Paper 7 – Direct Taxation

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Time Allowed: 3 Hours **Full Marks: 100**

Answer Question No. 1 which is compulsory and any FOUR from Question No 2 to 7.

1.

(a) Fill in the blanks: **5 x 1 = 5**

(i) Total Income of Mr Pankaj aged 30 is ₹ 7,26,500. His tax liability would be for assessment year 2017-18 is _______________.

(ii) The obligation to pay advance tax arises in every case where the advance tax payable is ₹ __________ or more.

(iii) Deduction in respect of interest on loan taken from financial institutions for residential house property, if certain conditions are satisfied is limited to maximum of ₹_______.

(iv) The rate of TDS if pan is not provided is _________.

(v) Dividend in aggregate exceeding ₹ ____________ received by certain persons to be taxed at the special rate of 10%.

Answer:

(i) ₹ 72,410
(ii) ₹ 10,000
(iii) ₹ 50,000
(iv) Maximum Marginal rate
(v) 10 Lakh

(b) Choose the most appropriate alternative. **5 x 1 = 5**

(i) Rebate u/s 87A is allowed to an Individual who is resident in India and whose total income does not exceed ________.
(a) ₹ 2,50,000
(b) ₹ 3,00,000
(c) ₹ 5,00,000
(d) None of the above

(ii) The payment under Bhopal Gas Leak Disaster shall be______
(a) Fully taxable
(b) Partially taxable
(c) Exempt
(d) None of the above

(iii) Compensatory field area allowance is exempt upto ______
(a) 1,300
(b) 1,800
(c) 2,500
(d) 2,600

(iv) The time limit for acquisition or construction of self occupied house property for claiming deduction of interest is:
(a) 3 years
(b) 5 years
(c) 8 years
(d) 10 years

(v) Tax to be collected at source in case of motor vehicle value exceeding ₹ ________.
(a) ₹ 2,50,000
(b) ₹ 5,00,000
(c) ₹ 7,50,000
(d) ₹ 1,000,000

Answer:

(i) c
(ii) c

(iii) d
(iv) b
(v) d

(c) State true or false with reasons: **5 x 2 = 10**

(i) TDS on commission or brokerage is levied when the amount exceeds ₹ 15,000.
(ii) Tax to be collected at source in case of sale of any goods (other than bullion and jewellery) or providing of service exceeding ₹ 1,00,000.
(iii) Circulars and classification are issued by the central government.
(iv) Provision of Section 44AE is not applicable in case the assessee owns more than 10 goods carriage or where he declares lower profits and gains than the profit and gains specified in section 44AE.
(v) Refund of income tax is not income as it was not allowed as deduction but interest received on refund will be treated as income.

Answer:

(i) **True:** TDS on commission or brokerage is levied when the amount exceeds ₹ 15,000.
(ii) **False:** Tax to be collected at source in case of sale of any goods (other than bullion and jewellery) or providing of service exceeding ₹ 2,00,000.
(iii) **False:** Circulars and classification are issued by the CBDT.
(iv) **True:** Provision of Section 44AE is not applicable in case the assessee owns more than 10 goods carriage or where he declares lower profits and gains than the profit and gains specified in section 44AE.
(v) **True:** Refund of income tax is not income as it was not allowed as deduction but interest received on refund will be treated as income.

2. a.) Amit earns the following income during the financial year 2016-17: **7 marks**

Particulars	Amount (₹)
Interest from an Indian company received in London.	1,20,000
Pension from former employer in India received in USA.	1,80,000
Profits earned from a business in Paris which is controlled in India, half of the profits being received in India.	2,00,000
Income from agriculture in Bhutan and remitted to India.	1,25,000
Income from property in England received there.	4,00,000
Past foreign income brought to India.	10,000

Compute his income for the assessment year 2017-18 if he is:
(i) Resident and ordinarily resident in India.
(ii) Not ordinarily resident in India.
(iii) Non-resident in India.

