Insight into Domestic Transfer Pricing Provisions

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The Finance Act, 2012 bought about a number of transfer pricing amendments, specifically the extension of the transfer pricing provisions to specified domestic transaction. The origin of the above amendment lies in the Supreme Court judgment of Glaxo Smithkline wherein the Apex Court stated the need to extend the existing transfer pricing provisions to domestic transactions. Consequent to the amendments made and the introduction of Section 92BA, the following transactions have been covered within the ambit of domestic transfer pricing regulations:-

i. ***any expenditure*** *in respect of which* ***payment has been made or is to be made*** *to a person referred to in* ***Section 40A(2)(b)****;*
ii. *any transaction referred to in section* ***80A****;*
iii. *any* ***transfer of goods or services*** *referred to in* ***Section 80IA(8)***
iv. *any* ***business transacted*** *between the assessee and other person as referred to in* ***section 80IA(10)***
v. *any* ***transaction****, referred to in any other section under* ***Chapter VI-A or section 10AA****, to which provisions of* ***sub-section (8) or sub-section (10) of section 80-IA*** *are applicable; or*
vi. ***any other transaction as may be prescribed***

and where the ***aggregate*** *of such transactions entered into by the assessee in the previous year* ***exceeds a sum of five crore rupees.***

In order to ensure a better understanding of the Domestic Transfer Pricing Regulations, it is pertinent to examine the following key issues relating to its applicability:-

Issue I **Are cross border transactions covered within the ambit of Specified Domestic Transactions? Whether a transaction can be subjected to both the Domestic and the International Transfer Pricing Regulations?**

1.1. The term **Associated Enterprise (AE)** has been specifically defined for the purposes of International and Specified Domestic Transactions, vide Rule 10A(i)/Section 92A and Rule 10A(ii) respectively. The term as is defined in relation to Specified Domestic Transactions, nowhere restricts its applicability to solely residents. Thus, where for example, a domestic company (ABC Ltd.) and a foreign company (non-resident) (XYZ Ltd.) are related to each other in any manner specified in Section 40A(2)(b) of the Act and an expenditure is incurred in relation to which payments are being made by ABC Ltd. to the foreign company XYZ Ltd. then although such transaction going by its literal meaning is not a "Domestic Transaction", it shall continue to be governed by the Domestic Transfer Pricing Regulations, subject to para 1.2 below.

1.2. The term Specified Domestic Transaction has been defined by Section 92BA of the Act to mean any transaction as discussed thereunder but specifically excludes international transactions from its scope. The relevant portion of the Section has been reproduced as hereunder:-

*"For the purposes of this section and sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions**, not being an international transaction,** namely :— ….."*

Amongst other criterias, as is specified in Section 92A, enterprises are deemed to be associated for the purposes of international transaction where one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise. Whereas Rule 10A(ii) read with Section 40A(2)(b), specifies a requirement of substantial interest i.e. beneficial ownership of shares/profits constituting not less than 20% of the voting power/profits of the business in order to be classified as associated enterprises for the purposes of specified domestic transactions. In continuance with the aforementioned example, the classification of a transaction of purchase of goods by the domestic company M/s ABC Ltd. from M/s XYZ Ltd. as international/domestic transaction is discussed in the light of the following two situations:-

Case A:-

The domestic company ABC Ltd holds 30% of the equity share capital of the foreign company XYZ Ltd. Such enterprises shall be deemed to be associated enterprises within the meaning of both Rule 10A(i)/Section 92A and Rule 10A(ii). In such cases, the transaction of payments for purchases by ABC Ltd. from XYZ Ltd. may be classified as both International and a Specified Domestic Transaction. However, pursuant to the exclusion carved out by Section 92BA, since such cross border transaction falls within the ambit of an International Transaction as is defined in Section 92B, the same shall automatically fall outside the scope of the Domestic Transfer Pricing Regulations.

Case B:-

The domestic company ABC Ltd. holds 21% of the share capital of the foreign company i.e. XYZ Ltd. Since the substantial interest of the foreign company in the domestic company is less than 26% as is required by the provisions of Rule 10A(i)/Section 92A, accordingly they cannot be classified as associated enterprises so as to fall within the ambit of International Transfer Pricing Regulations. However, such enterprises are regarded as associated enterprises under Rule 10A(ii) read with section 40A(2(b) for the purposes of domestic transfer pricing. Thus, in the absence of being classified as an International Transaction, such transaction between the associated enterprises shall continue to be governed by the Domestic Transfer Pricing regulations.

Issue II **Does the term expenditure as is used in clause (i) of Section 92BA, include capital expenditure?**

Clause (i) of Section 92BA of the Act, covers **expenditures incurred** in respect of which **payment has been made or is to be made** to a person referred to in **Section 40A(2)(b)**. The legislative intent behind the introduction of the relevant sub-section of Section 92BA as is specified in the Memorandum to the Finance Bill, 2012 was *"to provide applicability of transfer pricing regulations (including procedural and penalty provisions)* ***to transactions between related resident parties for the purposes of computation of income, disallowance of expenses etc. as required under provisions of sections 40A*** *……..".*

Thus, it is pertinent to examine the nature of transactions covered u/s 40A. The provisions of section 40A, begin with a non-obstante clause, stating that the provisions contained therein shall have an overriding effect over all other provisions pertaining to the computation of the income under the head Profits and Gains of business and profession. The provisions of the Section are computational in nature and specifically pertain to

determination of disallowances in respect of such expenses which are otherwise allowable when computing Income under the head Business and Profession.

