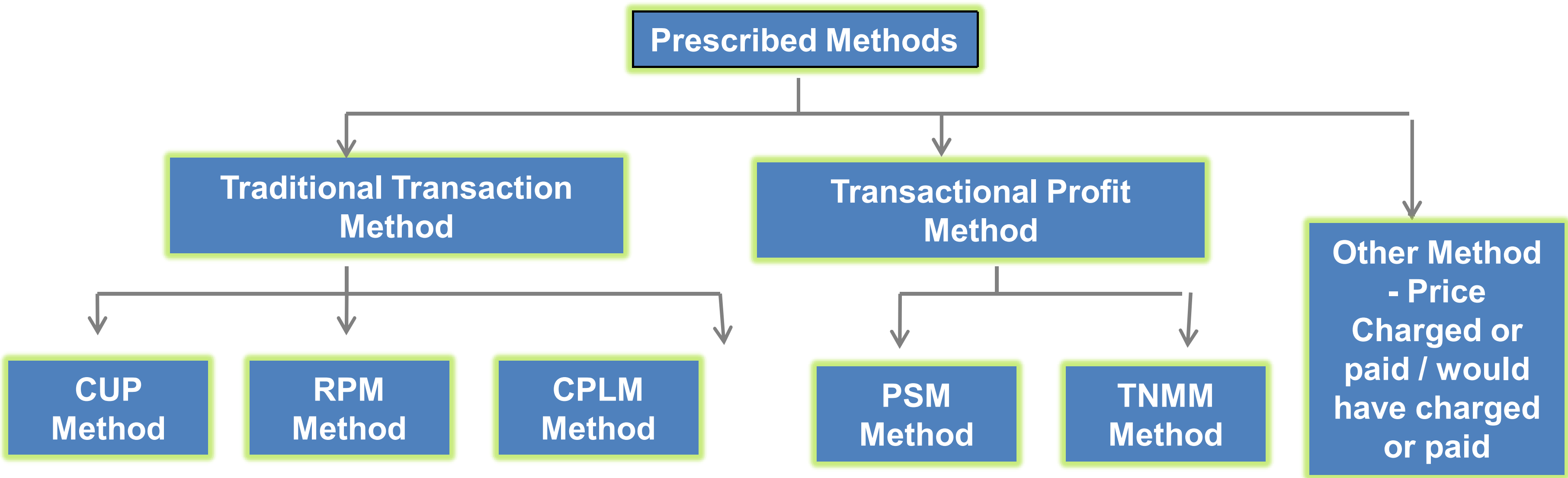
Y Ltd.
(tax holiday)

Inefficient pricing structure – Reduced tax holiday benefit

SDT –
Transfer Pricing Regime

Computation of Arm’s Length

- **Determination of ALP using one of the Prescribed methods –**
  - Best suited to the facts and circumstances of each particular international transaction and
  - Provides the most reliable measure of an arm’s length price in relation to the international transaction shall be “Most Appropriate Method”
- **Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP**



No hierarchy or preference of methods prescribed under the Act

SDT – Non-compliance may lead to significant exposure

Transfer Pricing addition – Tax payable thereon

Existing penalty provisions now also applicable to SDT

2% of Transaction Value for:

a) Non-maintenance of documents

b) Non-submission of documents

In case of adjustment

a) 100% to 300% of additional tax

New penalty provisions introduced for SDT & International Transactions

2% of Transaction Value for:

a) Non-reporting of transaction

b) For incorrect maintenance/submission of documents

SDT – Common transactions between related parties

- Purchase/lease of movable and immovable property
- Purchase of Goods / Provision of services - Domestic Procurement Company
- Centralised Corporate Services - Strategy, Marketing, Design & Engineering, HR, accounting, finance
- Common management personnel like common MD, CEO.
- Use of common facilities and Infrastructure - space, equipment,
- Payment to Managing Director / Directors
- Use of brand name or trademarks
- Group Restructuring
- Reimbursement of expenses

SDT – Key Challenges and Issues

SDT – Challenges and Issues

- **Directors Remuneration**
  - Difficult to apply any of the TP methods
  - Aggregation under TNMM method?
  - Whether regulatory/ corporate governance approvals can be considered as an evidence of arm's length conditions?
  - Remuneration paid by one company cannot be compared with other companies

- **Management Fees**
  - Maintenance of cost and benefit analysis – to commensurate the cost with the benefits derived
  - Allocation key used should be based on the nature of services and benchmarking analysis for mark-up charged
  - Proper documentation of services received from related party – Possibility of treating the services as duplicatory or shareholder or incidental services by revenue authorities
  - Selection of Tested party?

- **Cost Allocation**
  - Use of appropriate cost allocation key, adhoc- allocation keys may be questioned by revenue
  - How do we allocate certain common costs like, Managerial remuneration, Interest, Management Charges etc

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SDT – Summing Up and Way Forward

Companies should be aware that:

1. There could be significant impact on the business and cost structures due to these changes
2. There may be a need to assess impact of these changes on the business
3. Offers planning opportunities to reorganize your house
4. There may be a need to reorganize holding or transaction structures considering impact of GAAR and DTC provisions
5. Tight rope balancing while reorganizing the affairs – income-tax Vs. indirect taxes
6. Consider long term view in light of the forthcoming regimes – GAAR, DTC
7. Revising contracts and documentation to “ring fence” from potential uncertainties

Thank You