Exploring Provisions

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OVERVIEW OF SDT PROVISIONS

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PREFACE

Earlier, transfer pricing was applicable on companies with cross-border operations. However, from this financial year, the finance minister has brought domestic firms and transactions into the net.

The memorandum explaining the provisions states that while section 40A/ Chapter VI-A of Income Tax Act, 1961 empowers the tax officer to re-compute the income of the related parties if the transactions are not at fair market value, there is, however, no specific method to determine the fair market value. It is also contemplated that the methods followed to calculate ALP in international transactions shall also hold good for the purposes of SDT without validating their achievability.

SDT provisions will result in additional compliance burden on taxpayers and, in certain cases, may actually be more grueling than cross-border transfer pricing. Given the colossal litigation in the transfer pricing sphere, taxpayers may anticipate a similar destiny in the assessments of specified domestic transactions.

Purpose of this Document

Given their wide sweep, uncertainty looms over the extent and manner of application of domestic transfer pricing norms. This document seeks to study the functioning of the law and explore the potential answers to unlimited dodges.

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Disclaimer

1) EVOLUTION

Taking a cue from the Supreme Court's suggestions in the case of Glaxo Smithkline Asia, SDT provisions have been introduced [Appendix 1].

The Supreme Court had observed that tax laws may have to be amended to bring domestic transactions between related parties within the ambit of Indian transfer pricing provisions. The scope of transfer pricing regulations has now been expanded to include SDT and it covers even revenue-neutral transactions. However, to provide relief to small enterprises, it will apply only to transactions that exceed Rs 5 crore in aggregated value during the year.

2) INTRODUCTION:

The Indian Government has over the years focused on developing various sectors such as power and infrastructure, by offering tax incentives with a view to attract domestic as well as foreign investment in such sectors. The benefits provided include section 80IA, 80A and 10AA of the Act whereby entities carrying out certain qualifying activities enjoy partial or complete income tax exemption. However the fallout of such incentives is that they have sometimes been used to avoid taxes

This may result due to over-reporting of profits by the Indian entity which enjoys a tax holiday or over-reporting of profits in the tax-holiday unit within the same Indian entity.

The effect of such misuse is an erosion of India's income-tax base. Further, where losses are sought to be moderated through expense allocations in the domestic transactions with related persons, it needs to be reckoned with reference to the arm's length price. The Government intends to plug these loopholes by bringing domestic transactions within the

ambit of the transfer pricing legislation. It is noted that

the policy of broadening the ambit of TP provisions to domestic transactions is ubiquitous with most countries incorporating similar provisions in their domestic law, with certain exceptions like China, Japan and Australia.

3) THE TRANSACTIONS

Supreme Court in the case of Glaxo Smithkline Asia also noted that in the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses will ordinarily be revenue-neutral in nature, except under two circumstances:

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 (on account of different status, states, area-based incentives, nature of activity etc.) and if profit is diverted to the unit whose income is subject to a lower tax rate.

Interestingly, the I-T Act already contains provisions to curb claim of excess expenditure or re-compute income on transactions between related parties if it results in extraordinary profit in a tax-holiday enterprise/ unit. E.g.

i. Section 40A(2) empowers the tax officer to disallow excess/ unreasonable expenses between related parties. Though the insertion of sub section (2)(a) of section 40A by the Finance Act, 2012 w.e.f. 01/04/2013 prohibits such disallowance.
ii. Section 80-IA(8)/ 80-IA(10), empowers the tax officer can re-compute the income of an eligible undertaking based on the fair market value if the transactions with related parties or other undertakings of the same entity are not based on market value.

SDT, among other things, include payments to related persons and as specified in Section 40A(2)(b), and transactions/ transfers under section 80A, section 80-IA and section 10AA. The infrastructure sector, including power, which enjoys tax holiday under section 80-IA and tax payers operating in Special Economic Zones (under Section 10AA of ITA) will be governed by transfer pricing regulations from 2013-14.

3.1 Transaction relates to:

- expenditure paid or to be paid to related parties
- transfer of goods or services between units/ business claiming tax deduction and other units/ business of same assessee
- more than ordinary profits earned by business unit claiming tax holiday

3.2 "Arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions [sec 92F]

i. Arm's Length price is determined using the "Most Appropriate Method":
ii. If more than one comparable price is obtained using above methods, then the arm's length price would be 'Arithmetic Mean' of comparable prices
iii. Deviation of plus / minus three percent is permitted from arm's length price

3.3 Expenditure paid or to be paid to related parties will require to be at arm's length

When do certain payments not deductible?

Section 40 A (2) (b) can be invoked if following conditions are satisfied cumulatively:-

Condition 1: - Such payment is in respect of expenditure
for sourcing goods, services or facilities.

Condition 2: - For such expenditure, payment is made to select list of persons (see charts- Appendix 2)

Condition 3: - And such expenditure is considered as excessive or unreasonable having regard to any one of the following:-

Price variations compared to FMV. However there is a saving where FMV is comparable to arm's length price determined as per section 92F read with s. 92BA; or

Where the Assessing officer holds a view that the expenditure made by the assessee is in excess of the requirement or need of the business at the time when the expenditure was done; or

Where the Assessing officer hold an opinion that the benefit derived by or accruing to assessees as a result of the expenditure is unreasonable.

Objective of s. 40A (2)

The object of section 40A(2) is to prevent diversion of income. The Bombay High Court in Commissioner of Income-tax v. V. S. Dempo and Co. P. Ltd. (2011) 336ITR209 further explained the purpose of such section as in the case of an assessee who has large income and is liable to pay tax at the highest rate prescribed under the Act would often seek to transfer a part of his income to a related person who is not liable to pay tax at all or liable to pay tax at a rate lower than the rate at which the assessee pays the tax. In order to curb such tendency of diversion of income and thereby reducing the tax liability by illegitimate means, section 40A was added to the Act by an amendment made by the Finance Act, 1968. Clause (b) of section 40A(2) gives the list of related

persons. It is only where the payment is made by the assessee to the related persons mentioned in clause (b) of section 40A(2) of the Act that the Assessing Officer gets jurisdiction to disallow the expenditure or a part of the expenditure which he considers excessive or unreasonable.

