

TAXATION OF INTERNATIONAL TRANSACTIONS

1. What is arm's length price? What are the prescribed methods for its computation?

What are the methods under which the arm's length price, relating to an international transaction, is determined u/s.92C?

Answer: It means a price which is applied or proposed to be applied in a transaction -

- (a) Between persons other than associated enterprises,
- (b) In uncontrolled conditions.

Methods of Computation [Section 92C]; The arm's length price in relation to an international transaction shall be determined by any of the following methods -

- (a) Comparable Uncontrolled Price Method,
- (b) Resale Price Method,
- (c) Cost plus Method,
- (d) Profit Split Method,
- (e) Transactional Net Margin Method,
- (f) Such other method as may be prescribed by the Board.

2. Explain the computation of ALP using Comparable Uncontrolled Price method.

Answer:

Step I: Identify the price charged/ paid for property transferred or services provided in a **comparable uncontrolled transaction(s)**.

Step II: **Adjust** the price derived in Step I above **for differences**, if any, which could materially affect the price in the open market.

- (a) between the international transaction and the comparable uncontrolled transactions, or
- (b) between the enterprises entering into such transactions.

Step III: Arm's Length Price = Step I **Add/Less:** Step II

Illustration : Jackle, Korea and CD Ltd, an Indian Company are associated enterprises. CD Ltd manufactures Cel Phones and sells them to Jackle, Korea & Fox, a Company based at Nepal. During the year CD Ltd supplied 2,50,000 Cellular Phones to Jackle Korea at a price of Rs.3,000 per unit and 35,000 units to Fox at a price of Rs.5,800 per unit. The transactions of CD Ltd with Jackle and Fox are comparable subject to the following considerations -

- (a) Sales to Jackle are on FOB basis, sales to Fox are CIF basis. The freight and insurance paid by Jackle for each unit is Rs.700.
- (b) Sales to Fox are under a free warranty for Two Years whereas sales to Jackle are without any such warranty. The estimated cost of executing such warranty is Rs.500.
- (c) Since Jackle's order was huge in volume, quantity discount of Rs,200 per unit was offered to it.

Compute the Arm's Length Price and the amount of increase in the Total Income of AB Ltd, if any, due to such Arm's Length Price.

1. Computation of Arm's Length Price of Products sold to Jackle Korea by CD Ltd

Particulars	Rs.	Rs.
Price per Unit in a Comparable Uncontrolled Transaction		5,800
Less: Adjustment for Differences -		
(a) Freight and Insurance Charges	700	
(b) Estimated Warranty Costs	500	
(c) Discount for Voluminous Purchase	200	(1,400)
Arms's Length Price for Cellular Phone sold to Jackle Korea		4,400

2. Computation of Increase in Total Income of CD Ltd

Particulars	Rs.
Arm's Length Price per Unit	4,400
Less: Price at which actually sold to Jackle Korea	(3,000)
Increase in Price per Unit	1,400
No. of Units sold to Jackle Korea	2,50,000
Therefore, increase in Total Income of CD Ltd (2,50,000 x Rs.1,400)	Rs.35 Crores.

3. Resale price method.

Step I : Identify the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an **unrelated enterprise**.

Step II: Reduce the normal GP margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from II) obtaining and providing the same or similar services, in a comparable uncontrolled transaction (s).

Step III: Reduce expenses incurred by the enterprise in connection with the purchase of property or obtaining of services.

Step IV: Adjust for functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market.

Step V: Arm's Length Price = Step I

Less Step II & III

Add / Less Step IV.

Illustration: Swinhoe LLP of France and Rani Ltd of India are associated enterprises. Rani Ltd. imports 3,000 compressors for Air Conditioners from Swinhoe at Rs.7,500 per unit and these are sold to Paharpur Cooling Solutions Ltd at a price of Rs.11,000 per unit. Rani had also imported similar products from Cold Ltd and sold outside at a Gross Profit of 20% on Sales.

