***Capital Expenditure - Is it subject to domestic transfer pricing?***

*40A(2), 40A(2)(b), 92(2A),*

Indian Transfer Pricing compliances were extended to include specified domestic transactions (SDT) by the Finance Act, 2012 after the direction of the Hon’ble Supreme Court in the case of[*HYPERLINK "https://cms.cchtaxonline.com/alfresco/preview/Company%20Home/CCH\_India/Direct\_Tax/Articles/236CTR113"CIT vs. HYPERLINK "https://cms.cchtaxonline.com/alfresco/preview/Company%20Home/CCH\_India/Direct\_Tax/Articles/236CTR113"GlaxoHYPERLINK "https://cms.cchtaxonline.com/alfresco/preview/Company%20Home/CCH\_India/Direct\_Tax/Articles/236CTR113" SmithKline Asia (P) Ltd.*HYPERLINK "https://cms.cchtaxonline.com/alfresco/preview/Company%20Home/CCH\_India/Direct\_Tax/Articles/236CTR113"](https://cms.cchtaxonline.com/alfresco/preview/Company%20Home/CCH_India/Direct_Tax/Articles/236CTR113)(2010) 236 CTR (SC) 113 : (2010) 195 TAXMAN 35 : (2010) 47 DTR 65 : [TS-47-SC-2010-TP]. However, many controversies have since arisen from these extended regulations, including the scope of transactions covered within SDT provisions.

Sec. 40A(2) of the Income-tax Act, 1961 (Act) provides for disallowance of an expenditure, which is excessive or unreasonable as regards to the Fair Market Value (FMV) of such expenditure, when payment is made to a related party. Post the amendments made by Finance Act 2012, the aforementioned FMV should be computed by applying the prescribed Transfer Pricing provisions. For this purpose, Section 92BA defines “specified domestic transaction” to include *“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“.*

The two key conditions emerging from the Section are that there should be an expenditure and the payment of such expenditure should be to a person referred to in Section 40A(2)(b). One of the key issue which needs consideration here is, whether ***‘capital expenditure’*** is covered within the scope of ***‘expenditure’*** for the purposes of the aforesaid provisions.

Section 92BA provides no further guidance on the definition of the term expenditure or issue of inclusion of capital expenditure therein. In this context, it may be useful to refer to intent of the legislation as laid out in the Explanatory Memorandum to the Finance Bill, 2012. It states that *“S. 40A of the Act empowers the Assessing Officer to disallow on reasonable expenditure incurred between related parties. …… However, no specific method to determine reasonableness of expenditure or fair market value to re compute income in such related transactions is provided under these sections.”… “Therefore the transfer pricing regulations need to be extended to the transactions entered into by domestic related parties or by an undertaking with other undertakings of the same entity for the purposes of S. 40A, Chapter VIA and S. 10AA.”  … “It is, therefore, proposed to amend the Act 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, 80-IA, 10AA, 80A.”*

Hence, it appears that the intent is to provide a reasonable method for computing FMV of the transactions already covered under the purview of Section 40A and not to extend the scope of the section. Now the imperative question is whether capital transactions are covered under Section 40A(2)(b)?

The charging Section 40A.(1) states that, *“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”.*

Further, the charging Section, Sec. 92(2A) states that *“(2A) Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm’s length price.”*

A reading of any of the above two provisions, leads to the interpretation that an expenditure which does not impact computation of income under the head “Profits and gains of business or profession” or total income is, therefore, outside the purview of ALP determination. Now, the acquisition of a fixed asset results in a ‘capital expenditure’ which is not allowable as a deduction. Accordingly, it is possible to take a view that such capital expenditure, which itself does not qualify for deduction in computing taxable income is not intended to be covered by SDT.

So far as the issue of depreciation is concerned, a view could be taken that Section 92BA refers to any ‘**expenditure’** in respect of which ‘**payment’** is made to a specified party. Depreciation is referred to in Section 32 as a “deduction” and not in the nature of “expenditure”. Hence, depreciation is neither ‘expenditure’ nor is any ‘payment’ made for the same. Hence, depreciation would not be covered within the scope of SDT.

It is also imperative to note that Explanation 3 to Section 43(1) empowers the tax authority to restate the cost of acquisition of depreciable asset under certain circumstances. Thus, in the wake of specific powers being available with Assessing Officer for depreciable asset, one may argue that Section 40A(2) and consequently Section 92BA may not apply to capital expense.

It is interesting to note that the above debate may be of less relevance post notification of the Companies’ Act, 2013 as per which specified companies are required to obtain a special resolution from the shareholders (along with the board approval) in case the related party transactions are not undertaken on an arm's length basis. There is also a requirement to report these transactions in the Directors’ report. Further, a special resolution from the shareholders would also be required in case certain other transaction specific thresholds are crossed. The definition of related parties and related party transactions as per Companies’ Act is much wider in scope as compared to the Income-tax Act. Companies’ Act covers capital transactions and the companies covered within the scope will anyway need to determine arm’s length price for such transactions and undertake other necessary compliances under the Act.

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