Burden upon assessee

In cases falling under section 40A(2)(b) it is the duty of the assessee to prove and discharge its burden by leading proper evidence having regard to the price paid, legitimate business requirement and advantage derived by him and that thereafter would be subject to cross-examination by the Department.

Examples of related parties under section 40A(2)(b) [Appendix 2]

Payer	**Receiver of Payment**
Individual	• Relative of individual
Company	• Director of company or relative of the director
Association of Person (AoP) / Hindu Undivided Family (HUF)	• Member of AoP / HUF or relative of such member
Any taxpayer	1 Individual having substantial interest or his relative 2 Company having substantial interest or any director of such company or relative of such director 3 Company in whom the company having substantial interest in the taxpayer also has substantial interest (common holding) 4 Firm/ AoP/ HUF having substantial interest

or partner/ member of such person or their relatives

5 A person in whose business the individual or his relative or company/ any director or member/ any relative of such director or member has substantial interest

3.4 Comparability based on existing rules for international transactions

i. 'Price' of the transactions
ii. 'Gross margin' of company reselling products / services to unrelated parties
iii. 'Gross margin' of company selling manufactured products / services to related parties
iv. 'Splits profits' between parties to transactions based on economic parameters
v. 'Net Profit margin' (Operating Profit) of 'Tested parties'

3.5 Transfers Between Businesses of Assessee-'Some Clichés'

Only expenditure or payment subject to pricing scrutiny- Less than market rate sales or service not subject to new scheme

S. 40 A (2) (b) does not find any application where the assessee sell its goods or services at lower than the market price. In this context the Commissioner of Income-tax v. Udhoji Shrikrishnadas (MP) (1983) 139ITR827 the MP High Court in the context of agency transaction held that that even if the assessee sold bidis to the sole selling agents at a price less than the market rate, the difference between the market rate and the price at which the bidis were sold cannot be termed as expenditure incurred by the assessee. Further for the finding of the Tribunal that there was a real sole selling agency and the expenditure

incurred by way of commission paid to the sole selling
agents resulted in benefit to the business even no disallowance were warranted in that case viz a viz commission paid.

Discretion to AO

In the application of s. 40A (2) (b) the AO has the discretion to see whether the expenditure incurred is excessive or reasonable and he may or may not exercise his discretion to make a disallowance under the section. The Madras High Court in Commissioner of Income-tax v. Raman and Raman Ltd. (1969) 71ITR345 held that section 10(4A) of the Income-tax Act, 1922 (parallel to s. 40A(2) (b) , is not merely clarificatory of section 10(2)(xv) parallel to s. 37(1) as it will come into play even where the expenditure is wholly and exclusively laid out for the purpose of the business as discretion is given to the revenue to see whether the allowance is excessive or reasonable. But, under section 10(2)(xv) (parallel to s. 37(1) , there is no discretion on the revenue and once it is shown that a certain amount is wholly and exclusively laid out for the purpose of the business, there is no option for the department but to grant the allowance.

Thus in a case where the assessee has a long standing s. 40A(2) (b) relationship with a related person it would be wise to formulate ownership structure changes to do away with s. 40A(2) (b) link to avoid any disallowance under the new guidelines.

Moreover once the price incurred for an expenditure is held as comparable price on arm's length price comparison then the AO will have no reason to make a disallowance u/s 40A (2) (b) based on the ratio in Raman and Raman case (supra). This prodigy is set by the Punjab & Haryana High Court in Commissioner of Income-tax v. Amrit Soap Co. (2009) 308ITR287.

Thus where the assessee could explain the expenditure

or the payment having regard to the benefit derived from it and the commercial expediency of the same the AO may skip application of s. 40A(2) (b) altogether using his discretion as several factors could reason out allowance of an expenditure such as:

1. Withholding of tax on such expenditure;
2. No loss to revenue situation or no tax evasion being for instance where the assessee as well as the recipient are in the same tax bracket and paid the same rate of tax –See CIT v. V.S. Dempo & Co. (P) Ltd [2011] 196 Taxman 193 (Bom.);
3. Allowance of such expenditure in earlier years;
4. Proportion of business with related party viz a viz outsiders i.e. bulk sale/purchase scenario or sound business objective;
5. Assured supply may justify more than market price for instance in export business;
6. Detailed explanations by the assessee etc.

No application of s. 40A (2) (b) to Trade discount offered

The Delhi High Court in United Exports v. Commissioner of Income-tax (2011) 330ITR549 held that a trade discount is not an expenditure hence there is no question of applicability of section 40A(2)(b) of the Income-tax Act, 1961. More particularly it represents lesser sales realization so that the Court beautifully explained that this provision in the Act pertains to disallowance to an expenditure which is made by the assessee i.e. an amount actually spent by the assessee as an expenditure. The expression used in this provision is "incurs any expenditure in respect of which payment has been or is to be made to any person" (emphasis supplied). The emphasized words thus show that actual payment must be made and there has to be an expenditure incurred before the provision can be said to be applicable.

To escape application of s. 40A (2) (b) it may thus be advisable to form a discount policy among related party transactions and sign the original deals at their market prices.

Holding subsidiary transactions/ payments to associate/sister companies

The Bombay High Court in Commissioner of Income-tax v. V. S. Dempo and Co. P. Ltd. (2011) 336ITR209 held that it is only where the payment is made by the assessee to the related persons mentioned in clause (b) of section 40A(2) of the Income-tax Act, 1961, that the Assessing Officer gets jurisdiction to disallow the expenditure or a part of the expenditure which he considers excessive or unreasonable. In the context of holding subsidiary transactions it held that while the holding company is a member of its subsidiary company, the subsidiary company is not a member of the holding company. The subsidiary company is not a related person of the holding company within the meaning of section 40A(2).

