

**COMPUTATION OF INCOME FROM INTERNATIONAL TRANSACTION
HAVING REGARD TO ARM'S LENGTH PRICE. SECTION 92**

(1) Any income (also includes expense or interest) arising from an international transaction shall be computed having regard to the arm's length price.

(2) Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

PROVISIONS ARE ONLY FOR THE BENEFIT OF REVENUE

The provisions transfer pricing shall not apply in a case where the computation of income or the determination of the allowance for any expense or interest or any cost or expense allocated or apportioned, or, as the case may be, has the effect of reducing the income chargeable to tax or increasing the loss. 92(3)

MEANING OF INTERNATIONAL TRANSACTION. SECTION 92B.

"international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

A transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

MEANING OF ASSOCIATED ENTERPRISE. SECTION 92A

“associated enterprise”, in relation to another enterprise, means an enterprise

- (a) Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (b) In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

DEEMED ASSOCIATE ENTERPRISE

- (a) One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or
- (b) Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- (c) A loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or
- (d) One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- (e) More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or
- (f) More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or
- (g) The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (h) Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

- (i) The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or
- (j) Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
- (k) Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or
- (l) Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or
- (m) There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

ILLUSTRATIVE CASES OF ASSOCIATE ENTERPRISE

Case study 1

‘A’ Limited is a resident of India with Head Office at Mumbai. It has a wholly owned subsidiary company ‘B’ (UK) Ltd. in U.K. where the holding of “A” Limited in “B” Limited is 26% or more. There are following transactions between the two companies :

1. ‘A’ Ltd. has exported goods to ‘B’ (UK) Ltd. for Rs.2 crores.
2. ‘B’ (UK) Ltd. has charged Pound 50000 to ‘A’ Ltd. for rent and incidental charges for use of its U.K. office premises by branch of ‘A’ Ltd.
3. ‘A’ Ltd. has given loan of Pound 1 million to ‘B’ (UK) Ltd. @ 3% P.A. interest.

All the above transactions will be considered as international transactions between two associated enterprises. ‘A’ Ltd. will have to establish that each of these transactions is at arm’s length price. If it is shown that in transaction (ii) the amount charged by ‘B’ (UK) Ltd. is less than the arm’s length price, the difference cannot be adjusted against the amount receivable under (i) or (iii) if the price charged by ‘A’ Ltd. is also shown to be less than arm’s length price. In other words, it will have to be established that each transaction is at arm’s length price.

Case Study 2

In the above case, the position will not alter even if 'C' Ltd. of Delhi holds 26% or more voting power in 'A' Ltd. and 26% or more voting power in 'B' (UK) Ltd. and 'A' Ltd. does not hold any shares in 'B' (UK) Ltd. By virtue of shareholding of 'C' Ltd., 'A' Ltd. and 'B' (UK) Ltd. will be deemed to be associated enterprises.

Case study 3

If 'X' Ltd. exports goods worth Rs.5 crores to its branch in U.K. and also imports goods worth Pound 3 million from the branch, these transactions will not be considered as international transactions. However, any sales by such U.K. branch of 'X' Ltd. to 'B' (UK) Ltd. will be considered as international transaction between associated enterprises and it will be necessary to establish that the same is at arm's length price.

Case study 4

PQR Ltd. of USA has advanced loan of USD 5 million to XYZ Ltd. of Bangalore. The rupee equivalent of this amount is about Rs.20 crores. PQR Ltd. is holding 12 % of equity capital in XYZ Ltd. The total book value of the assets of XYZ Ltd. (Factory building and other assets) is Rs.35 crores. PQR Ltd. has given guarantees to a bank in USA for loan of USD 3 million is about Rs.12 crores taken by XYZ Ltd. There are following transactions between these two companies :

1. XYZ Ltd. is paying royalty @ 10% of its sales to PQR Ltd. under a collaboration agreement for the use of know-how for 10 years.
2. XYZ Ltd. is paying USD 80000 per year to PQR Ltd. for use of patents of USA Company.
3. PQR Ltd. had supplied certain machinery and spare parts to XYZ Ltd. and charged USD one million for machinery and USD 50000 for spares.
4. XYZ Ltd. is paying interest @ 10% P.A. to PQR Ltd. on the loan advanced by PQR Ltd.
5. XYZ Ltd. has exported finished goods worth USD 2 million to PQR Ltd.