The provisions of Section 37(1) specifically disallow expenditures of a capital nature in computing income under the head profits and gains from business and profession. Accordingly, where the expenses are disallowed at the very instance, the question of their allowability/disallowability u/s Section 40A(2)(b) of the Act in relation to the persons specified therein does not arise.

Thus, a combined reading of Section 40A (2)(b) with Section 37(1) suggests that capital expenditure shall not fall within the ambit of Section 40A(2)(b). Accordingly, the provisions of Specified Domestic Transactions pertaining to "expenditure incurred in respect of which payments are made to persons specified in Section 40(A)(2)(b)" should also be solely confined to revenue expenditure.

Issue III **Whether the threshold limit of Rs. 5 crore applies to the aggregate amount under all the relevant sub-sections of Section 92BA or individually to each sub-section?**

The provisions of Domestic Transfer Pricing are triggered where the **aggregate value** of all the transactions enumerated in Section 92BA and entered into by the assessee in the previous year **exceeds a sum of five crore rupees,** even though the value of each such transaction may individually be less than five Crores.

The threshold limit of Rupees 5 Crores may be computed on the basis of the method of accounting as is regularly employed by the assessee. The threshold may be determined either on a net basis without including indirect tax levies in case the assessee is availing the credit of such taxes, or on a gross basis in case the assessee is not availing the credit.

Issue IV **Whether indirect shareholding is covered within the ambit of Section 40A(2)(b)(iv) so as to qualify as a specified domestic transaction?**

Section 40(A)(2)(b)(iv) of the Act covers transactions between Companies having the same parent company holding a substantial interest of not less than 20% in each of these companies. For instance where XYZ Ltd. has a substantial interest of 25% each in ABC Ltd. and DEF Ltd. the transactions between ABC Ltd. and DEF Ltd. shall also be covered within the ambit of Section 40(A)(2)(b)(iv).

The term substantial interest has been defined by the explanation to Section 40A(2)(b) to include beneficial ownership of shares carrying not less 20% of the voting power. The concept of beneficial ownership has been discussed in Para 4A.16 of the Guidance Note on Transfer Pricing wherein it is clarified that "*The term beneficial owner needs to be construed in contrast to legal owner and not in the context of determining indirect ownership of shares.* ***This proposition is also supported by legal jurisprudence which states that in a multi-tier structure, a parent cannot be regarded as the beneficial owner of shares in a downstream subsidiary merely because is owns the shares of the intermediate subsidiary companies*****".**

The memorandum to the Finance Bill 2012 explaining the legislative intent of the amendments made to Section 40(A)(2)(b) also purports to *expand the definition of related parties for the purpose of section 40A to cover only cases of companies which have the* ***same parent company***. Accordingly, the consequent ownership of XYZ Ltd. in any company in which ABC Ltd/DEF Ltd holds substantial interest shall not be regarded as beneficial ownership for the purposes of the Explanation to Section 40(A)(2)(b). Such indirect/derivative shareholding shall not attract the provisions of Domestic Transfer Pricing.

Issue V **Whether the inter-unit cost allocation/apportionment arrangements fall within the ambit of Domestic Transfer Pricing Regulations?**

The provisions of Section 92(2) provides that **where in a specified domestic transaction**, enterprises enter into any **mutual agreement or arrangement for the allocation/apportionment of,** or any contribution to, any cost/expense incurred or to be **incurred in connection with a benefit/service/facility** provided or to be provided to any one or more of such enterprises, the cost/expense allocated/apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be. The existence of a specified domestic transaction is imperative to bring such cost allocation arrangements within the ambit of specified domestic transactions. Thus the provisions of Section 92(2) have to be read harmoniously with Section 40(A)(2)(b), 80(IA)(8) and 80(IA)(10) in order to determine the applicability of domestic transfer pricing provisions to such cost allocations/apportionments.

The cost allocation/apportionment between associated enterprises being persons referred to in **Section 40A(2)(b)** may be classified as an expenditure, thereby attracting the Specified Domestic Transfer Pricing provisions.

The provisions of **Section 80IA(8)** specifically cover transactions wherein there is a **transfer of goods/services held for the purposes of business** from an eligible business to another business carried on by the assessee or vice versa. Pure cost allocations between the eligible/non-eligible businesses to determine the appropriate profits do not entail any service. The common activities as is undertaken by the Head Office or the other units do not constitute rendering of any services. Such cost allocations on a reasonable basis are mere sharing of the costs incurred amongst the various units.

Further, the allocation of common cost is a requirement pursuant to the provisions contained in Section 80(IA)(5) wherein there exists a requirement to compute the profits and gains of an eligible business as if such eligible business were the only source of income of the assessee during the previous year. The Domestic Transfer Pricing Regulations are applicable to sub-section (8) of Section 80IA. Accordingly, a view may be taken that such cost allocations falling within the ambit of sub-section (5) shall not be regarded as Specified Domestic Transactions.

The provisions of **Section 80IA(10)** covers arrangements made during the course of business transacted between the eligible assessee and such other person with whom the assessee has close business connections. Thus, a cost allocation arrangement entered into thereto may be regarded as an arrangement made by the eligible assessee during the course of its business transactions. Accordingly, the same may fall within the ambit of Specified Domestic Transactions.