

ELECTIVE PAPER 6C: INTERNATIONAL TAXATION

SOLUTION TO CASE STUDY 4

I. ANSWERS TO MCQs

MCQ No.	Answer		MCQ No.	Answer
1.	(d)		6.	(c)
2.	(c)		7.	(a)
3.	(d)		8.	(c)
4.	(b)		9.	(d)
5.	(d)		10.	(d)

II. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1

- (i) Since ABC Inc., a foreign company, holds 40% $[1,20,000 \times 100 / 3,00,000]$ of the voting power in ABC Ltd., an Indian company, ABC Ltd. and ABC Inc. are deemed to be associated enterprises as per section 92A(2). In this case, ABC Limited, the Indian company, supplied steel manufactured by it to its associated enterprise, ABC Inc. ABC Ltd. supplies similar product to PQR Inc., Country A. From the information given in Exhibits A & B, ABC Ltd. does not have any shareholding in PQR Inc; and PQR Inc also does not have any shareholding in ABC Ltd. PQR Inc. has neither borrowed nor lent money to ABC Ltd. It has not given a guarantee on behalf of ABC Ltd. nor has ABC Ltd. given any guarantee on its behalf. The supplies made by ABC Ltd. to PQR Inc. constitute only 10% of the requirement of PQR Inc. Therefore, from the information given in Exhibits A & B, it would be logical to infer that ABC Ltd. and PQR Inc are unrelated parties. Therefore, the transactions between ABC Limited and PQR Inc. can be considered as comparable uncontrolled transactions for the purpose of determining the arm's length price of the transactions between ABC Ltd. and ABC Inc. Accordingly, comparable Uncontrolled Price (CUP) method of determination of arm's length price (ALP) can be applied in this case.

Transactions with ABC Inc. are on FOB basis, whereas transactions with PQR Inc. are on CIF basis. This difference has to be adjusted before comparing the prices.

Particulars	Amount (in Euro)
Price per MT of steel to PQR Inc.	1,200
Less: Cost of insurance and freight per M.T.	<u>400</u>
Adjusted Price per M.T.	<u>800</u>

Since the adjusted price for PQR Inc., Country A and the price fixed for ABC Inc. are the same, the arm's length price is Euro 800 per MT. Since the sale price to associated enterprise (i.e., ABC Inc.) and unrelated party (i.e., PQR Inc.) is the same, the transaction with associated enterprise ABC Inc. has also been carried out at arm's length price.

- (ii) Sigma Ltd., India and Epsilon Ltd., Country B are deemed to be associated enterprises, since Epsilon Ltd. holds shares carrying 26.66% $[1,40,000 \times 100/5,25,000]$, voting power in Sigma Ltd, from the information given in Exhibit C. Since Epsilon Ltd. is a non-resident, the transactions of purchase by Sigma Ltd. of goods manufactured by Epsilon Ltd. for sale in India would fall within the meaning of “international transaction” under section 92B. Therefore, transfer pricing provisions would be attracted in this case and the arm’s length price have to be applied to such transactions.

Accordingly, penalty would be leviable under the provisions of the Income-tax Act, 1961 for failure to report such transactions and maintain requisite records in respect of such transactions.

The penalty leviable under the provisions of the Income-tax Act, 1961 in respect of its failures are -

- (1) Failure to report transactions with Epsilon Ltd. would attract penalty of Rs.132.252 lakhs, being @ 200% of the amount of tax payable on under reported income of Rs.2 crore, since it is a case of misreporting of income referred under section 270A(9) read with section 270A(8).

Computation of penalty leviable under section 270A

Particulars	Rs
Under-reported income [Rs. 8 crore – Rs.6 crore]	2,00,00,000
Tax payable on under-reported income:	
Tax on under-reported income of Rs. 2 crore <i>plus</i> total income of Rs. 6 crore declared [30% of Rs. 8 crore + surcharge@ 7% + EC & SHEC@3%]	2,64,50,400
Less: Tax on total income declared [30% of Rs. 6 crore + Surcharge@7% + EC & SHEC@3%]	<u>1,98,37,800</u>
	<u>66,12,600</u>
Penalty leviable@200% of tax payable on under-reported income	1,32,25,200

- (2) Failure to report the transaction and maintain the requisite records as required under section 92D in relation to international transaction makes it liable for penalty under section 271AA which would be 2% of the value of international transaction with Epsilon Ltd.¹

However, if reasonable cause can be shown by Sigma Ltd. for failure to maintain requisite records under section 92D, penalty under section 271AA can be avoided.

