ELECTIVE PAPER 6C: INTERNATIONAL TAXATION

CASE STUDY - 4

M/s. Vaish & Co., an Indian firm, is a leading Delhi-based international tax consultant, specializing in transfer pricing assignments. The following are the details pertaining to some of its assignments:

(1) ABC Ltd., an Indian Company, supplied steel manufactured by it to ABC Inc., Country A during the previous year 2017-18. ABC Limited also supplied the same product to another Country A based company, PQR Inc. The transactions with ABC Inc. are priced at Euro 800 per MT (FOB), whereas the transactions with PQR Inc. are priced at Euro 1200 per MT (CIF). Insurance and Freight amounts to Euro 400 per MT. ABC Ltd. wants to know if transfer pricing provisions would be attracted in such a case.

(2) Sigma Ltd., operating in India, is one of the dealers for the goods manufactured by Epsilon Ltd., Country B. During the course of assessment, the Assessing Officer, after verification of transactions between Sigma Ltd. and Epsilon Ltd., opined that transfer pricing provisions would become applicable in this case. The Assessing Officer adjusted the total income of Sigma Ltd. by making an addition of Rs.2 crore to the declared income of Rs.6 crore for A.Y.2018-19. It also issued show cause notice asking the company to explain why penalty should not be levied for failure to report such transactions and maintain the requisite records. Sigma Ltd is of the opinion that transfer pricing provisions would not be applicable in its case and hence, there is no question of levy of such penalty. Sigma Ltd. wants to know the lines in which reply needs to be given to the show cause notice.

(3) XYZ Motors Ltd., an Indian company declared business income of Rs.585 crores computed in accordance with Chapter IV-D of the Income-tax Act, 1961 but before making transfer pricing adjustments in respect of the following transactions for the year ended on 31.3.2018:

- (i) 8,500 vans sold to LMN Inc., Country A, at a price which is less by Euro 280 each van than the price charged from PQR Inc., Country A.
- (ii) 4500 vans sold to GHI Inc., Country D at a price which is less by Euro 100 each van than the price charged from PQR Inc., Country A.
- (iii) Royalty of $ 80,00,000 was paid to RST Ltd., Country C, for use of technical know-how in the manufacturing of van. However, RST Ltd. had provided the same know-how to Birla Motors Ltd. for $ 60,00,000.

(iv) Loan of Euro 74 crores carrying interest @8% p.a. advanced by HIT Ltd., a Country D company, was outstanding on 31.3.2018. The said Country D company had also advanced a loan of similar amount to Aravalli Ltd. @7% p.a. Total interest paid for the year was EURO 5.92 crores.

XYZ Motors Ltd. wants to know the provisions of the Income-tax Act, 1961 affecting all these transactions. It also wants to know its business income chargeable to tax for A.Y.2018-19.

(4) OMR Limited, an Indian company, is engaged in manufacturing electronic components. OMR Limited has borrowed Country L $ equivalent to Rs.200 lakhs from Omega Inc., a Country L based company at LIBOR plus 200 points. The LIBOR prevalent at the time of borrowing is 5% for Country L $. The borrowings allowed under the External Commercial Borrowings guidelines issued under Foreign Exchange Management Act are LIBOR plus 300 basis points. OMR Limited wants to know whether transfer pricing provisions are attracted in respect of this transaction.

(5) The following clients want to know whether the operating profit margin declared by them would be accepted by the Income-tax Authorities. They have all exercised a valid option for application of safe harbour rules,–

a) Alpha Ltd., an Indian company, provides user documentation preparation services to Xylo Inc., which is a "specified foreign company" in relation to Alpha Ltd. The value of the transaction entered into in the P.Y.2017-18 is Rs.87 crore. The operating expenses incurred are Rs.68 crore. It has declared operating profit of Rs.10 crore.

b) Fulcrum Ltd. is an Indian company, solely engaged in the original manufacture and export of non-core auto components. It exports these parts to Gigo Inc., a foreign company. Fulcrum Ltd. appoints seven out of the twelve Directors of Gigo Inc. The aggregate value of transactions entered into in the P.Y.2017-18 is Rs.25 crore. The operating expenses incurred are Rs.18 crores. It has declared operating profit of Rs.1 crore.

c) Buttons and Bows Ltd., an Indian company, provides call centre services with the use of information technology to Yale Inc., its foreign subsidiary. The aggregate value of transactions entered into in the P.Y.2017-18 is Rs.192 crore. The operating expenses incurred are Rs.160 crores. It has declared operating profit of Rs.32 crore.

