

Transfer Pricing and Other Provisions to Check Avoidance of Tax

Some Key Points

Safe harbour rules [Section 92CB]

Section 92CB empowers the Board to make rules for safe harbour. The determination of arm's length price under section 92C or section 92CA shall be subject to safe harbour rules.

"Safe harbour" means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.

Penalties

- Section 271 provides for penalty in respect of cases where the Assessing Officer adjusts total income by determining ALP. The penalty for such concealment is minimum 100% and maximum 300% of tax on such concealed income.
- Sections 271AA and 271G provide for penalty for failure to keep and maintain transfer price information or documentation or to produce the same during assessment proceedings. If any person fails to keep and maintain any such information as required by section 92D (1) and (2) or fails to produce the same under section 92D(3), the Assessing Officer or Commissioner (Appeals) may direct such person to pay by way of penalty, a sum equal to 2% of the value of each international transaction entered into by such person.
- Section 271BA provides for penalty for failure to furnish accountant's report. The penalty for failure to furnish a report from Chartered Accountant as required by section 92E is ₹ 1 Lac.
- In all the above cases, if the assessee can show that there was reasonable cause for the failure, no penalty will be leviable.

Recent Amendments

Permissible variation between ALP and transfer price to be such percentage of the transfer price, as may be notified by the Central Government [Section 92C]

- (i) Section 92C requires application of the most appropriate method for determination of arm's length price (ALP). Where more than one price is determined by the most appropriate method, the ALP shall be the arithmetical mean of such prices. However, if the ALP so determined is within 5% of the transfer price, then no adjustment is required to be made and the transfer price would be deemed to be the ALP of the

international transaction.

- (ii) The permissible variation at a standard rate of 5% of the transfer price for all segments of business activity and range of international transactions has been substituted by such percentage of the transfer price, as may be notified by the Central Government in this behalf by the Finance Act, 2011, effective from A.Y. 2012-13 [Second proviso to section 92C(2)].
- (iii) The Central Government may, therefore, prescribe the rate of permissible variation for different segments of business activity and class of international transactions.

Broadening the scope of powers of Transfer Pricing Officer (TPO) [Section 92CA(2A) & (7)]

The powers of the TPO under section 92CA have been extended by the Finance Act, 2011, with effect from 1st June, 2011, to empower him to -

- (i) determine the arm's length price of other international transactions, identified subsequently in course of proceedings before him. So far, his powers were restricted to determining the ALP of international transactions referred to him by the Assessing Officer.
- (ii) conduct a survey by exercising the powers conferred upon an income-tax authority under section 133A for the purpose of determining the ALP.

Introduction of specific anti-avoidance measures in respect of transactions with persons located in notified jurisdictional area [New Section 94A]

The objective of the introduction of anti-avoidance measures by the Finance Act, 2011, effective from 1st June, 2011, is to discourage assessee from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. The following are the anti-avoidance measures introduced -

- (i) The Central Government empowered to notify any such country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.
- (ii) A transaction where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction and all parties to the transaction to be deemed as associated enterprises, and accordingly, all the provisions of transfer pricing to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price [provided for in the second proviso to section 92C(2)] based on the rate notified by the Central Government would not be available in respect of such transaction.
- (iii) Such transaction may be in the nature of –
 - (1) purchase, sale or lease of tangible or intangible property or
 - (2) provision of service or

- (3) lending or borrowing money or
- (4) any other transaction having a bearing on the profits, income, losses or assets of the assessee. It may include a mutual agreement or arrangement for allocation or apportionment of, or contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided by or to the assessee.
- (iv) Person located in a NJA shall include a person who is a resident of the NJA and a person, not being an individual, which is established in the NJA. It would also include a permanent establishment of any other person in the NJA.
- (v) Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.
- (vi) No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.
- (vii) Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.
- (viii) The rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –
 - (1) rates specified in the relevant provision of the Income-tax Act, 1961; or
 - (2) rate or rates in force; or
 - (3) 30%.

Question 1

Can the Transfer Pricing Officer accept use of multiple-year data for determination of Arm's Length Price in an international transaction?