Answer to Q.2

- (i) Any income arising from an international transaction between two or more “associated enterprises” shall be computed having regard to arm’s length price.

Section 92A defines an “associated enterprise” and sub-section (2) of this section speaks of the situations when the two enterprises shall be deemed to associated enterprises. Applying the provisions of section 92A(2)(a) to (m) to the given facts in the case study along with Exhibit D, it is clear that “XYZ Motors Ltd.” is deemed to be associated with :-

¹ Since the value of international transaction is not given in the question, computation of penalty is not possible in this case.

- (1) LMN Inc., Country A, as per section 92A(2)(a), because this company holds shares carrying 38.46% $[50,000 \times 100/1,30,000]$ (i.e., more than 26%) of the voting power in XYZ Motors Ltd.;
- (2) RST Ltd., Country C, as per section 92A(2)(g), since this company is the sole owner of the technology used by XYZ Motors Ltd. in the manufacturing process and the manufacture of vans by XYZ Motors Ltd. is wholly dependent on the use of know-how owned by RST Ltd.;

However, GHI Inc., Country D is not an associated enterprise of XYZ Motors Ltd. since its voting power in XYZ Motors Ltd. is only 2.31% $[3,000 \times 100/1,30,000]$. Further, HIT Ltd., Country D, is not an associated enterprise of XYZ Motors Ltd., since this company has financed an amount which is only 49.95% $[74 \times 81 \times 100 /12,000]$ (i.e., less than 51%) of the book value of total assets of XYZ Motors Ltd. Also, it holds shares carrying only 0.77% $[1,000 \times 100/1,30,000]$ voting power in XYZ Motors Ltd.

The transactions entered into by XYZ Motors Ltd. with LMN Inc. and RST Ltd. are, therefore, to be adjusted accordingly to work out the income chargeable to tax for the A.Y. 2018-19.

- (1) From the details given in Exhibit B & D, it would be logical to conclude that XYZ Motors Ltd. and PQR Inc. are unrelated parties on the same lines of reasoning for concluding ABC Ltd. and PQR Inc. are unrelated parties. Therefore, the price charged from PQR Inc. can be taken as the price of a comparable uncontrolled transaction for determining the arm's length price of the transaction with LMN Inc.
- (2) From the details given in Exhibit E, it would be logical to conclude that RST Ltd. and Birla Motors Ltd. are unrelated parties. Birla Motors Ltd. does not have any voting power in RST Ltd.; nor does RST Ltd. have any voting power in Birla Motors Ltd. Birla Motors Ltd. does not solely depend on technical knowhow provided by RST Ltd. It has neither lent nor borrowed money from RST Ltd. Also, it has neither provided guarantee to, nor obtained guarantee from, RST Ltd. It has not appointed any of the directors of RST Ltd; nor has RST Ltd. appointed any of its directors. Therefore, it is apparent that Birla Motors Ltd. and RST Ltd. are unrelated parties. Therefore, the price charged by RST Ltd. from Birla Motors Ltd. for use of technical knowhow can be taken as the price of a comparable uncontrolled transaction for determining the arm's length price of the transaction with XYZ Motors Ltd.

Particulars	(Rs. in crores)
Income of XYZ Motors Ltd. as computed under Chapter IV-D, prior to adjustments as per Chapter X	585.00
<i>Add:</i> Difference on account of adjustment in the value of international transactions:	
(i) Difference in price of van @ Euro 280 each for 8,500 vans (Euro 280 x 8,500 x Rs.81) sold to LMN Inc.	19.278
(ii) Difference for excess payment of royalty of \$ 20,00,000 (\$ 20,00,000 x Rs.60) to RST Ltd.	<u>12.000</u>
Total Income	<u>616.278</u>