It will be necessary for XYZ Ltd. to establish that each of the above transactions is at arm's length price since PQR Ltd. and XYZ Ltd. will be considered as associated enterprises as the loan given by PQR Ltd. is more than 50% of the total book value of assets of XYZ Ltd.

Case study 5

In the above case if the book value of assets of XYZ Ltd. is Rs.120 crores, and the total borrowings of XYZ Ltd. are Rs.100 crores, PQR Ltd. and XYZ Ltd. will be deemed to be associated enterprises. This is because the amount for which guarantee is given by PQR will exceed 10 % of total borrowings. XYZ Ltd. will have to explain that the above transactions are at arm's length prices.

Case study 6

M/s. CDX is a partnership firm in which there are four partners viz. Mr. J (12%), Mr. C (20%), Mr. D (40%) and Mr. X (28%). Mr. C, D and X are brothers but not related to Mr. J. Mr J is proprietor of M/s Jems India and exporters of jewelry from India. During the year he has exported to following firms.

Name	Country	Items	(Amount)(Rs. in Lacs)
M/s. ABC	Dubai	40	50
M/s. BCD	Europe	100	120
M/s. CDX	U.K.	10	30

From the above facts, it will be noted that all the above exports by M/s. Jems India will be deemed to have been made to associated enterprises and M/s. Jems India will have to establish that they are at arm's length prices.

BRIEF TIME TABLE FOR MAY 2005 C.A. FINAL EXAMINATION. SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
MAY 2005 (A.Y. 2005-2006)	ANDHERI	17-01-2005	Few Seats Available
MAY 2005 (A.Y. 2005-2006)	CHARNI ROAD	22-11-2004	FULL
MAY 2005 (A.Y. 2005-2006)	GHATKOPAR	15-01-2005	Few Seats Available

Course Coverage for all the branches is the same.

All lectures are conducted by Professor Kalpesh Sanghavi Only.

COMPUTATION OF ARM'S LENGTH PRICE. SECTION 92C

(1) The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely :

- (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) The most appropriate method referred above shall be applied, for determination of arm's length price, in the manner as may be prescribed : **Provided** that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.

Provided that no deduction under section 10A or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section :

Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible under the provisions of Chapter XVIIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

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RULE 10B. DETERMINATION OF ARM'S LENGTH PRICE**COMPARABLE UNCONTROLLED PRICE METHOD**

- i. The price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified ;
- ii. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market ;
- iii. The adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction ;

GUIDELINES FOR COMPARABLE PRICE

The comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely :

- (a) the specific characteristics of the property transferred or services provided in either transaction ;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions ;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions ;
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

USABILITY OF DATA

The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into. Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

(B) RESALE PRICE METHOD

- i. 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, is identified ;
- ii. Such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions ;
- iii. The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services ;
- iv. The price so arrived at is adjusted to take into account the 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 ;
- v. The adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise ;

(C) COST PLUS METHOD.

- i. The direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined ;
- ii. The amount of a normal gross profit mark-up to such costs (computed according to the 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, or a number of such transactions, is determined ;
- iii. The normal gross profit mark-up referred to in sub-clause (ii) is adjusted 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 ;
- iv. The costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii) ;
- v. The sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise ;

(D) PROFIT SPLIT METHOD,

which may be applicable mainly 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

- i. The combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined ;
- ii. The relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances ;
- iii. The combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii) ;
- iv. The profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction :

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction ;

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(E) TRANSACTIONAL NET MARGIN METHOD

- i. The net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base ;
- ii. The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base ;
- iii. The net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, 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 net profit margin in the open market ;
- iv. The net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii) ;
- v. The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

92CA. REFERENCE TO TRANSFER PRICING OFFICER.

(1) Where any person, being the assessee, has entered into an international transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said international transaction under section 92C to the Transfer Pricing Officer.

(2) Where a reference is made the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction.

(3) On the date specified in the notice, or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents and after considering such evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the international transaction in accordance with 92C and send a copy of his order to the Assessing Officer and to the assessee.

(4) On receipt of the order, the Assessing Officer shall proceed to compute the total income of the assessee under 92C having regard to the arm's length price determined by the Transfer Pricing Officer.

(5) With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him and the provisions of section 154 shall, so far as may be, apply accordingly.

(6) Where any amendment is made by the Transfer Pricing Officer, he shall send a copy of his order to the Assessing Officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.

(7) The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified 131 (Power regarding discovery, production of evidence, etc.) or 133(6) (Power to call for information in relation to banks) .

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