

GUIDANCE NOTE ON DOMESTIC TRANSFER PRICING

Transfer Pricing - Specified Domestic Transactions

With the Finance Act, 2012 casting its net wider to include domestic transactions between related parties, within transfer pricing regulations, more organizations and transactions will be impacted. This note provides a brief perspective on the extension of transfer pricing regulations to specified domestic transactions.

Specified Domestic Transactions

Till very recently, the transfer pricing regulations introduced in India in 2001 covered only cross border related party transactions. The Finance Act 2012, however, has extended its scope to cover even transactions between related parties in India, defined as specified domestic transactions.

This will have a two-fold impact. Firstly, the pricing of domestic transactions will need to comply with the Arm's Length Principle by application of one of the prescribed methods. Additionally, there will be compliance and documentation obligations for such specified domestic transactions.

A synopsis of the regulation has been explained below.

Regulation

1. What are the transactions that would be considered as specified domestic transactions?

The following transactions, with an aggregate value exceeding INR 50 million, (approximately close to US\$1 million) are covered:

- expenditure for which payment is made or to be made to specified domestic related parties as mentioned in Sec 40A(2)(b).
- transfer of goods or services to/from eligible business (tax holiday undertaking) from/to other businesses (non-tax holiday undertaking).
- business transactions between eligible business (tax holiday unit) and other person(s) producing more than ordinary profits owing to close connection.
- any other transactions as may be prescribed.

2. Which tax payers are covered under specified domestic transactions?

Any taxpayer incurring any expenditure with specified domestic related parties are required to comply with the regulations.

3. How do you define a specified domestic related party?

A specified domestic related party for a company may be defined as:

- a director of the company.
- a relative of the director.
- a person who has substantial interest (carrying not less than 20% of the voting power) in the company and
- fellow related parties where a single person has substantial interest in the two tax payers.

Any tax payer incurring any expenditure for which deduction can be claimed with specified domestic related parties is required to comply with the regulations.

4. Which other tax payers are covered under specified domestic transactions?

Tax payers enjoying tax holiday benefits are covered as under:

Location based tax holidays

- Undertakings having a unit in a special economic zone - Sec 10AA
- Undertakings located in industrially backward districts (e.g. Jaisalmer in Rajasthan, Bhojpur in Bihar, etc.) - Sec 80-IB
- Undertakings located in Himachal Pradesh, Uttaranchal, or notified areas in North Eastern States (Assam, Tripura, etc.) - Sec 80-IC
- Undertakings engaged in the hotel/ convention center industry in specified areas/ districts - Sec 80-ID

Sector based tax

- Generation/transmission or distribution of power or holidays developing, operating, maintaining of infrastructure facilities, etc. - Sec 80-IA
- Company/companies engaged in refining oil, under-takings engaged in developing and building housing projects, etc. - Sec 80-IB

5. Highlight a few illustrative examples of a transaction with a related party.

A few examples are:

- normal operating business transactions, e.g., purchase/sale of goods and services, interest, etc.
- payment of remuneration to directors,
- allocation of common cost within the group entities.

6. What is the effective date for application of the proposed regulation?

- It will be applicable to all transactions entered into with effect from 1 April 2012.

Compliance requirements

7. What are the compliance requirements for tax payers that have specified domestic transactions?

Tax payers that have specified domestic transactions should comply with the following:

- maintain requisite information and documents as prescribed.
- obtain and furnish a prescribed report from an Accountant in Form 3CEB.

8. What is the due date for filing the Accountant's report and documentation?

- The Accountant's report needs to be submitted with the tax authorities by the due date of filing annual return of income. At present, the due date is 30 November.
- Documentation is not required to be submitted along with the Accountant's report, but should be in place by the due date. It does need to be submitted during the course of the audit/assessment.

Documentation

9. Is there any prescribed list of documentation to be maintained?

The documentation would mainly include the following:

- ownership structure and group profile.
- industry and business analysis.
- Functions, Assets and Risks analysis. (FAR analysis)
- selection and application of most appropriate method.
- comparability analysis
- determination of arm's length price.

Economic Analysis - Comparables Search

10. How can the search for potential comparables be conducted?

Apart from internal data available external comparables may be searched on the basis of information available on websites, industry magazines and databases including Prowess and Capitaline.

Methods for determining Arm's Length Price

11. Are there prescribed methods to determine arm's length price?

The arm's length price has to be determined by applying any of the following methods:

- Comparable Uncontrolled Price Method (CUP)
- Resale Price Method (RPM) • Cost Plus Method (C+)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)
- Any other method as prescribed by the Central Board of Direct Taxes

Assessment/Audit

12. Who will be assessing the specified domestic transactions?

A separate cell consisting of transfer pricing officers will now assess these transactions in place of the assessing officers.

13. What is the statute of limitation for completion of the assessment?

The time limit for completion of assessment is extended to 48 months (as against 36 months currently) from the end of the relevant tax year.

Penal Consequences

14. What is the penalty for non-compliance with the regulations?

A stringent penalty regime has been prescribed:

- failure to maintain documents - 2% of the value of the transaction.
- failure to furnish documents - 2%of the value of the transaction.
- failure to report a transaction in Accountant's report - 2% of the value of the transaction.
- maintaining or furnishing incorrect information or documents - 2% of the value of the transaction.
- adjustment for incorrect pricing - 100% to 300% of the additional tax payable.

Next steps

15. How can one prepare for the regulations?

It will be necessary to identify and map the transactions which could be covered under the expanded scope of transfer pricing regulations. Such identified transactions are to be analyzed so as to comply with the arm's length principle based on the application of the most appropriate method and adequately supported by a robust economic analysis. Tax payers would be better prepared to conduct the analysis either before the transaction or when the transaction is taking place during the particular financial year and not wait till the end of the financial year.

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