Based on the facts given above and the exhibits given at the end, you are required to answer the following questions:

I. MULTIPLE CHOICE QUESTIONS

Write the most appropriate answer to each of the following questions by choosing one of the four options given. Each question carries two marks

1 If Fulcrum Ltd. had entered into an agreement for sale of 1000 units of non-core auto components to Mr. Rajiv, an unrelated party, on 13.7.2017, and Mr. Rajiv had entered into an agreement for sale of such components with Gigo Inc. on 8.7.2017, which of the following statements is correct?

(a) Transfer pricing provisions would not be attracted since Fulcrum Ltd. and Mr. Rajiv are not associated enterprises

(b) Transaction between Fulcrum Ltd. and Mr. Rajiv would be deemed to be an international transaction between associated enterprises, only if Mr. Rajiv is a non-resident.

(c) Transaction between Gigo Inc. and Mr. Rajiv would be deemed to be an international transaction between associated enterprises, only if Mr. Rajiv is a non-resident.

(d) Transaction between Fulcrum Ltd. and Mr. Rajiv would be deemed to be an international transaction between associated enterprises, whether or not Mr. Rajiv is a non-resident.

2 In respect of the transaction referred to in Q.1 above, what would be the penalty leviable if Fulcrum Ltd. fails to report the above transaction?

(i) 2% of the value of transaction

(ii) 50% of tax payable on under-reported income

(iii) 200% of tax payable on under-reported income

(a) Only (i) above

(b) (i) and (ii) above

(c) (i) and (iii) above

(d) No penalty is leviable since Fulcrum Ltd. and Rajiv are not associated enterprises

3 Let us suppose Alpha Ltd. has entered into an advance pricing agreement (APA) in respect of its transactions with Xylo Inc. for the P.Y.2016-17. The company decides to make an application for roll back of the said APA. However, rollback provision shall not be available in respect of the said transaction for a rollback year, if –

(i) such application has the effect of reducing total income declared in the return of income of the said year

(ii) determination of the arm's length price of the said transactions for the said year has been the subject matter of appeal before Commissioner (Appeals) and the Commissioner (Appeals) has passed an order disposing of such appeal at any time before signing of the agreement

(iii) determination of the arm's length price of the said transactions for the said year has been the subject matter of appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement

(iv) return of income for the relevant roll back year has been furnished by the company under section 139(4)

The most appropriate answer is -

(a) (i) and (ii) above.

(b) (i) and (iii) above

(c) (i), (ii) and (iv) above

(d) (i), (iii) and (iv) above.

4 Assuming that Fulcrum Ltd.'s business income of A.Y.2018-19 has increased by Rs.2 crores due to application of arm's length price by the Assessing Officer, and the same has been accepted by Fulcrum Ltd., then, -

(a) business loss of A.Y.2017-18 cannot be set-off against the enhanced income

(b) deductions under Chapter VI-A cannot be claimed in respect of the enhanced income.

(c) unabsorbed depreciation of A.Y.2012-13 cannot be set-off against the enhanced income

(d) business loss referred to in (a) above, deductions referred to in (b) above and unabsorbed depreciation referred to in (c) above cannot be set-off against the enhanced income.

5 Assuming that there has been an increase in the total income of Alpha Ltd. by Rs.3 crores due to application of arm's length price, and the same has been accepted by Alpha Ltd., the said sum of Rs.3 crores

(a) is not required to be repatriated if the said increase is as per the safe harbor rules

(b) is not required to be repatriated if the said increase is determined by an advance pricing agreement

(c) need not be repatriated in both cases (a) and (b) mentioned above. However, had the increase been made by the Assessing Officer during the course of assessment, the same has to be repatriated failing which it would be treated as a deemed advance.

(d) has to be repatriated in both cases (a) and (b) mentioned above, failing which the same would be treated as a deemed advance.

6 Which of the following pairs of companies are Associated Enterprises/deemed to be associated enterprises?

(i) ABC Ltd. & ABC Inc.

(ii) Satpura Ltd. & Sigma Ltd.

(iii) XYZ Motors Ltd. & RST Ltd.

(iv) XYZ Motors Ltd. & HIT Ltd.

The correct answer is -

(a) Only (i) above

(b) (i) and (ii) above

(c) (i) and (iii) above

(d) (i), (iii) and (iv) above.

7 If Himalaya Ltd. has two Units, Unit 1 is engaged in power generation business and Unit 2 is engaged in manufacture of wires. Both the units were set up in Himachal Pradesh in the year 2014. In the year 2017-18, fourteen lakh metres of wire are transferred from Unit 2 to Unit 1 at Rs.150 per metre when the market price per metre was Rs.200. Which of the following statements is correct?