In this decision the revenue side sought coverage under sub-clause (ii) or sub-clause (iv) of clause (b) of section 40A(2) and omitted to draw reference of the Court to sub-clause (vi) which more particularly may have advanced the object of the revenue as that may have covered payments to subsidiary. *The Court here was guided by the Board Circular no.6-P of 1968 dated 6th July, 1968. In that Circular the Board explained the scope and effect of provisions of s. 40A (2) and in particular wanted AO to make a disallowance viz a viz payments to associate concerns only in cases which involve tax evasion. As in this case the holding and subsidiary company were in same tax bracket the Court held such transaction outside the provisions of this section. But that does not mean that there is any blanket approval to holding subsidiary or associate company transactions.*

However, in the context of imports from holding non-resident company the situation may demand inquiry u/s 40A (2) (b) as is the case in the case of Commissioner of Income-tax v.

Samsung India Electronics Ltd.(2011) 338ITR186. For the finding of fact in this case that the raw materials were imported by the assessee subsidiary from SEC, Korea, at reasonable/competitive rates which were neither excessive nor unreasonable helped the Delhi High Court to record inapplicability of the provisions of section 40A(2)(b).

Even one instance of higher price may be sufficient to defend prices

In view of the ratio laid down in CIT v. T. T. Krishnamachary and Co. [2002] 256 ITR 82 (Mad) the court cannot interfere in a situation where another party is found to have also purchased at increased price certain goods or services.

Point wise:

i. Assessee claiming tax holiday / deductions will now be covered by Transfer Pricing
ii. Transfers between units/ business claiming tax holiday and other units/ businesses will be subject to arm's length pricing
iii. Allocation of corporate costs and overheads for computation of tax holiday
iv. Imperative to use appropriate allocation keys
v. Use of ad hoc allocation keys may be questioned
vi. Transfer of semi-finished goods between domestic units and tax holiday units
vii. Valuation of transfers between business units
viii. Excise law provides valuation based on market price followed by 110% of cost of production based on Cost Accounting Standard 4 (CAS-4)
ix. Capital transactions including transfer of machinery, technology, etc. will be subject to arm's length pricing

x. As per Foreign Trade Policy/ SEZ Regulations, transfer of used capital assets to be carried out at Written Down Value arrived at after provision of depreciation at prescribed rates

xi. Will notional mark-up / profitability be imputed for transfer of goods / services between different units of same assessee?

xii. Covers transactions referred in Sec 80A and Sec. 80IA(8)

3.6 Excessive Profits of Tax Holiday Units

i. This is an anti-abuse provision brought to check the excessive tax holiday claims

ii. Generic framework of 'More than ordinary profit' was provided in law to compute the excessive tax holiday claims

iii. Various Tribunal rulings in favor of taxpayers virtually made this clause redundant

iv. To plug the loophole, it is now proposed to compute more than ordinary profits through the 'arm's length price' mechanism

Typically, due to the legal and commercial requirements in the infrastructure sector, a separate entity is formed for each project. In many cases, a separate entity is also formed for the operation and management services provided to group entities. The domestic transfer pricing provisions require such entities to charge arm's length price for the support services provided to group entities.

Capital financing could emerge as a key area in domestic transfer pricing, say consultants. Many domestic companies make inter-corporate advances and give guarantees to group

firms. At market rates, these transactions attract charges of three-four per cent. These charges will be added to the taxable income

4) Method of Calculation of FMV

It is contemplated that the methods followed to calculate ALP shall continue to apply on SDT. In this context it would definitely be unfair to compare the profits of Delhi manufacturing Company with that of US manufacturing Company. More precisely in Indian context:

- Comparing Companies between Developing countries and Developed countries
- Comparing companies between developing companies and developing countries

Accordingly, TNMM method shall have nil applicability in domestic transaction and CUP method logically is the generally acceptable method leaving all the software using international comparable redundant. AO would not like to compare the net profit margin of an Orissa based manufacturing / Service Company with the tested parties from US based companies and for that matter net profit margin of Mumbai based manufacturing / Service Company with the tested parties of Bangla Desh based companies. Though one can always compare FMV intra Indian industries. There will be lots of comparable available within the country given their location conditions and considering the state exemptions. It would thus be pertinent for the Government to bring out a clarification on all such issues so that domestic transfer pricing provisions can achieve the purpose for which they were introduced.

5) COMPLIANCE BURDEN

Indian taxpayers availing tax exemptions or having transactions with other related Indian enterprises or those that have several operating companies within India transacting with each other will have to face the music. At the same time, taxpayers will need to corroborate their intercompany transactions at an arm's length price by maintaining robust supporting documentation. With the revenue authorities being judicious, it would be extremely difficult for taxpayers to determine the correct/ exact arm's length price to the satisfaction of the tax officer. Any arm's length price above or below the taxpayer's calculation would lead to needless litigation.

Taxpayers will have to file Form 3CEB along with their tax return. The domestic transactions will be assessed by transfer pricing officer instead of assessing officer

6) DOCUMENTATION

5.1 Entity Related

i. Profile of Industry
ii. Profile of group
iii. Profile of Indian entity
iv. Profile of AEs

5.2 Price Related

i. Transaction terms
ii. Functional Analysis (functions, assets and risks)
iii. Economic Analysis (method selection, comparable benchmarking)
iv. Forecasts, budgets, estimates

5.3 Transaction Related

(i) Agreements

(ii) Invoices

(iii) Pricing related correspondence (letters, e-mails, fax, etc.)