Answer

Rule 10B of the Income-tax Rules, 1962, has prescribed the methods of determining Arm's Length Price under section 92C.

As per Rule 10B(4), the data to be used in analyzing 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. However, data relating to a period of maximum 2 years prior to such financial year may also be considered if such data reveals

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the facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

In effect, the transfer pricing officer can use the data of maximum 2 years prior to the relevant financial year for determination of arm's length price in an international transaction provided the same influence the determination of transfer price in the relevant financial year.

Question 2

"Mingle Engineering Ltd", a Korean non-resident company, had entered into an agreement for designing, fabricating, hook-up and commissioning of a platform in the Bombay High with "Crude Oil India Ltd", an Indian company. The agreement entered into was in two parts, one for the value to be charged for fabrication of structure in Korea for ₹ 20 crores (having element of profit in it of ₹ 2 crores) and other for the installation and commissioning of the structure in Bombay High for ₹ 15 crores (having element of profit in it of ₹ 1.5 crores). The activity of installation and commissioning in India would commence only after the activity of fabrication of structure in Korea. The Korean company will also be setting up an office in India for the activity of installation and commissioning of the platform which is likely to be completed in 9 months.

On these facts, you are required to answer/work out:-

- (a) *Whether the office of Mingle Engineering Ltd. to be opened in India be considered as its "permanent establishment"?*
- (b) *The amount of profits, if any, of the non-resident company subject to tax in India.*
- (c) *The income subject to tax in India, when the arm's length price of the fabrication of structure is determined at ₹ 19 crores by applying the arithmetical mean of two prices determined by the most appropriate method. Assume that the permissible variation notified by the Central Government is 5%.*

Answer

The facts given in the problem are similar to the facts of the case decided by the Apex Court in *CIT v. Hyundai Heavy Industries Co. Ltd.* [2007] 291 ITR 482. The answer to the various parts of the question is accordingly based upon the ruling of the Apex Court in this case and the provisions as contained in sections 9, 92B, 92C and 92F of the Income-tax Act, 1961.

- (a) The Korean Company, for the purpose of commissioning of the platform in Bombay High, shall be having an office in India for a period of around 9 months. The business of the enterprise shall be wholly or partly carried on in India through the office to be set up by the non-resident company. As per section 92F(iia), maintaining of an office by the non-resident in India for the conduct of its business, shall be treated as a 'permanent establishment'. Therefore, the office of Mingle Engineering Ltd. to be opened in India can be considered as its permanent establishment in India.
- (b) The total income of a person who is a non-resident includes only income which accrues or arises or is deemed to accrue or arise to him in India during the previous year. The

income which accrues or arises outside India is not includible in the total income of a non-resident assessee.

Accordingly, only the profits attributable to the permanent establishment of the Korean non-resident company i.e., ₹ 1.5 crores relating to the second part of the agreement for carrying out the activity of installation and commissioning of the platform in Bombay High (which is being conducted/supervised from the office in India) would be taxable in India, since it accrues or arises in India.

The profit of ₹ 2 crores relating to the fabrication work of the platform shall not be taxable in India because the completed structure is to be supplied from Korea. Such profits are not attributable to the permanent establishment, because the work of fabrication was completed in Korea prior to coming into existence of the permanent establishment in India.

- (c) Since the variation between the ALP and the transfer price (TP) is within 5% of the TP, the TP shall be deemed to be the arm's length price and no adjustment is required to be made.

In this case, the TP is ₹ 20 crores and 5% of the TP is ₹ 1 crore. Since the variation between the ALP of ₹ 19 crores and the TP of ₹ 20 crores is within 5% of TP (i.e., ₹ 1 crore), no adjustment is required and the TP of ₹ 20 crores shall be deemed to be the ALP.

The income subject to tax in India would, therefore, continue to be only ₹ 1.50 crores.

Question 3

Discuss whether adjustment is required in the context of transfer pricing provisions where the transfer price adopted for an international transaction of sale of goods by an Indian company during the financial year 2011-12, is ₹ 50 lacs whilst the Arm's Length Price determined using appropriate method are ₹ 48 lacs and ₹ 56 lacs. Assume that the rate of permissible variation prescribed by the Central Government is 6% of the transfer price for this class of international transaction.

