

ELECTIVE PAPER 6C: INTERNATIONAL TAXATION

CASE STUDY - 1

'A' Ltd., an Indian company, was incorporated in the year 2008. It is a wholly owned subsidiary of A Inc, USA. A Ltd. is engaged in the business of manufacturing and selling virtual reality cameras. During the previous year 2017-18, A Ltd. entered into various transactions with the following enterprises for purchase of raw materials, use of technology and sale of finished goods. The earnings before interest, dividend, tax and amortization of A Ltd for Financial year 2017-18 is ₹ 100 crores. The details of the transactions entered into by A Ltd. during F.Y.2017-18 are given hereunder:

S. No	Transaction	Enterprise	Amount (₹ in crores)
1	Purchase of raw-materials	AA Ltd, China	80
2	Payment of royalty	A Inc, USA	5
3	Sale of finished goods	AAA Ltd, Taiwan	50
4	Interest-free loan obtained	A Pty, Singapore	50

Prior to F.Y.2017-18, A Ltd. had obtained loan of ₹ 200 crores @8% from A LLC, Cyprus in April, 2016.

The following additional information pertaining to loans obtained by A Ltd. is provided for the previous year 2017-18:

- Interest of ₹ 16 crores paid to A LLC, Cyprus on the loan of ₹ 200 crores, which constituted 52% of the total assets of A Ltd.
- A Ltd. obtained loan of ₹ 100 crores from Bank of Chennai, India based on a guarantee provided by A Inc., USA. Interest of ₹ 8 crores paid on such loan and guarantee fee of ₹ 50 lacs paid to A Inc., USA.
- A Ltd. obtained loan of ₹ 50 crores from TN Mercantile Bank, India based on a letter of comfort provided by Mr. Balaji, who is an Indian resident and director of A Ltd. Interest of ₹ 4 crores is paid towards such loan.
- A Ltd. obtained an independent loan of ₹ 300 crores from Union City Bank, India for which interest of ₹ 3 crores has been paid to the bank.
- A Ltd. obtained loan of ₹ 50 crores from Bank of Taiwan, India Branch. Guarantee was provided by AAA Ltd., Taiwan. Interest paid for the concerned year is ₹ 3 crores. Guarantee

fees paid to AAA Ltd. is ₹ 25 lakhs. A Ltd. holds shares carrying 25% voting power in AAA Ltd., Taiwan.

- A Ltd. obtained interest-free loan of ₹ 50 crores from A Pty, Singapore. 40% of the directors of A Pty., Singapore is appointed by A Ltd.
- A Ltd. obtained foreign currency loan of \$ 10 million from Wells Fargo Bank of USA, in USA, based on a back to back deposit made by A Inc. USA to the tune of \$ 5 million in the bank. Interest of ₹ 6 crores is paid on such loan.
- A Ltd. obtained foreign currency loan of \$ 20 million from Bank of USA, in USA, based on a back to back deposit made by A Inc., USA to the tune of \$ 20 million in the bank. Interest works out to ₹ 12 crores.
- A Ltd. had to incur a sum of ₹ 1 crore as an interest towards the delayed payment to AA Ltd. China, being its creditor for supply of raw material. 90% of raw materials required by A Ltd. is supplied by AA Ltd., China.

Based on the above facts, you are required to answer the following questions:

I. OBJECTIVE TYPE QUESTIONS

Write the correct answer to each of the following questions by choosing one of the four options given.

1. The provisions relating to limitation of interest deduction in respect of debt issued by a non-resident associated enterprise are **not** applicable to an Indian company engaged in the business of:
 - (a) Information Technology
 - (b) Banking and Insurance
 - (c) Bio-technology
 - (d) Aviation
2. The provisions relating to limitation of interest deduction in respect of debt issued by a non-resident associated enterprise would **not** apply where the expenditure by way of interest or similar nature is -

- (a) ₹ 2.10 crore
 - (b) ₹ 2 crore
 - (c) ₹ 1.50 crore
 - (d) ₹ 1 crore
3. Which of the following enterprises are associated enterprises/deemed associated enterprises of A Ltd.?
- (a) A Inc., USA; A LLC, Cyprus; and AAA Ltd., Taiwan.
 - (b) A Inc., USA; A LLC, Cyprus; and A Pty, Singapore.
 - (c) A Inc., USA; A LLC, Cyprus; and AA Ltd., China.
 - (d) A Inc., USA; AA Ltd., China; and A Pty, Singapore.
4. In respect of any payment made to a person located in a Notified Jurisdictional Area (NJA), tax is deductible at higher of the rate specified in the Income-tax Act 1961 or rates in force or -
- (a) 10%
 - (b) 15%
 - (c) 20%
 - (d) 30%
5. A Ltd. has a wholly owned subsidiary in Sri Lanka, and it extends corporate guarantee to the said non-resident subsidiary. If the amount guaranteed is ₹ 95 crore, the Assessing Officer has to accept the guarantee fee declared by A Ltd. for F.Y.2017-18, if the guarantee fee declared is -
- (a) ₹ 47.50 lakhs
 - (b) ₹ 90 lakhs
 - (c) ₹ 95 lakhs
 - (d) Either (a) or (b)