7) PENALTIES / DEFAULT

Penalties/ **Default**	**Nature of penalty**
In case of a post-inquiry adjustment, there is deemed to be a concealment of income	100-300% of tax on the adjusted amount
Failure to maintain documents	2% of the value of each international transaction or specified domestic transaction
Failure to furnish documents	2% of the value of each international transaction or specified domestic transaction
Failure to report a transaction in accountants report	2% of the value of each international transaction or specified domestic transaction
Maintaining or furnishing incorrect information or documents	2% of the value of each international transaction or specified domestic transaction

8) Expenses

i. Expenses paid by domestic companies to related parties will be challenged
ii. Corresponding adjustment not permitted for disallowed expenses; will lead to double taxation
iii. Transaction within Company
iv. Company with multiple units and claiming tax holiday will be questioned on inter unit transfers
v. Authorities will attempt to reduce profitability of exempted unit for reducing the quantum of deduction

9) Way forward

As such, domestic transfer pricing provisions have come as a double-edged sword, especially for infrastructure and power sector companies. It would be pertinent for the Government to bring out a clarification on all such issues so that domestic transfer pricing provisions can achieve the purpose for which they were introduced.

The new domestic TP provisions would have significant anti-abuse effects to redress any such non-arm's length pricing of domestic transactions.

In what appears to be a silver lining for affected taxpayers, the said TP provisions would help taxpayers formalize their product pricing methods and also enable legitimate tax cost management (TCM) opportunities. It would be possible for such taxpayers to utilize TP concepts and methodologies (such as risk -reward planning, benchmark driven pricing, supply chain re-engineering, location planning study, etc.) for both commercial gains and TCM purposes

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APPENDIX 1

[2010] 195 TAXMAN 35 (SC)

SUPREME COURT OF INDIA

Commissioner of Income-tax-IV, Delhi

v.

Glaxo Smithkline Asia (P.) Ltd.

K.S. RADHAKRISHNAN, CJ. AND SWATANTER KUMAR, J.

SPECIAL LEAVE TO APPEAL (CIVIL) NO. 18121 OF 2007

OCTOBER 26, 2010

Section 40A(2), read with section 80-IA, of the Income-tax Act, 1961 and rule 10D of the Income-tax Rules, 1962 - Business disallowance - Excessive or unreasonable payments - Whether in order to reduce litigation, section 40A(2) and section 80-IA(10) need to be amended to empower Assessing Officer to make adjustments to income declared by assessee, having regard to fair market value of transactions between related parties by applying any of generally accepted methods of determination of arm's length price, including methods provided under Transfer Pricing Regulations - Held, yes - Whether law should also be amended to make it compulsory for taxpayers to maintain books of account and other documents on lines prescribed under rule 10D in respect of such domestic transactions and taxpayers should obtain an audit report from their chartered accountants so that taxpayers maintain proper documents and requisite books of account

reflecting transactions between related entities at arm's length price, based on generally accepted methods specified under Transfer Pricing Regulations - Held, yes

FACTS

The key question for determination before the authorities below was whether the assessee-company and its service provider were related companies in terms of section 40A(2) and whether allocation of cross-charges by the assessee was the correct test applied by the assessee. In other words, whether allocation of cross-charges should be allowed or disallowed by the department. The authorities below had recorded a concurrent finding that the said two companies were not related companies under the said section. Being aggrieved by the said decision, the matter came to the Supreme Court by way of instant special leave petition filed at the instance of the department.

HELD

As far as the instant special leave petition was concerned, no interference was called for as the entire exercise was a revenue neutral exercise. Hence, the special leave petition filed by the department stood dismissed. [Para 2]

However, a larger issue was involved in the instant case. The main issue which needed to be addressed was, whether Transfer Pricing Regulations should be limited to cross-border transactions or be extended to domestic transactions. In the case of domestic transactions the under-invoicing of sales and over-invoicing of expenses ordinarily would be revenue neutral in nature, except in the following two circumstances having tax arbitrage—

(i)If one of the related companies is a loss making company and the other is a profit making company and profit is shifted to the loss making concern; and

(ii)If there are different rates for two related units [on account of different status, area-based incentives, nature of activity, etc.] and if profit is diverted towards the unit on the lower side of the tax arbitrage. For example, sale of goods or services from non-SEZ area, [taxable division] to SEZ unit [non-taxable unit] at a price below the market price so that taxable division will have less taxable profit and non-taxable division will have a higher profit exemption. [Para 4]

All these complications arise in cases where fair market value is required to be assigned to the transactions between related parties in terms of section 40A(2). To get over this situation, the matter needs to be examined by the CBDT. The matter has been examined by the CBDT and it is of the view that amendments would be required to be made to the provisions of the Act, if such Transfer Pricing Regulations are required to be applied to domestic transactions between related parties under section 40A(2). [Para 5]

In order to reduce litigation, certain provisions of the Act, like section 40A(2) and section 80-IA(10), need to be amended to empower the Assessing Officer to make adjustments to the income declared by the assessee, having regard to the fair market value of the transactions between the related parties. The Assessing Officer may thereafter apply any of the generally accepted methods of determination of arm's length price, including the methods provided under the Transfer Pricing Regulations. However, in a number of matters, the Assessing Officer is constrained by non-maintenance of relevant documents by the taxpayers as, currently, there is no specific requirement for maintenance of documents or of getting specific transfer pricing audit done by the taxpayers in respect of domestic transactions between the related parties. One of the suggestions which needs consideration is whether the law should be amended to make it compulsory for the taxpayers to maintain books of account and other documents on the lines prescribed under rule 10D in respect of such domestic transactions and whether the taxpayers should obtain

audit reports from their chartered accountants so that
the taxpayers would maintain proper documents and requisite books of account reflecting the transactions between related entities at arm's length price, based on generally accepted methods specified under the Transfer Pricing Regulations. Normally, the Supreme Court does not make recommendations or suggestions. However, in order to reduce litigation in complicated matters, the question of amendment, as indicated above, may require consideration expeditiously by the Ministry of Finance. In the meantime, the CBDT may also consider to issue appropriate instructions in this regard. [Para 6]

Gopal Subramaniam, V. Shekhar, Arijit Prasad, Ms. Pia Singh, Tanmay Mehta, H. Raghavendra Rao and **B.V. Balaram Das** for the Appellant. **Ajay Vohra** and **Ms. Kavita Jha** for the Respondent.