Answer

The proviso to section 92C(2) provides that where more than one price is determined by the most appropriate method, the arm's length price (ALP) shall be taken to be the arithmetical mean of such prices.

However, if the arithmetical mean, so determined, is within such percentage of the transfer price notified by the central government, then the transfer price shall be deemed to be the arm's length price and no adjustment is required to be made.

The arithmetical mean of the prices = $(₹ 48 + ₹ 56) / 2 = ₹ 52$ lacs.

The rate of permissible variation prescribed by the Central Government is 6% i.e. ₹ 3 lacs (₹ 50 lacs x 6%).

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Since the variation between the arm's length price of ₹ 52 lacs and the transfer price of ₹ 50 lacs is within 6% of TP (i.e., ₹ 3 lacs), no adjustment is required and the transfer price of ₹ 50 lacs shall be deemed to be the arm's length price.

Question 4

I. Limited, an Indian Company supplied billets to its holding company, U. Limited, UK during the previous year 2011-12. I. Limited also supplied the same product to another UK based company, V. Limited, an unrelated entity. The transactions with U. Limited are priced at Euro 500 per MT (FOB), whereas the transactions with V. Limited are priced at Euro 700 per MT (CIF). Insurance and Freight amounts to Euro 200 per MT. Compute the arm's length price for the transaction with U. Limited.

Answer

In this case, I Limited, the Indian company, supplied billets to its foreign holding company, U Limited. Since the foreign company, U Limited, holds more than 26% shares in I Limited, I Limited and U Limited shall be deemed to be associated enterprises within the meaning of section 92A.

As I Limited supplies similar product to an unrelated entity, V Limited, UK, the transactions between I Limited and V. Limited can be considered as comparable uncontrolled transactions for the purpose of determining the arm's length price of the transactions between I. Limited and U Limited. Comparable Uncontrolled Price (CUP) method of determination of arm's length price (ALP) would be applicable in this case.

Transactions with U Limited are on FOB basis, whereas transactions with V Limited are on CIF basis. This difference has to be adjusted before comparing the prices.

	Amount (in Euro)
Price per MT of billets to V. Limited	700
Less: Cost of insurance and freight per M.T.	<u>200</u>
Adjusted Price per M.T.	<u>500</u>

Since the adjusted price for V. Limited, UK and the price fixed for U Limited are the same, the arm's length price is Euro 500 per MT. Since the sale price to related party (i.e., U Limited) and unrelated party (i.e., V Limited) is the same, the transaction with related party U Limited has also been carried out at arm's length price.

Question 5

X Ltd., operating in India, is the dealer for the goods manufactured by Yen Ltd. of Japan. Yen Ltd. owns 55% shares of X Ltd. and out of 7 directors of the company, 4 were appointed by them. The Assessing Officer, after verification of transactions of ₹ 300 lacs of X Ltd. for the relevant year and by noticing that the company had failed to maintain the requisite records and had also not obtained the accountants report, adjusted its income by making an addition

of ₹ 30,00,000 to the declared income and also issued a show cause notice to levy various penalties. X Ltd seeks your expert opinion.

Answer

The facts of the case indicate that X Ltd. and Yen Ltd. of Japan are associated enterprises since Yen Ltd. holds shares carrying more than 26% of the voting power in X Ltd. and has appointed more than half of the board of directors of X Ltd. Since Yen Ltd. is a non-resident, any transaction between X Ltd. and Yen Ltd. would fall within the meaning of “international transaction” under section 92B. Therefore, the income arising from such transactions have to be computed having regard to the arm's length price. The action of the Assessing Officer in making addition to the declared income and issuing show cause notice for levy of various penalties is correct since X Ltd. had committed defaults, as listed hereunder, in respect of which penalty, as briefed hereunder, is imposable -

- (i) Since X Ltd. has entered into an international transaction as defined in section 92B, any amount added or disallowed in computing the total income under section 92C(4), shall be deemed to represent income in respect of which particulars have been concealed or inaccurate particulars have been furnished which makes it liable for penalty under section 271(1)(c) read with Explanation 7. The penalty would be 100% to 300% of the amount of tax sought to be evaded.
- (ii) Failure to maintain the requisite records as required under section 92D in relation to international transaction makes it liable for penalty under section 271AA which will be 2% of the value of each international transaction.
- (iii) Failure to furnish report from an accountant as required under section 92E makes it liable for penalty under section 271BA i.e., a fixed penalty of ₹ 1 Lac.