2. b.) Mrs. Y has the following income during the previous year 2016-17: **8 marks**

Sl/No.	Particulars	Amount (₹)
(i)	Salary	3,10,000
(ii)	Dearness Allowance (forming part of salary for retirement benefits)	72,000
(iii)	Medical Allowance (Actual expenditure ₹ 28,000)	30,000
(iv)	Education Allowance (for three children)	5,200
(v)	Rent free house in Delhi for which X Ltd., the employer, paid ₹ 5,000 per month as rent. The house is equipped with rented furniture. The rent of the furniture is ₹ 3,000 per month.	
(vi)	The employer had provided her a domestic servant, a sweeper and a watchman. The employer paid ₹ 500 per month to each.	
(vii)	The employer spent ₹ 2,500 on her refresher course.	
(viii)	Telephone bills paid by Mrs. Y	22,200

(ix)	Profession tax paid by Mrs. Y	1,200

Compute her taxable income for the AY 2017-18 assuming that she has no other income.

Answer:

a. Calculation of Income of Mr. Amit for A.Y 2017-18

Particulars	**Resident and Ordinary resident**	**Not Ordinary resident**	**Non Resident**
1. Income deemed to accrue/arise in India Interest from Indian Company Pension from employer in India	1,20,000 1,80,000	1,20,000 1,80,000	1,20,000 1,80,000
2. Income received in India 50% of profits of business in Paris.	1,00,000	1,00,000	1,00,000
3. Income earned and received outside India, from a business controlled from India 50% of profit of business in Paris	1,00,000	1,00,000	___
4. Income earned and received outside India other than (3) Income from Agriculture in Bhutan Income from Property in England.	1,25,000 4,00,000	___ ___	___ ___
	10,25,000	5,00,000	4,00,000

b. Computation of income of Mrs Y for A.Y 2017-18 assuming that she has no other income.

Particulars	Amount (₹)	Amount (₹)
Salary		3,10,000
Dearness Allowance		72,000
Medical Allowance		30,000
Education Allowance *Less:* Exempt (₹100 x 2 x 12)	5,200 2,400	2,800
Perquisites: (i) Value of rent free furnished house (ii) Domestic servant @ ₹200 p.m. (iii) Sweeper @ ₹200 p.m. (iv) Watchman @ ₹200 p.m.	96,000 6,000 6,000 6,000	1,14,000
Gross salary		5,28,800
Less Professional tax u/s 16 (iii)		1,200
Net Income from Salary		5,27,600

Note:

1. Medical allowance is fully taxable irrespective of the actual expenditure.
2. Salary for purpose of rent free accommodation is ₹ 3,10,000 + ₹ 72,000 (DA) + ₹ 30,000 (Medical Allowance) + ₹ 2,800 (Education Allowance) *i.e.* ₹ 4,14,800.
3. Valuation of rent free accommodation is 15% of ₹4,14,800 *i.e.* ₹ 62,220 or ₹ 60,000 whichever is less. To this add ₹ 36,000 for furniture.
4. Amounts spent on refresher course and telephone bills are exempted perquisites.

3. a.) Pankaj has 2 house properties situated in Delhi. Property A is self-occupied for first 6 months i.e. from 1.4.2016 to 30.09.2016 and w.e.f. 1.10.2017, it is let out for ₹ 10,000 per month. Property B is let out w.e.f. 1.4.2016 at rent of ₹ 12,000 p.m and w.e.f from 1.10.2016 , it was self-occupied as Pankaj shifted his residence from property A to property B.

The other details of the above two house properties are as under: **7 marks**

Particulars	Amount (₹)	Amount (₹)
Municipal tax paid	30,000	24,000
Insurance premium paid	3,000	4,000
Interest on money borrowed for purchase of house property	35,000	40,000

Compute the income from house property of Mr Pankaj for A.Y 2017-18.