JUDGMENT

1. In this special leave petition, the key question which arose for determination before the Authorities below was, whether the assessee-Company and its service provider [GSKCH] are related Companies in terms of section 40A(2) of the Income-tax Act, 1961. If the answer to the said question was to be in the affirmative, then the next question on merits which arose for determination was, whether allocation of cross-charges by the assessee was the correct test applied by the assessee. In other words, whether allocation of cross-charges should be allowed or disallowed by the Department. The Authorities below have recorded a concurrent finding that the said two Companies are not related Companies under the said section. Being aggrieved by the said decision, the matter has come to this Court by way of a special leave petition filed at the instance of the Department. In this special leave petition, we are concerned with assessment year 2001-02.

2. Having gone through the relevant material placed before us concerning assessment year 2001-02, we are of the view that, as far as this special leave petition is concerned, no interference is called for as the entire exercise is a revenue neutral exercise. Hence, this special leave petition filed by the Department stands dismissed. However, we may clarify that proceedings are pending even today at various stages for different assessment years before the Authorities under the Income-tax Act. We express no opinion with regard to those proceedings.

3. However, we direct the Authorities to examine as to whether there is any loss of revenue in any of the assessment years in question. If, however, the Authorities find that the exercise is a revenue neutral exercise, then the matter may be decided, accordingly. We say no more in that regard.

4. However, a larger issue is involved in this case. The main issue which needs to be addressed is, whether Transfer Pricing Regulations should be limited to cross-border transactions or whether the Transfer Pricing Regulations be extended to domestic transactions. In the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances having tax arbitrage—

(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 (on account 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, sale of goods or services from non-SEZ area (taxable division) to SEZ unit (non-taxable unit) at a price below the market price so that

taxable division will have less profit taxable and non-taxable division will have a higher profit exemption.

5. All these complications arise in cases where fair market value is required to be assigned to the transactions between related parties in terms of section 40A(2) of the Income-tax Act, 1961 ('Act', for short). To get over this situation, we are of the view that the matter needs to be examined by Central Board of Direct Taxes (`CBDT', for short). We are informed that the matter has been examined by CBDT and it is of the view that amendments would be required to the provisions of the Act if such Transfer Pricing Regulations are required to be applied to domestic transactions between related parties under section 40A(2) of the Act.

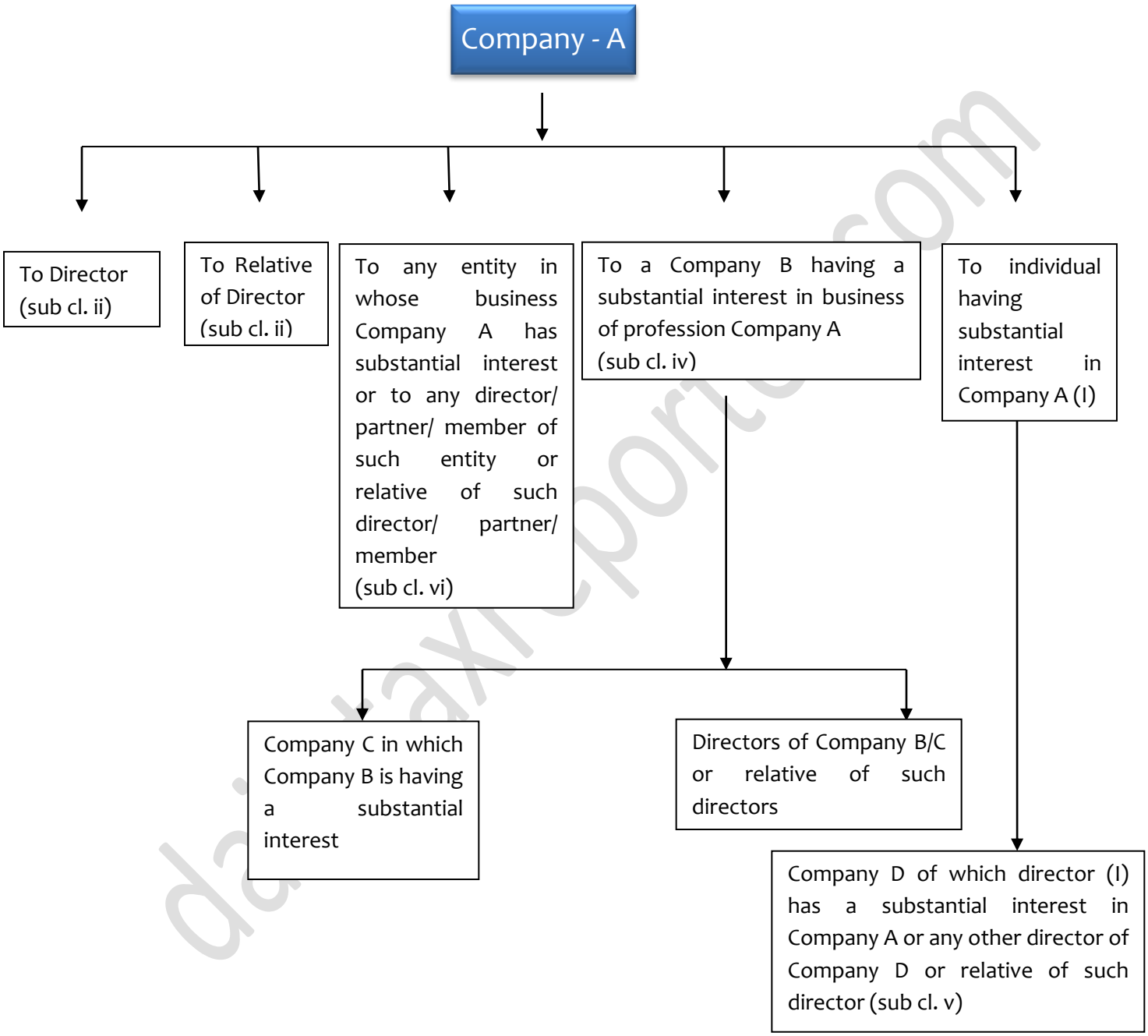
6. In order to reduce litigation, we are of the view that certain provisions of the Act, like section 40A(2) and section 80-IA(10), need to be amended empowering the Assessing Officer to make adjustments to the income declared by the assessee having regard to the fair market value of the transactions between the related parties. The Assessing Officer may thereafter apply any of the generally accepted methods of determination of arm's length price, including the methods provided under Transfer Pricing Regulations. However, in a number of matters, we find that, many a times, the Assessing Officer is constrained by non-maintenance of relevant documents by the taxpayers as, currently, there is no specific requirement for maintenance of documents or getting specific transfer pricing audit done by the taxpayers in respect of domestic transactions between the related parties. The suggestions which need consideration are whether the law should be amended to make it compulsory for the taxpayer to maintain books of account and other documents on the lines prescribed under rule 10D of the Income-tax Rules in respect of such domestic transactions and whether the taxpayer should obtain an audit report from his Chartered Accountant so that the taxpayer maintains proper documents and requisite books of

