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Income from a domestic related party cannot be adjusted by applying transfer pricing provisions under section 40A(2) of the Act

In brief

In a recent ruling in case of Durga Rice & Gen Mills¹ (the taxpayer), the Chandigarh Bench of the Income-tax Appellate Tribunal (the Tribunal), held that provisions of section 40A(2) of the Income-tax Act, 1961 (the Act) cannot be applied to adjust sale value realised by a taxpayer from its domestic related party.

Facts

The taxpayer is in the business of running a rice mill and selling the rice bran. During the year, the taxpayer sold rice bran to its domestic related party. The

assessing officer (AO) challenged the rate and was of the view that the rate was lower than the rate charged by other independent third parties for sale of similar product. The AO accordingly, proposed to adopt a higher rate based on available comparable price.

The taxpayer contended that the sale value of rice bran depends on its quality and that the sales made to the domestic related party were at comparable rates. The AO rejected the taxpayer's arguments and made an adjustment on the profit of the taxpayer by considering the average sale price realised by independent parties. Aggrieved, the taxpayer appealed to the CIT(A), who upheld the findings of the AO.

Aggrieved, the taxpayer appealed before the Tribunal.

¹ Durga Rice & Gen Mills v. AO [TS-446-ITAT-2012(Chandi)]

Revenue's contentions

The sale price of rice bran realised by independent third parties is higher than the sale price charged by the taxpayer to its domestic related party. Thus, there has been under reporting of profits and an adjustment is warranted under section 40A(2) of the Act.

Taxpayer's contentions

The taxpayer argued that sale value of rice bran was based on its quality which depends on the content of oil. In addition the taxpayer contended that –

- The law does not oblige any business entity to sell goods at the maximum available rates;
- No addition should be made on account of difference in sale price under section 40A(2) of the Act as this provision deals with expenditure and not revenue²;
- Suitable amendments are required in section 40A(2) of the Act to make addition on account of difference in sales value³.

Tribunal ruling

- It is settled law that section 40A(2) of the Act cannot be applied for making addition for the difference in value of sales made to domestic related party; section 40A(2) of the Act is restricted to disallowance of expenditure value.
- Relying on the findings of Supreme Court in case of Glaxo Smithkline Asia (P) Ltd, the Tribunal held that the Central Board of Direct Taxes (Revenue) also acknowledges that suitable amendments are required to be made in section 40A(2) of the Act, if transfer pricing provisions were required to be

applied to domestic transactions between related parties and undertaking adjustments on account of difference in sale value effected by the taxpayer in comparison of the fair market value⁴. Given this, provisions of section 40A(2) of the Act cannot be attracted in the taxpayers case.

PwC observations

- The ruling of the Tribunal clearly brings out the principle that the provisions of section 40A(2) of the Act do not grant powers to the AO to adjust income reported by a taxpayer from domestic related parties.
- Following the observations of the Supreme Court in the case of Glaxo Smithkline Asia Pvt Ltd., Finance Act, 2012 has amended section 40A(2) of the Act to provide that transfer pricing provisions will apply to determine the reasonableness of expenditure incurred towards domestic related parties and related transfer pricing compliances would have to be undertaken, with effect from 1 April 2012.
- It is relevant to note that the above amendments have not extended the scope of section 40A(2) of the Act, to income earned from domestic related parties. In fact, the Memorandum to the Finance Bill 2012 explaining the amendments noted that extending the transfer pricing requirements to all domestic transactions will lead to increase in compliance burden on all assesseees which may not be desirable.
- Taxpayers earning income from related parties should, however be cognizant of an adverse impact to the group where a related party making payment to the taxpayer faces a disallowance of the payment under section 40A(2) of the Act but a corresponding reduction in income is not available to the taxpayer. A holistic review of the pricing policy of transactions between domestic related parties and a coordinated effort towards robust transfer pricing documentation needs paramount consideration.

² CIT v A.K. Subbaraya Chetty & Sons [1980] 123 ITR 592 (Mad)

³ CIT v. Glaxo Smithkline Asia (P) Ltd [2010] 195 Taxman 35 (SC)

⁴ Relying on the findings of the Supreme Court in the case of Galxo Smithkline (above)

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