6. If A Ltd. does not furnish transfer pricing report for F.Y.2017-18, what would be the quantum of penalty imposable under the Income-tax Act, 1961 for such a failure?
- (a) 1% of the value of international transaction
 - (b) 2% of the value of international transaction
 - (c) ₹ 1 crore – fixed penalty
 - (d) ₹ 1 lakh – fixed penalty
7. Interest paid to non-resident associated enterprise disallowed under the relevant provision of the Income-tax Act, 1961, during the A.Y.2018-19 can be carried forward upto-
- (a) A.Y.2022-23
 - (b) A.Y.2023-24
 - (c) A.Y.2026-27
 - (d) Indefinitely
8. In a case where primary adjustment to transfer price is made *suo motu* by A Ltd., the time limit for repatriation of “excess money” is -
- (a) 60 days from 30th September of the Assessment Year
 - (b) 90 days from 30th September of the Assessment Year
 - (c) 60 days from 30th November of the Assessment Year
 - (d) 90 days from 30th November of the Assessment Year
9. If the excess money is not repatriated, A Ltd. has to make secondary adjustment in A.Y.2018-19, if the primary adjustment to transfer price, made by it *suo motu* in its return of income, is in respect of -
- (a) A.Y.2016-17 and the amount of primary adjustment is ₹ 2 crores.
 - (b) A.Y.2017-18 and the amount of primary adjustment is ₹ 1 crore
 - (c) A.Y.2017-18 and the amount of primary adjustment is ₹ 1.05 crore

(d) A.Y.2018-19 and the amount of primary adjustment is ₹ 1 crore.

10. Which of the following approaches does India follow in relation to secondary adjustments?

(a) Deemed equity approach

(b) Deemed dividend approach

(c) Deemed loan approach

(d) Either (a) or (c)

II. DESCRIPTIVE QUESTIONS

1. Based on the details provided in respect of interest paid by A Ltd., determine the amount of interest to be disallowed for A.Y.2018-19 under the relevant provisions of the Income-tax Act, 1961 relating to limitation of interest deduction, giving reasons for treatment of each item of interest. Consequently, determine the permissible interest deduction while computing income under the head "Profits and gains of business or profession". *(10 Marks)*

2. (a) (i) Examine how thin capitalization is an anti-avoidance measure *(2 Marks)*

(ii) Which Action Plan of BEPS is based on thin capitalization? Mention the provision incorporated in the Income-tax Act, 1961 in line with this Action Plan. *(2 Marks)*

(iii) A Ltd. is contemplating to stop the current business activity and start a new business vertical. In this regard, it wants to know whether the interest disallowed under the relevant provision of the Income-tax Act, 1961 can be carried forward to next year and whether it could be set-off against the income of the new business. *(2 Marks)*

(b) The Assessing Officer has, while carrying out the transfer pricing assessment for Assessment Year 2017-18, arrived at an arm's length rate interest of 4% on the loan obtained from A LLC Cyprus (Interest paid ₹ 16 crores). Accordingly, he has made a primary adjustment to the tune of ₹ 8 crores for A.Y. 2017-18. In this regard,

(i) You are required to examine whether any secondary adjustment is to be made under the relevant provision of the Income-tax Act, 1961 in the A.Y.2018-19, where –

(1) A Ltd has not gone on an appeal on the said matter.

(2) A Ltd. has opted to file an appeal before the CIT (Appeals)

(ii) What would be the consequence if the CIT (Appeals) reduces the primary adjustment to the transfer price made by the Assessing Officer to ₹ 6 crores, by considering the arm's length interest rate@5% instead of 4%, and the same is accepted by A Ltd.? (4 Marks)

3. (a) On the facts provided, A Ltd makes interest payment to A LLC, Cyprus. While making the interest payment to A LLC, Cyprus, A Ltd had withheld taxes at 10% based on Article 11 of India-Cyprus double taxation avoidance agreement. The Assessing Officer has issued a show cause notice contending that the assessee has deducted tax at a lower rate, based on the view that A LLC, Cyprus is a notified jurisdiction area. You are required to reply to the show cause notice of the Assessing Officer, giving your views. (4 Marks)

Extract of ARTICLE 11 of DTAA between India and Cyprus
INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the interest.
3. Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State shall be exempt from tax in that State, provided that it is derived and beneficially owned by:
 - (a) the Government, a political sub-division or a local authority of the other Contracting State; or
 - (b) in the case of India, the Reserve Bank of India, the Export-Import bank of India, the National Housing bank; and
 - (c) any other institution as may be agreed upon from time to time between the Competent authorities of the Contracting States through exchange of letters
4. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other

Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement.

- (b) A Ltd wants to understand whether it can opt for safe harbour rules in order to avoid litigation on transfer pricing related matters, for the intra-group loans that it has taken from its Associated Enterprises. If the answer is in the affirmative, what are the conditions to be satisfied? (3 Marks)
- (c) A Ltd, being a wholly owned subsidiary of a US entity A Inc., wants to understand whether transfer pricing provisions under the Income-tax Act, 1961 will trigger if it receives interest-free loan from its foreign AE parent A Inc., USA. Advise. (3 Marks)