- (ii) Omega Inc., Country L and OMR Limited, the Indian company are deemed to be associated enterprises, since Omega Inc. has advanced loan constituting 53.33% of the book value of total assets of OMR Ltd. $[1,600 \times 100/3,000]$, as per the information given in Exhibit F. Accordingly, transfer pricing provisions would be attracted. The arm's length rate of interest can be

determined by using CUP method having regard to the rate of interest on external commercial borrowing permissible as per guidelines issued under Foreign Exchange Management Act. The interest rate permissible is LIBOR plus 300 basis points i.e., $5\% + 3\% = 8\%$, which can be taken as the arm's length rate. The interest rate applicable on the borrowing by OMR Limited, India from Omega Inc., Country L, is LIBOR plus 200 basis points i.e., $5\% + 2\% = 7\%$. Since the rate of interest, i.e. 7% is less than the arm's length rate of 8%, the borrowing made by OMR Ltd. is not at arm's length. However, in this case, the taxable income of OMR Ltd., India, would be lower if the arm's length rate is applied. Hence, no adjustment is required since the law of transfer pricing will not apply if there is a negative impact on the existing profits.

Answer to Q.3

- (a) Xylo Inc. is a specified foreign company in relation to Alpha Ltd. Therefore, the condition of Alpha Ltd. holding shares carrying not less than 26% of the voting power in Xylo Inc is satisfied. Hence, Xylo Inc. and Alpha Ltd. are deemed to be associated enterprises. Therefore, provision of user documentation services by Alpha Ltd., an Indian company, to Xylo Inc., a foreign company, is an international transaction between associated enterprises, and consequently, the provisions of transfer pricing are attracted in this case.

Preparation of user documentation services falls within the definition of "software development services", and hence, is an eligible international transaction. Since Alpha Ltd. is providing software development services to a non-resident associated enterprise and has exercised a valid option for safe harbour rules, it is an eligible assessee.

Since the value of international transaction entered does not exceed Rs.100 crore, Alpha Ltd. should have declared an operating profit margin of not less than 17% in relation to operating expense, to be covered within the safe harbour rules. However, since Alpha Ltd. has declared an operating profit margin of only 14.71% [$10 \times 100/68$], the same is not in accordance with the circumstance mentioned in Rule 10TD. Hence, it is not binding on the income-tax authorities to accept the transfer price declared by Alpha Ltd.

- (b) Fulcrum Ltd. and Gigo Inc. are deemed to be associated enterprises since Fulcrum Ltd. appoints more than half of the Board of Directors of Gigo Inc. Manufacture and export of non-core auto components is an eligible international transaction. Since Fulcrum Ltd. is engaged in original manufacture of non-core auto components and export of the same, it is an eligible assessee.

Fulcrum Ltd. should have declared an operating profit margin of not less than 8.5% in relation to operating expense, to be covered within the scope of safe harbour rules. In this case, since Fulcrum Ltd. has declared an operating profit margin of 5.55% [$1 \times 100/18$], the same is not in accordance with the circumstance mentioned in Rule 10TD. Hence, it is not binding on the income-tax authorities to accept the transfer price declared by Fulcrum Ltd in respect of such international transaction.

- (c) Yale Inc., a foreign company, is a subsidiary of Buttons & Bows Ltd., an Indian company. Hence, Yale Inc. and Buttons & Bows Ltd. are associated enterprises. Therefore, provision of call centre services by Buttons & Bows Ltd., an Indian company, to Yale Inc., a foreign company, is an international transaction between associated enterprises, and consequently, the provisions of transfer pricing are attracted in this case.

Call centre services with the use of information technology falls within the definition of "information technology enabled services", and is hence, an eligible international transaction. Since Buttons & Bows Ltd. is providing call centre services to a non-resident associated enterprise and has exercised a valid option for safe harbour rules, it is an eligible assessee.

Since the aggregate value of transactions entered into in the P.Y.2017-18 exceeds Rs.100 crore but does not exceed Rs.200 crore, Buttons & Bows Ltd. should have declared an operating profit margin of not less than 18% in relation to operating expense, to be covered within the scope of safe harbour rules. In this case, since Buttons & Bows Ltd. has declared an operating profit margin of 20% [$32 \times 100/160$], the same is in accordance with the circumstance mentioned in Rule 10TD. Hence, the income-tax authorities shall accept the transfer price declared by Buttons & Bows Ltd. in respect of such international transaction.

The safe harbour rules shall not apply in respect of eligible international transactions entered into with an associated enterprise located in a notified jurisdictional area. Therefore, in respect of (c) above, if Yale Inc. is located in a NJA, the safe harbour rules shall not be applicable, irrespective of the operating profit margin declared by the assessee.