Swinhoe offered a quantity discount of Rs.1,500 per unit. Cold could offer only Rs.500 per unit as Quantity Discount. The freight and customs duty paid for imports from Poland had cost Rani Rs. 1,200 a piece. In respect of purchase from Cold Ltd, Rani had to pay Rs.200 only as freight charges.

Determine the Arm's Length Price and the amount of increase in Total Income of Rani Ltd.

1. Computation of Arm's Length Price of Products bought from Swinhoe, France by Rani Ltd

Resale Price of Goods Purchased from Swinhoe	11,000
Less: Adjustment for Differences –	
(a) Normal Gross Profit Margin at 20% of Sale Price [20% x Rs.11,000]	2,200
(b) Incremental Quantity Discount by Swinhoe[RS.1,500 -Rs.500]	1,000
(c) Difference in Purchase related Expenses[Rs. 1,200 -Rs.200]	1,000
Arms Length Price	6,800

2. Computation of Increase in Total Income of Rani Ltd

Particulars	Rs.
Price at which actually bought from Swinhoe LLP of France	7,500
Less : Arms Length Price per unit under Resale Price Method	(6,800)
Decrease in Purchase Price per Unit	700
No. of Units purchased from Swinhoe	1,000
Therefore, increase in Total Income of Rani Ltd [3,000 Units x Rs.700]	Rs. 21,00,000

4. Explain Cost plus Method in determining ALP.

Step I: Determine the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise.

Step II: Determine the normal GP mark-up to such costs (computed under same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction(s).

Step III: Adjust the normal gross profit mark-up referred to in Step II to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market.

Step IV: Arm's Length Price = Step I
Add Step III

Illustration: Branco Inc., a French Company, holds 45% of Equity in the Indian Company Chirag Technologies Ltd (CTL). CTL is engaged in development of software and maintenance of the same for customers across the globe. Its clientele includes Branco Inc.

During the year, CTL had spent 2,400 Man Hours for developing and maintaining software for Branco Inc, with each hour being billed at Rs.1,300. Costs incurred by CTL for executing work for Branco Inc. amount to Rs. 20,00,000.

CTL had also undertaken developing software for Harsha Industries Ltd for which CTL had billed at Rs.2,700 per Man Hour. The persons working for Harsha Industries Ltd and Branco were part of the same team and were of matching credentials and caliber. CTL had made a Gross Profit of 60% on the Harsha Industries work.

CTL's transactions with Branco Inc. are comparable to the transactions with Harsha Industries, subject to the following differences:

- (a) Branco gives technical know how support to CTL which can be valued at 8% of the Normal Gross Profit. Harsha Industries does not provide any such support.
- (b) Since the work for Branco involved huge number of man hours, a quantity discount of 14% of Normal Gross Profits was given.
- (c) CTL had offered 90 Days credit to Branco the cost of which is measured at 2% of the Normal Billing Rate, No such discount was offered to Harsha Industries Ltd.

Compute ALP and the amount of increase in Total Income of Chirag Technologies Ltd.

Computation of Arms Length Gross Profit Mark Up

Particulars	%	%
Normal GP Mark Up		60
Less: Adjustment for Differences		
(a) Technical Support from Branco 8% of Normal GP [8% of 60%]	4.8	
(b) Quantity Discount 14% of Normal GP [14% of 60%]	8.4	(13.2)
		46.8
Add: Cost of Credit to Branco 2% of Normal Bill [2% x GP 60%]	1.2	1.2
Arms Length Gross Profit Mark-up		48

2. Computation of Increase in Total Income of Branco Ltd

Particulars	Rs.
Cost of Services Provided to CTL	20,00,000
Arms Length Billed Value [Cost / (100 - Arms' Length Mark up)] [=Rs. 20,00,000 / (100% - 48%)]	38,46,154
Less: [2,400 Hours x Rs.1,300]	(31,20,000)
Therefore, increase in Total Income of Branco	7,26,154

5. Explain Profit Split Method.

This method is mainly applicable in international transactions involving transfer of unique intangibles or in multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the Arm's Length Price of any one transaction.