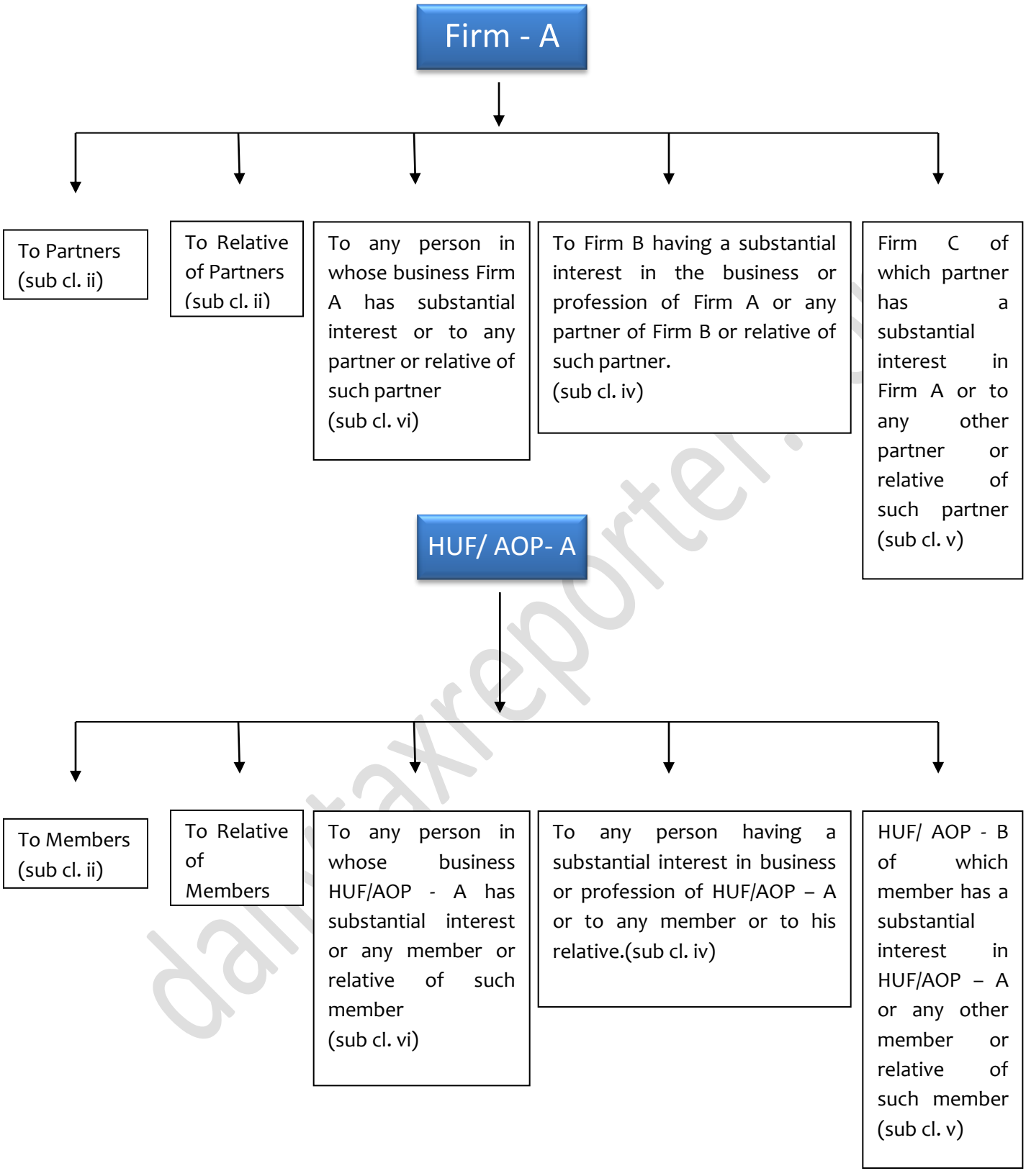
account reflecting the transactions between related entities as at arm's length price based on generally accepted methods specified under the Transfer Pricing Regulations. Normally, this Court does not make recommendations or suggestions. However, as stated above, in order to reduce litigation occurring in complicated matters, we are of the view that the question of amendment, as indicated above, may require consideration expeditiously by the Ministry of Finance. In the meantime, CBDT may also consider issuing appropriate instructions in that regard.