The Assessing Officer shall give an opportunity of hearing to the assessee with a notice as to why the arm's length price should not be determined on the basis of material or information or document in the possession of the Assessing Officer.

Question 6

EF Limited, an Indian company, is engaged in manufacturing electronic components. 74% of shares of the company are held by EF Inc., incorporated in USA. EF Limited has borrowed funds from EF Inc. at LIBOR plus 150 points. The LIBOR prevalent at the time of borrowing is 4% for US \$. The borrowings allowed under the External Commercial Borrowings guidelines issued under Foreign Exchange Management Act are LIBOR plus 200 basis points. Discuss whether the borrowing made by EF Limited is at arm's length ('LIBOR' means London Inter-Bank Offer Rate).

Answer

One of the methods for determination of arm's length price in an international transaction is Comparable Uncontrolled Price method (CUP). Under the CUP method, the price charged or paid for property transferred or services rendered in a comparable uncontrolled transaction, or

a number of such transactions, is identified. Such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price so arrived at is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.

EF Inc., USA and EF Limited, the Indian company shall be deemed to be associated enterprises since the former holds more than 26% voting power in the latter.

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 200 basis points i.e., $4\% + 2\% = 6\%$, which can be taken as the arm's length rate. The interest rate applicable on the borrowing by EF Limited, India from EF Inc., USA, is LIBOR plus 150 basis points i.e., $4\% + 1.5\% = 5.5\%$. Since the rate of interest, i.e. 5.5% is less than the arm's length rate of 6%, the borrowing made by the EF Ltd. is not at arm's length. However, in this case, the taxable income of EF 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.

Question 7

In the context of transfer pricing provisions, read with rules, what are the factors to be considered while selecting the most appropriate method?

Answer

Rule 10C deals with the determination of the most appropriate method. Under this Rule, the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction will be considered as the most appropriate method.

For the purpose of selecting the most appropriate method, the following factors should be taken into account -

- (i) the nature and class of the international transaction;
- (ii) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- (iii) the availability, coverage and reliability of data necessary for application of the method;
- (iv) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;
- (v) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

- (vi) the nature, extent and reliability of assumptions required to be made in application of a method.

Question 8

Anush Motors Ltd., an Indian company declared income of ₹ 300 crores computed in accordance with Chapter IV-D but before making any adjustments in respect of the following transactions for the year ended on 31.3.2012:

- (i) 10,000 cars sold to Rida Ltd. which holds 30% shares in Anush Motors Ltd. at a price which is less by \$ 200 each car than the price charged from Shingto Ltd.
- (ii) Royalty of \$ 1,20,00,000 was paid to Kyoto Ltd. for use of technical know-how in the manufacturing of car. However, Kyoto Ltd. had provided the same know-how to another Indian company for \$ 90,00,000.
- (iii) Loan of Euro 1000 crores carrying interest @ 10% p.a. advanced by Dorf Ltd., a German company, was outstanding on 31.3.2012. The total book value of assets of Anush Motors Ltd. on the date was ₹ 90,000 crores. The said German company had also advanced a loan of similar amount to another Indian company @ 9% p.a. Total interest paid for the year was EURO 100 crores.

Explain in brief the provisions of the Act affecting all these transactions and compute the income of the company chargeable to tax for A.Y.2012-13 keeping in mind that the value of 1\$ and of 1 EURO was ₹ 45 and ₹ 55, respectively, throughout the year.

Answer

Any income arising from an international transaction, where two or more “associated enterprises” enter into a mutual agreement or arrangement, shall be computed having regard to arm’s length price as per the provisions of Chapter X of the Act.