Step I: Determine the combined net profit of the associated enterprises arising from the international transaction in which they are engaged.

Step II: Determine the relative contribution made by each of the associated enterprises to the earning of such combined net profit. This is determined on the basis of the functions performed, assets employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be determined by unrelated enterprises performing comparable functions in similar circumstances.

Step III: Split the combined net profit amongst the enterprises on the basis of reasonable returns and in proportion to their relative contributions, as determined in Step II. (See note below)

Step IV: Arm's Length Price - Profit apportioned to the assessee under Step III.

NOTE: Combined Net Profit shall be split as under:

III.A. First Split = Reasonable Return: Allocate an amount to each enterprise so as to provide it with a basic return appropriate for the type of international transaction with reference to market returns achieved in similar types of transactions by independent enterprises.

III.B. Second Split = Contribution Ratio: Allocate the residual net profit amongst the enterprises in proportion to their relative contribution.

III.C. Total Profit: Share of profit of each enterprise = Step III.A + III.B

Illustration: NBR Medical Equipments Inc. (NBR) of Canada has received an order from a leading UK based Hospital for development of a hi-tech medical equipment which will integrate the best of software and latest medical examination tool to meet varied requirements. The order was for 3,00,000 Euros. To execute the order, NBR joined hands with its subsidiary Precision Components Inc. (PCI) of USA and Bioinformatics India Ltd (BIL), an Indian Company. PCI holds 30% of BIL. NBR paid to PCI and BIL Euro 90,000 and Euro 1,00,000 respectively and kept the balance for itself. In the entire transaction, a profit of Euro 1,00,000 is earned. Bioinformatics India Ltd incurred a Total Cost of Euro 80,000 in execution of its work in the above contract. The relative contribution of NBR, PCI and BIL may be taken at 30%, 30% and 40% respectively. Compute the Arm's Length Price and the incremental Total Income of Bioinformatics India Ltd, if any due to adopting Arms Length Price determined here under.

Particulars	Euros
A.	
Share of each of the Associates in the Value of the Order	3,00,000
Value of the Order	
Share of BIL [Given]	1,00,000
Share of PCI [Given]	90,000
Share of NBR [Amount Retained = 3,00,000 – 1,00,000 - 90,000]	1,10,000
B. Share of each of the Associates in the Profit of the Order	
Combined Total Profits	1,00,000
Share of BIL [Contribution of 40% x Total Profit € 1,00,000]	40,000
Share of PCI [Contribution of 30% x Total Profit € 1,00,000]	30,000
Share of NBR [Contribution of 30% x Total Profit € 1,00,000]	30,000
C.	
Computation of Incremental Total Income of BIL	
Total Cost to Bioinformatics India Ltd	80,000
Add: Share in the Profit to BIL (from B above)	40,000
Revenue of BIL on the basis of Arm's Length Price	1,20,000
Less: Revenue Actually received by BIL	(1,00,000)
Increase in Total Income of BIL	20,000

6. Transaction Net Margin Method.

Step I: Compute the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise, in relation to costs incurred or sales effected or assets employed by enterprise or having regard to any other relevant base.

Step II: Compute the net profit margin realised by the enterprise or by an unrelated enterprise from a **comparable uncontrolled transaction (s)**, having regard to the same base as in Step I.

Step III: Adjust the net profit margin as per Step II for differences, if any, which could materially affect amount of net profit margin in the open market:

- (a) between the international transaction and the comparable uncontrolled transactions, or
- (b) between the enterprises entering into such transactions.

Step IV: Net Profit Margin for uncontrolled transactions = Step II **Add/Less** Step III.

Step V: Arm's Length Price = Transaction Value x Net Profit Margin as per Step IV above.