(a) Transfer pricing provisions would be attracted in this case

(b) Transfer pricing provisions would not be attracted in this case, since Unit 1 and Unit 2 belong to the same company and are not associated enterprises.

(c) Transfer pricing provisions would not be attracted in this case as it is not an international transaction as both the Units are in India. For the purpose of Chapter VIA deduction, the profits of power generation business shall, however, be computed as if the transfer has been made at the market value of Rs.200 per MT.

(d) Transfer pricing provisions would not be attracted in this case due to reasons mentioned in both (b) and (c) above.

8 Ram, an individual aged 35 years resident in India, bought 3,000 equity shares of Rs.10 each of ABC Ltd. at Rs.70 per share on 1.6.2017. He sold 1800 equity shares at Rs.50 per share on 3.11.2017 and the remaining 1200 shares at Rs.60 per share on 23.3.2018. ABC Ltd. declared a dividend of 40%, the record date being 14.8.2017. On 15.3.2018, Ram sold a house from which he derived a long-term capital gain of Rs.1,25,000. Assuming Ram's interest income from bank fixed deposit is Rs.3,00,000, his tax liability (rounded off) for A.Y.2018-19 would be -

(a) 18,440

(b) 18,810

(c) 19,920

(d) 19,410

9 Which of the following is not an eligible international transaction for application of safe harbor rules?

(i) Preparation of user documentation

(ii) Receipt of intra-group loans where the amount of loan is denominated in Indian rupees

(iii) Providing implicit corporate guarantee

(iv) Purchase and export of core auto components

(v) Receipt of intra-group services from group member

(a) Only (ii)

(b) (ii) and (v)

(c) (ii), (iv) and (v)

(d) (ii), (iii), (iv) and (v)

10 Let us consider two hypothetical cases -

Case 1: Ganga Ltd., Yamuna Ltd. and Saraswati Ltd. amalgamate to form Ganga Ltd.

Case 2: Ganga Ltd., Yamuna Ltd. and Saraswati Ltd. merge to form new company, Triveni Sangam Ltd.

Which companies are eligible to apply for rollback provisions post amalgamation/merger in the above cases, assuming that all other conditions are satisfied?

(a) In Cases 1 & 2: Ganga Ltd., Yamuna Ltd. and Saraswati Ltd.

(b) In Case 1: Ganga Ltd and in Case 2 : Ganga Ltd., Yamuna Ltd. and Saraswati Ltd.

(c) In Case 1: Ganga Ltd., Yamuna Ltd. and Saraswati Ltd. and in Case 2, None.

(d) In Case 1: Ganga Ltd. and in Case 2, None.

II. DESCRIPTIVE QUESTIONS

1. (i) Would transfer pricing provisions be attracted in respect of the transaction of supply of steel by ABC Ltd. to ABC Inc.? If so, compute the arm's length price of such transaction. *(4 Marks)*

   (ii) Examine whether transfer pricing provisions would be attracted in respect of transactions between Sigma Ltd. and Epsilon Ltd. If so, what is the penalty leviable for defaults, if any, by Sigma Ltd. in compliance of the requisite provisions under the Income-tax Act? *(6 Marks)*

2. (i) Examine whether transfer pricing provisions are attracted in respect of the transactions entered into by XYZ Motors Ltd. Also, compute the total income of XYZ Motors Ltd. chargeable to tax for A.Y.2018-19. *(7 Marks)*

   (ii) Would transfer pricing provisions be attracted in respect of the transaction of borrowal of funds by OMR Ltd. from Omega Inc? Examine. *(3 Marks)*

3. With respect to the transactions listed in (a) to (c) under para (5) in the case study, you are required to analyze –

   (i) the basis on which the parties to the transactions can be deemed as associated enterprises for attracting transfer pricing provisions

   (ii) how the transactions qualify as eligible international transactions.

   (iii) whether the transfer price declared by the assessee in each case can be accepted by the Income-tax authorities, without making any adjustment thereto.

   Would your answer change if Yale Inc. is located in a notified jurisdictional area? Examine. *(10 Marks)*

Exhibit A: Shareholding pattern of ABC Ltd.

Shareholder	Number of equity shares
Ganga Ltd., India	20,000
Yamuna Ltd., India	10,000
Saraswati Ltd., India	10,000
Thames Inc., Country A	30,000
ABC Inc., Country A	1,20,000
General public	1,10,000

Exhibit B : Details relating to PQR Inc.

(1) Shareholding pattern of PQR Inc.