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, it is clear that “Anush Motors Ltd.” is associated with :-

- (i) Rida Ltd. as per section 92A(2)(a), because this company holds shares carrying more than 26% of the voting power in Anush Motors Ltd.;
- (ii) Kyoto Ltd. as per section 92A(2)(g), since this company is the sole owner of the technology used by Anush Motors Ltd. in its manufacturing process;
- (iii) Dorf Ltd. as per section 92A(2)(c), since this company has financed an amount which is more than 51% of the book value of total assets of Anush Motors Ltd.

The transactions entered into by Anush Motors Ltd. with different companies are, therefore, to be adjusted accordingly to work out the income chargeable to tax for the A.Y. 2012-13.

	Income of Anush Motors Ltd. as computed under Chapter IV-D, prior to adjustments as per Chapter – X	₹ 300 crore
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Add:	Difference on account of adjustment in the value of international transactions:	
(i)	Difference in price of car @ \$ 200 each for 10,000 cars (\$ 200 x 10,000 x 45)	₹ 9 crore
(ii)	Difference for excess payment of royalty of \$ 30,00,000 (\$ 30,00,000 x 45) [See Note below]	₹ 13.5 crore
(iii)	Difference for excess interest paid on loan of EURO 1000 crores (55*1000*1/100)	₹ 550 crore
	Total Income	<u>₹ 872.5 crore</u>

Note – The difference for excess payment of royalty has been added back presuming that the manufacture of cars by Anush Motors Ltd is wholly dependent on the use of know-how owned by Kyoto Ltd.

Question 9

What is the legislative objective of bringing into existence the provisions relating to transfer pricing ?

Answer

The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions prompted the Government to set up an Expert Group to examine the issues relating to transfer pricing.

There is a possibility that two or more entities belonging to the same multinational group can fix up their prices for goods and services and allocate profits among the enterprises within the group in such a way that there may be either no profit or negligible profit in the jurisdiction which taxes such profits and substantial profit in the jurisdiction which is tax haven or where the tax liability is minimum. This may adversely affect a country's share of due revenue. The increasing participation of multinational groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, which may lead to erosion of tax revenue. Therefore, transfer pricing provisions have been brought in by the Finance Act, 2001 with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises.

Question 10

US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND. Ltd. at ₹ 11,000 per unit. The price fixed for CMI Ltd. is ₹ 10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a

standard rate of ₹ 1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?

Answer

US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd holds not less than 26% voting rights in IND Ltd. (being a subsidiary of US Ltd., more than 50% of its voting rights would be held by US Ltd.). US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd also sells identical computer monitors to CMI Ltd, which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is, therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm's length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm's length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	₹
Sale price charged by US Ltd. to CMI Ltd.	50,000	10,000
Less: Cost of warranty included in the price charged to CMI Ltd. (₹ 1,000 x 3/12)		250
Arm's length price		9,750
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		1,250
No. of units supplied by US Ltd. to IND Ltd. Addition required to be made in the computation of total income of IND Ltd. (1,250 × 50,000)		6,25,00,000

No deduction under chapter VI-A would be allowable in respect of the enhanced income of ₹ 6.25 crores.

Question 11

Discuss the concept of Arm's length price as envisaged in section 92C of the Income-tax Act, 1961. What are the methods under which the arm's length price, relating to an international transaction, is determined under section 92C?

Answer

"Arm's length price" is defined in section 92F(ii) to mean price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled

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conditions. Section 92C deals with the method to be adopted for determining the arm's length price and the factors to be considered for applying a particular method.

Section 92C provides that 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 the 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.

Out of the above, the most appropriate method shall be selected in the manner as may be prescribed by the Rules. However, if more than one price is determined by the most appropriate method, then the arithmetical mean of such price shall be taken as arm's length price.

If the variation between the arm's length price determined and the price at which the transaction was actually undertaken does not exceed such percentage of the latter (i.e. the actual transaction price) as may be notified by the Central Government in the Official Gazette, then the price at which the international transaction was undertaken shall be deemed to be the arm's length price.