Meaning of certain terms: For the computation of Arm's Length Price -

1. **"Transaction"** includes a number of closely linked transactions.
2. **"Uncontrolled Transaction"** means a transaction between unrelated enterprises, whether resident or non-resident.
3. **"Unrelated Enterprises"**: Enterprises are said to be unrelated, if they are not associated or deemed to be associated u/s 92A.
4. **"Uncontrolled conditions"**: Conditions which are not controlled or suppressed or moulded for achievement of pre-determined results are said to be uncontrolled conditions.
5. **"Property"** includes goods, articles or things, and intangible property.
6. **"Services"** include financial services.

Illustration: Fox Solutions Inc. a US Company, sells Laser Printer Cartridge Drums to its Indian Subsidiary Quality Printing Ltd at S 20 per drum. Doc Solutions Inc. has other takers in India for its Cartridge Drums, for whom the price is \$ 30 per drum. During the year, Fox Solutions had supplied 12,000 Cartridge Drums to Quality Printing Ltd.

Determine the Arm's Length Price and taxable income of Quality Printing Ltd if its income after considering the above is Rs.45,00,000. Compliance with TDS provisions may be assumed and Rate per USD is Rs.45. Also determine income of Doc Solutions Inc.

1. Computation of Total Income of Quality Printing Ltd

Particulars	Rs.	Rs.
Total Income before adjusting for differences due to Arm's Length Price		45,00,000
Add: Difference on Account of Adopting Arm's Length Price		
Amount actually paid to Doc Solutions [12,000 x \$ 20 x Rs.45]	1,08,00,000	
Less: Amount under Arms Length Price [12,000 x \$ 30 x Rs.45]	<u>(1,62,00,000)</u>	
Incremental Cost on adopting ALP	<u>54,00,000</u>	
U/s 92(3), Taxable Income cannot be reduced on applying ALP. Therefore, difference on account of ALP is ignored.		
Total Income of Quality Printing Ltd		45,00,000

2. Computation of Total Income of Fox Solutions Inc.

The provisions relating to taxing income of Fox Solutions Inc., on applying Arm's Length Price for transactions entered into by a Foreign Company is given in Circular 23 dated 23.7.1969, which is as follows:

a. Transactions Not Taxable in India: Transactions will not be subject tax in India if transactions are on principal-to-principal basis and are entered into at ALP, and the subsidiary also carries on business on its own.

b. Transactions Taxable in India if the Indian Subsidiary does not carry on any business on its own. The following are the other considerations in this regard -

- (i) Adopting ALP does not affect the computation of taxable income of Fox Solutions Inc. if tax has been deducted at source or if tax is deductible.
- (ii) Where ALP is adopted for taxing income of the Parent Company, income of the recipient Company (i.e. Quality Printing Ltd) will not be recomputed.

Illustration: Khazana Ltd is an Indian Company engaged in the business of developing and manufacturing Industrial components. Its Canadian Subsidiary Techpro Inc. supplies technical information and offers technical support to Khazana for manufacturing goods, for a consideration of Euro 1,00,000 per year.

Income of Khazana Ltd is Rs.90 Lakhs. Determine the Taxable Income of Khazana Ltd if Techpro charges Euro 1,30,000 per year to other entities in India. What will be the answer if Techpro charges Euro 60,000 per year to other entities. (Rate per Euro may be taken at Rs.50.)

Computation of Total Income of Khazana Ltd

Particulars	Rs.(Lakhs)	Rs.(Lakhs)
When Price Charged for Comparable Uncontrolled Transaction is	€ 1,00,000	€ 50,000
Price actually paid by Khazana Ltd [€ 1,00,000 x Rs.50]	50	50
Less: Price Charged in Rupees (under ALP) [1,30,000 x 50] / [60,000 x 50]	65	30
Incremental Profit on adopting ALP [A]	(15)	20
Total Income before adjusting for differences due to Arm's Length Price Add:	90	90
Difference on Account of Adopting Arm's Length Price (if [A] is positive)		20
Total Income of Khazana Ltd	90	110

Note: U/s 92(3), Taxable Income cannot be reduced on applying ALP. Therefore, difference on account of ALP which reduces the Taxable Income is ignored.