Shareholder	Number of equity shares
Peru Inc., Country A	30,000
Andes Inc., Country A	40,000
Niagra Inc., Country A	25,000
Atlanta Inc., Country A	15,000
EFG Ltd., India	50,000
General Public	80,000

(2) List of Lenders:

1	Barclays Bank
2	Grindlays Bank
3	Bank of America
4	American Express Bank

(3) List of Borrowers:

1	Titanic Inc., Country A
2	Bolivia Inc., Country A
3	Detro Inc., Country A
4	Santro Inc., Country A

(4) PQR Inc. has not provided guarantee in respect of loan taken by any person

(5) PQR Inc's loans are guaranteed by Peru Inc. and Andes Inc.

(6) The directors of PQR Inc. are appointed by Peru Inc. and Andes Inc.

(7) PQR Inc. purchases steel from different suppliers in India. Only 10% of its requirement is met out of supplies from ABC Ltd.

(8) PQR Inc. manufactures auto parts using steel purchased from different suppliers. It is also a dealer in automobiles.

(9) Apart from XYZ Motors Ltd., it is a dealer for automobiles manufactured by several other companies in India and other countries.

(10) List of Debtors for sales:

1	Michigan Inc., Country A
2	Celro Inc., Country A
3	Dolphin Inc., Country A
4	Elephanta Inc., Country A

Exhibit C: Details relating to Sigma Ltd.

(1) Shareholding pattern of Sigma Ltd.

Shareholder	Number of equity shares
Himalaya Ltd., India	75,000
Satpura Ltd., India	90,000
Vindhyas Ltd., India	45,000
Epsilon Ltd., Country B	1,40,000

Aravalli Ltd., India	25,000
General public	1,50,000

(2) Particulars of turnover of Sigma Ltd.

Previous Year	Turnover
2014-15	Rs.35 crores
2015-16	Rs.55 crores
2016-17	Rs.82 crores
2017-18	Rs.117 crores

Exhibit D: Details relating to XYZ Motors Ltd.

(1) Shareholding pattern of XYZ Motors Ltd.

Shareholder	Number of equity shares
DEF Ltd., India	6,000
GHI Inc., Country D	3,000
LMN Inc., Country A	50,000
RST Ltd., Country C	10,000
HIT Ltd., Country D	1,000
Others	60,000

(2) Total book value of its assets. as on 31.3.2018 : Rs.12,000 crores.

(3) XYZ Motors Ltd. has neither entered into advance pricing agreement nor has it opted for safe harbor rules.

(4) The manufacture of vans by XYZ Motors Ltd is wholly dependent on the use of know-how owned by RST Ltd. RST Ltd. is the sole owner of such technical knowhow.

(5) The value of 1 Country C $ and of 1 EURO was Rs.60 and Rs.81, respectively, throughout the year.

Exhibit E : Details relating to Birla Motors Ltd., India

(1) Shareholding pattern of Birla Motors Ltd.

Shareholder	Number of equity shares
Sahara Ltd., India	15,000
Thar Ltd., India	20,000
Gobi Ltd., India	7,000
Sunderbans Ltd., India	8,000
General Public	1,50,000

(2) List of Lenders:

1	State Bank of India
2	Bank of Baroda
3	Union Bank of India
4	Sundaram Finance Ltd.
5	Apple Finance Ltd.

(3) List of Borrowers:

1	Xansa Ltd., India
2	Munnar Ltd., India
3	Podhigai Ltd., India
4	Vanasthali Ltd., India

(4) Birla Motors Ltd. has not provided guarantee in respect of loan taken by any person

(5) Birla Motors Ltd.'s loans are guaranteed by Sahara Ltd. and Thar Ltd.

(6) The directors of Birla Motors Ltd. are appointed by Sahara Ltd. and Thar Ltd.

(7) Birla Motors Ltd. uses the technical know how provided by a few companies outside India, including RST Ltd.

(8) Birla Motors Ltd. is not a shareholder of RST Ltd; It does not appoint any of the directors of RST Ltd.

Exhibit F : Details relating to OMR Ltd.

(1) Shareholding pattern of OMR Ltd.

Shareholder	Number of equity shares
A Ltd., India	5,000
B Inc., Country L	7,000
C Inc., Country L	14,000
D Ltd., India	12,000
E Inc., Country L	8,000
Omega Inc., Country L	10,000
Others	24,000

(2) Total book value of assets of OMR Ltd as on 31.3.2018 : Rs.3,000 crores.

(3) OMR Ltd. has neither entered into advance pricing agreement nor has it opted for safe harbor rules.

(4) Loan advanced by Omega Inc., Country L to OMR Ltd : Rs.1,600 crores

***Note**: In all the above exhibits, the shareholding pattern is reflective of the voting power, i.e., all shares have equal voting rights.*