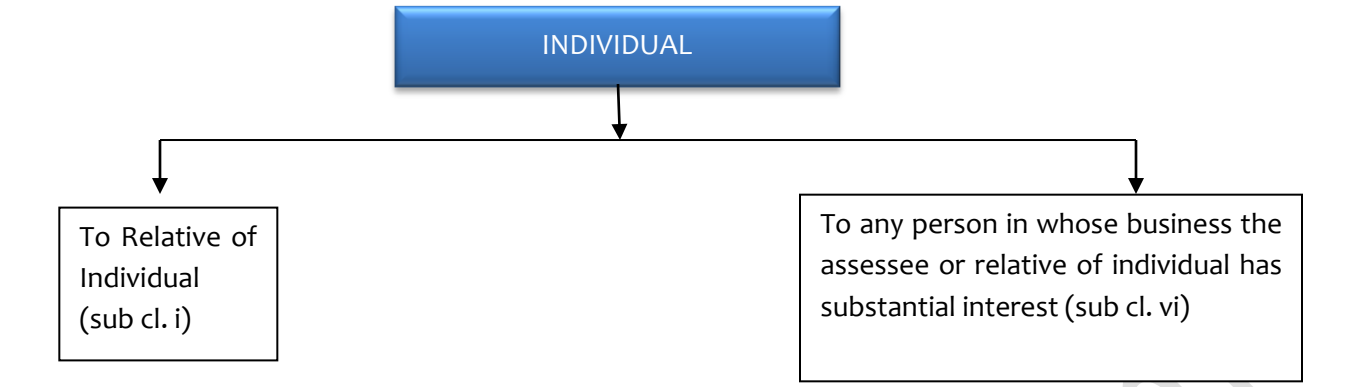
7. Accordingly, we direct the Registry to forward copies of this Order both to the Ministry of Finance and CBDT for consideration.

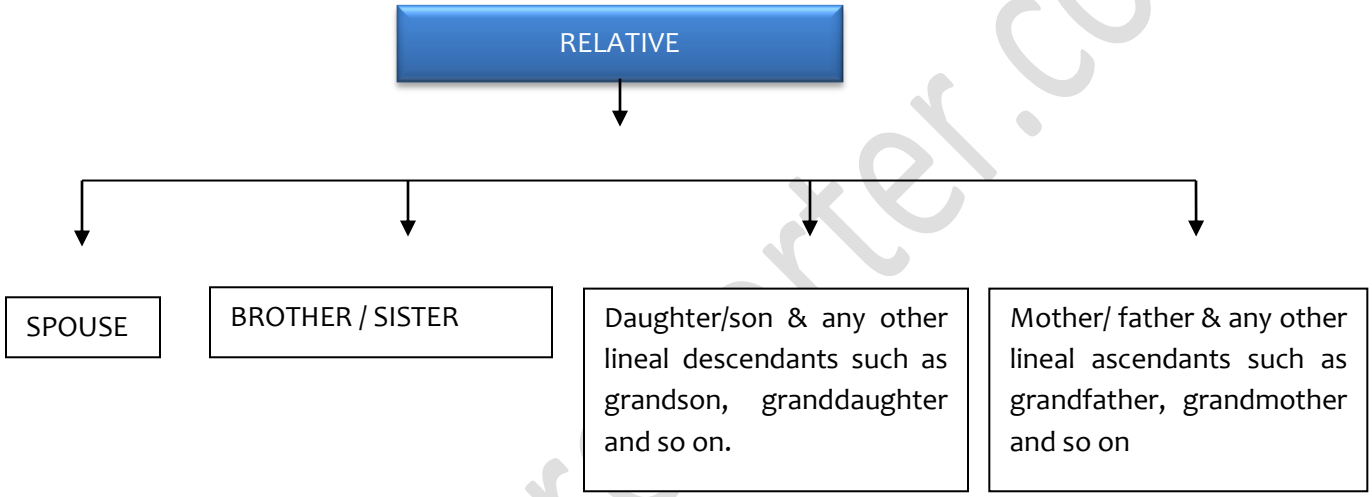
Appendix 2

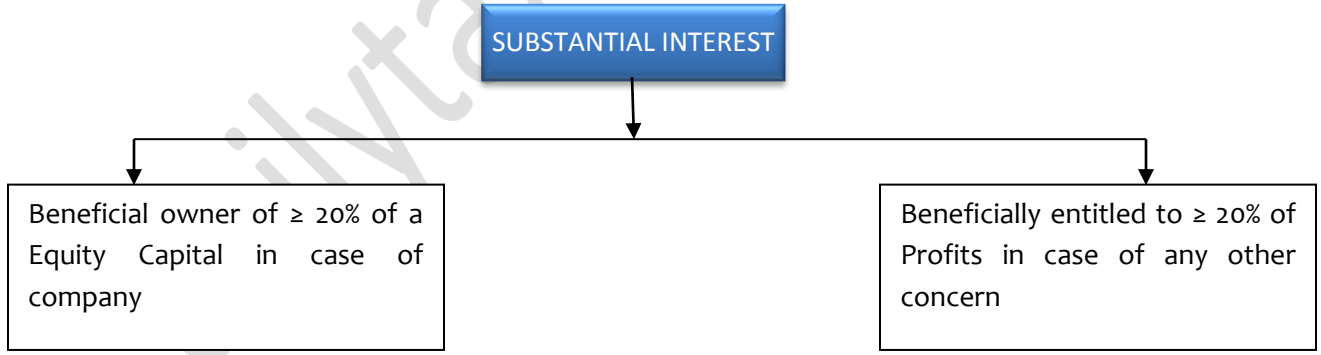
CHART OF RELATED PARTY PAYMENTS











Appendix 3

The Relevant Sections

40A. Expenses or payments not deductible in certain circumstances.--(1) The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other provision of this Act relating to the computation of income under the head "Profits and gains of business or profession".