Question 12

- (a) *When shall a transaction be considered as an international transaction?*
- (b) *In what circumstances shall a transaction entered into with a person other than an associated enterprise be deemed to be a transaction between two associated enterprises?*

Answer

- (a) An international transaction is one which satisfies the following criteria -
 - (i) A transaction between two or more associated enterprises, either or both of whom are non-residents;
 - (ii) It is in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, lending/borrowing money or any other transaction having a bearing on the profits, income, losses or assets of such enterprises;
 - (iii) It includes a transaction in the nature of a mutual agreement, or arrangement between two or more associated enterprises for the allocation or apportionment of any contribution, 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.

- (b) As per the provisions of section 92B(2), a transaction entered into by an enterprise with a person other than the associated enterprise, shall for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises if
- (i) there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise; or
 - (ii) the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Question 13

R, an individual resident in India, bought 1,000 equity shares of ₹ 10 each of A Ltd. at ₹ 50 per share on 30.5.2011. He sold 700 equity shares at ₹ 35 per share on 30.9.2011 and the remaining 300 shares at ₹ 25 per share on 20.12.2011. A Ltd. declared a dividend of 50%, the record date being 10.8.2011. R sold on 1.2.2012, a house from which he derived a long-term capital gain of ₹ 75,000.

Compute the amount of capital gain arising to R for the assessment year 2012-13.

Answer

The amount of capital gains arising to R has to be computed applying the provisions of sub-section (7) of section 94, which provides that “where:

- (a) any person buys or acquires any securities or unit within a period of three months prior to the record date; and
- (b) such person sells or transfers -
 - (i) such securities within a period of three months after such date; or
 - (ii) such unit within a period of nine months after such date; and
- (c) the dividend or income on such securities or unit received or receivable by such person is exempted,

then the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received or receivable on such securities or unit, shall be ignored for the purpose of computing his income chargeable to tax”.

For this purpose, “record date” means such date as may be fixed by a company for the purpose of entitlement of the holder of the securities to receive dividend and “securities” includes stocks and shares.

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Computation of capital gains of Mr. R for the assessment year 2012-13

Particulars	₹	₹
Long-term capital gain on sale of building		75,000
Less: Short-term capital loss on sale of shares		
700 shares	7,000	
300 shares	7,500	14,500
Taxable long-term capital gains		60,500

Computation of capital gain on sale of shares of A Ltd. by Mr.R

Date of purchase of shares		30.5.2011
Record date		10.8.2011
Date of sale of shares	30.9.2011	20.12.2011
Number of shares sold	700	300
Sale price per share	₹ 35	₹ 25

Particulars	₹	₹
Sale consideration	24,500	7,500
Less: Cost of acquisition	35,000	15,000
	10,500	7,500
Less: Dividend income as per section 94(7) [700×10×50%] [See Note below]	3,500	Not deductible
Short-term capital loss on sale of shares	7,000	7,500

Note:

1. 700 shares are sold within 3 months after the record date, hence related dividend income should be deducted from the loss as per section 94(7).
2. 300 shares having been sold after 3 months of record date, section 94(7) is not applicable. So, the dividend income of ₹ 1,500/- should not be deducted. Such dividend is exempt under section 10(34).
3. Short-term capital loss can be set-off against long-term capital gains as per the provisions of section 74(1)(a). Therefore, short-term capital loss on sale of shares can be set-off against long-term capital gains on sale of building.

Self-examination Questions

1. Discuss the meaning of the term "Arm's length principle" and its significance.
2. What are the practical difficulties in application of arm's length principle?
3. What are the guidelines to be followed while applying the arm's length principle?

4. Discuss the methods for calculating arm's length price, briefing the advantages and limitations of each method.
5. What are the issues involved in applying arm's length principle to -
 - (a) Intangibles
 - (b) Intra-group services.
6. What is the legislative objective of bringing into existence the provisions relating to transfer pricing in India?
7. Discuss the meaning of the following terms -
 - (a) Associated Enterprise
 - (b) International Transaction
8. What is the procedure for making reference to a Transfer Pricing Officer?
9. What are the information and documents prescribed under Rule 10D to be kept and maintained by the assessee?
10. Write short notes on -
 - (a) Bond washing transactions
 - (b) Dividend stripping.