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ARE YOUR TRANSACTIONS WITH YOUR SUBSIDIARY IN GIFT/IFSC AT ARM-LENGTH PRICE ?

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Several of Indian stock brokers, asset managers, wealth managers, investment advisors and other financial service players have set up business in International Financial Service Centre (IFSC) in Gujarat International Finance Tech City (GIFT) to avail of business opportunities and special incentives provided by the Special Economic Zone or SEZ regime.

SEZs aim to facilitate export of products and services and are treated as a foreign territory for the purposes of trade operations, duties and tariffs, i.e., goods and services going into SEZ are treated as exports and goods and services coming from the SEZ as imports. SEZs provide easy access to global trading hubs that facilitates the flow of capital, movement of goods and economies of scale. Hence SEZ regulations provide for several fiscal and no-fiscal incentives. One of the fiscal incentives provided to units set up in IFSC is a tax holiday for a certain number of years.

Most of the businesses set up in IFSC are set up in the legal form of a company which is a subsidiary of the parent group or organisation head quartered in any other city in India for example Mumbai, Delhi, etc. In some instances, the business is set up in the form of a partnership firm wherein the partners are same as the partners or promoters of the parent organisation. Thus, the unit or entity in IFSC is a part of the larger group headquartered elsewhere within India.

A stock broking or a clearing member subsidiary in IFSC may be engaged in proprietary trading on the stock exchanges in IFSC or providing trading services to offshore investors or providing other products or services to clients overseas or to other units operating in IFSC. It is quite natural that there will be business transactions between the parent organisation and the IFSC subsidiary in the form of provision of management or administrative support, know-how, technical expertise, databases, research reports or even sharing of resources such as technology or tools or intellectual property.

Various provisions under of income tax laws are designed to ensure that the transactions between sister concerns or related parties should be at the market value or at arms-length price. It's a common knowledge that the tax laws require cross border transactions between related parties to be at arms-length price. However in certain circumstances even the transactions within India are required to be done at arm-length price. The relevant provisions are contained in sections 40A(2), 80A, 80LA, 92 and 92BA of Income tax Act. The author has attempted to simplify these provisions below in a layman's terms to the extent possible.

Payments made to related party

According to one requirement relating to expenditure incurred by any business entity, if any payment for expenditure made to a related party is considered to be excessive or unreasonable by the tax officer then such excess can be ignored for computing profits on which tax is paid. A related party for this purpose could be a substantial shareholder, director, partner, an entity under common ownership or control or management, etc. Thus a parent of an entity in IFSC would be regarded as related party. Hence any payment in the form of expenditure by an entity in IFSC to a its parent would be covered by this requirement and hence one needs to ensure that the pricing for any product or service availed from such related party is determined appropriately.

For this purpose however there is no requirement for a Chartered Accountant to certify the price or for maintenance of any specific documentation.

Intra-company supplies made by a unit enjoying tax holiday/exemption to another unit

Another requirement under tax laws is with respect to certain transactions in respect of which the unit in IFSC avails of fiscal incentive in the form of exemption from income tax for a certain number of years. This provision requires that where any good or services are sold or bought by the unit availing of tax exemption to or from any other business carried on by the taxpayer then such sell should be at market value for the purpose of determining profits that qualify for tax exemption. This in the context of a unit in IFSC, envisages that the business in IFSC and the other business are owned by the same taxpayer or the legal entity. For example, where a company or a partnership having its head office in Mumbai has a branch in IFSC that avails of tax exemption whereas the head office or other branches do not enjoy any exemption.

The purpose of this requirement is obviously to ensure that the profits that enjoy tax exemption are not overstated.

Inter-company transactions

Yet another requirement in the law relates specifically to the units in IFSC. All transactions carried out by an entity in IFSC that enjoys exemption from income tax, with a related party (a different legal entity) must be done at arms-length price.

For this purpose, the arms-length price should be arrived at based on the recognised methodology in transfer pricing provisions. This requirement however does not apply if the aggregate of such transactions in a year do not exceed Rs 20 crores.

The intention of the requirement be to ensure that profits are not shifted to the entity enjoying tax holiday. In other words, the entity enjoying tax exemption does not overstate profits. The tax officer examining the tax holiday entity would be examining whether the profits are overstated so that tax exemption can be restricted to the correct amount of profits based on arms-length price. Normally any payment to a related party is examined, there is a suspicion of excessive payment. But if the IFSC units is making payment to a related party the suspicion could be that is an underpayment. Similarly, the tax officer examining profits of the parent of IFSC subsidiary may want to examine if the price for receipts from IFSC subsidiary from is understated.

The entity claiming exemption from income tax must obtain a report from a Chartered Accountant certifying the amount of profits eligible for tax exemption. Similarly, there is a requirement to obtain a report form a Chartered Accountant certifying the arms-length price.

The broking entities having subsidiaries in IFSC therefore need to plan their affairs keeping the above provisions in mind.

(Any questions, feedback or comments can be sent to *sunil.gidwani@nangia-andersen.com*)