(2)(a) Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction.

Provided that no disallowance, on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA, if such transaction is at arm's length price as defined in clause (ii) of section 92F.

(b) The persons referred to in clause (a) are the following, namely:--

(i) where the assessee is an individual	any relative of the assessee;
(ii) where the assessee is a company, firm association of persons or Hindu undivided family	any director of the company/partner of the firm, or member of the association or family, or any relative of such

director, partner or member;

(iii) any individual who has a substantial interest in the business or profession of the assessee, or any relative of such individual;

(iv) a company, firm, association of persons or Hindu undivided family having a substantial interest in the business or profession of the assessee or any director, partner or member of such company, firm, association or family, or any relative of such director, partner or member ##or any other company carrying on business or profession in which the first mentioned company has substantial interest;

(v) a company, firm, association of persons or Hindu undivided family of which a director, partner or member, as the case may be, has a substantial interest in the business or profession of the assessee; or any director, partner or member of such company, firm, association or family or any relative of such director, partner or member;

(vi) any person who carries on a business or profession,--

(A) where the assessee being an individual, or any relative of such assessee, has a substantial interest in the business or profession of that person; or

(B) where the assessee being a company, firm, association of persons or Hindu undivided family, or any director of such company, partner of such firm or member of the association or family, or any relative of such director, partner or member, has a substantial interest in the business or profession of that person.

Explanation.--For the purposes of this sub-section, a person shall be deemed to have a substantial interest in a business or profession, if,--

(a) in a case where the business or profession is carried on by a company, such person is, at any time during the previous year, the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent. of the voting power; and

(b) in any other case, such person is, at any time during the previous year, beneficially entitled to not less than twenty per cent. of the profits of such business or profession.

92BA. Meaning of specified domestic transaction.-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 :—

(i) 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 ;

(ii) any transaction referred to in section 80A ;

(iii) any transfer of goods or services referred to in sub-section (8) of section 80-IA ;

(iv) any business transacted between the assessee and other person as referred to in sub-section (10) of section 80-IA ;

(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.

Note: The underlined portion is new entries.

Board Circular

Central Board of Direct Taxes Circular No. 6-P dated July 6, 1968

Departmental circular.—The following portion of the departmental circular elaborates the scope and effect of the provisions of section 40A(2):—

Section 40A(2)—Expenditure incurred in businesses and professions involving payment to relatives and associate concerns.—'**72.** The Finance Act, 1968, has introduced a new section 40A in the Income-tax Act with effect from the 1st April, 1968. Under sub-section (2) of new section 40A, expenditure incurred in a business or profession for which payment has been or is to be made to the tax-payer's relatives or associate concerns is liable to be disallowed in computing the profits of the business or profession to the extent the expenditure is considered to be excessive or unreasonable. The reasonableness of any expenditure is to be judged having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession or the benefit derived by, or accruing to, the tax-payer from the expenditure. Such portion of the expenditure which, in the opinion of the Income-tax Officer, is excessive or unreasonable according to these criteria is to be disallowed in computing the profits of the business or profession.

73. The categories of persons payments to whom fall within the purview of this provision comprise, *inter alia*,—

(*a*) any relative of the tax-payer, or where the tax-payer is a company, firm, association of persons or Hindu undivided family, any director of the company, partner of the firm or member of the association or family, and also relatives of such director, partner or member;

(*b*) persons who have a substantial interest in the business or profession of the tax-payer, and relatives of such persons; where such person is a company, firm, association of persons or Hindu undivided family, the directors, partners and members, and their relatives;

(*c*) persons in whose business or profession the tax-payer has a substantial interest directly or indirectly.

The term "relative", as defined in section 2(41) of the Income-tax Act, means, in relation to an individual, the husband, wife, brother or sister or any lineal ascendant or descendant of that individual. A person will be deemed to have a substantial interest in a business or profession if, in a case where the business or profession is carried on by a company, the person beneficially owns shares in the company (other than preference shares) carrying not less than 20% of the voting power and, in any other case, where the person is beneficially entitled to not less than 20% of the profits of the business or profession.

74. It may be noted that the new provision is applicable to all categories of expenditure incurred in businesses and professions, including expenditure on purchase of raw materials, stores or goods, salaries to employees and also other expenditure on professional services, or by way of brokerage, commission, interest, etc. Where payment for any expenditure is found to have been made to a relative or associate concern falling within the specified categories, it will be necessary for the Income-tax Officer to scrutinise the reasonbleness of the expenditure with reference to the criteria mentioned in the section. The Income-tax Officer is expected to exercise his judgment in a reasonable and fair manner. It should be borne in mind that the provision is meant to check evasion of tax through excessive or unreasonable payments to relatives and associate concerns and should not be applied in a manner which will cause hardship in *bona fide* cases.

75. The above-mentioned provision in section 40A(2) is not applicable in the case of a company in respect of any expenditure referred to in section 40(*c*)(*i*), *i.e.*, that relating to remuneration, benefits and amenities to directors of the company, persons substantially interested in the company or to relatives of such director or person. The provisions in section 40(*c*)(*i*) will continue to govern the admissibility of such expenditure. In regard to the latter provisions, the Deputy Prime Minister and Minister of Finance observed in *Lok Sabha* (during the debates on the Finance Bill, 1968) that where the scale of remuneration of a director of a company had been approved by the Company Law Administration, there was no question of the disallowance of any part thereof in the income-tax assessment of the company on the ground that the remuneration was unreasonable or excessive.' [*Circular No. 6-P (LXXVI-66) of 1968, dated 6th July, 1968.*]

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