3. b.) Mr. Amit furnished the following information relevant for the assessment year 2017-18:

Profit & Loss A/c for the year ending 31.3.2017

8 marks

Particulars	Amount (₹)	Particulars	Amount (₹)
Household expenses	11,200	Gross Profit	2,69,000
Bad debts	600	Commission	5,000
Provision for bad debts	4,800	Sundry receipts	8,000
Fire insurance	1,000	Bad debts recovered (earlier allowed as deduction)	2,000
Salary to Staff	8,000	Interest on Govt. securities	17,000
Salary to Amit	3,000		
Contribution towards Unrecognized Provident fund	32,000		
Interest on overdraft from bank	6,000		
Interest on capital	13,000		
Interest on loan given by Amit 's brother	1,000		
Depreciation on building and furniture	13,600		
Advertisement Revenue expenses	3,800		
Expenses on Neon sign board	1,000		
General expenses	4,700		
Net profit	1,97,300		
	3,01,000		3,01,000

Other Information-

1. General expenses include personal expenses of ₹ 1,700.
2. Business income of ₹3,000, accrued during previous year ending 31.3.2017 is not recorded in the Profit and loss A/c.
3. Amit contributes ₹ 14,000 towards public provident fund.
4. Depreciation on building and furniture comes to 3,000 according to the tax provisions.

Determine the tax liability of Mr. Amit for the Assessment Year 2017-18.

Answer:

(a)

In the above question, properties A & B are both part of the year let out and part of the year self-occupied. Since both the house properties have been let for part of the year, the benefit of annual value to be taken as nil for one self-occupied house shall not be allowed. The annual value of both the houses shall be determined as per section 23(1).

	Property-A	Property-B
	Amount (₹)	Amount (₹)
Gross Annual value shall be	1,20,000	1,44,000

Less: Municipal taxes	30,000	24,000
Net Annual Value	90,000	1,20,000
Less: deduction u/s 24 (a) Deduction @30% (b) Interest	 27,000 35,000	 36,000 40,000
Income from House Property	28,000	44,000

b. Computation of Taxable Income of Shri Amitfor the A.Y 2017-18

	Amount (₹)	Amount (₹)
Net Profit as per P&L A/c.		1,97,300
Add: Expenses/Payments not admissible: Household expenses Provision for bad debts Salary to Amit Contribution towards URPF Interest on capital Depreciation (in excess of tax provision *i.e.* ₹13,600 - ₹3,000) General Expenses to the extent of personal expenses	 11,200 4,800 3,000 32,000 13,000 10,600 1,700	 76,300
		2,73,600
Add: Income not recorded in P & L A/c		3,000
		2,76,600
Interest on Govt Securities		17,000
Business Income		2,59,600
Income from Other Sources: Interest on Govt Securities		17,000
Gross Total Income		2,76,600
Less Deduction u/s 80C PPF		 14,000
Taxable Income		2,62,600
Note: Expenses on Neon sign and glow board is treated as revenue expenditure.		

4. a.) Prabir, a resident of India, aged 81 years, submits the following information for the previous year 2016-17: **7 Marks**

Sl/No.	Particulars	Amount (₹)
1.	Income from salary	4,86,000
2.	Interest on Fixed Deposits with Banks	49,000
3.	Long-term capital gains	1,10,000
4.	Short-term capital gains on the sale of equity shares on which securities transaction tax has been paid	10,000
5.	He pays ₹ 5,000 as life Insurance Premium on a policy of ₹ 22,000 in Public Provident Fund Account	

Compute the tax payable by Mr X for the A.Y 2017-18.

4. b.) Mrs. Banerjee received the following amounts during financial year 2016-17: **8 Marks**

Particulars	Amount (₹)
Gross Salary	5,30,000
Family Pension ₹ 10,000 x 12	1,20,000
Income of a minor child	49,000
Accumulated balance in PF of her husband after his death	1,00,000
Gratuity received after the death of husband	1,00,000

Calculate taxable income of Mrs. Banerjee and tax liability for the assessment year 2017-18.

Answer:

a. Computation of tax payable by Mr Prabir for the A.Y 17-18

	Amount (₹)

Gross total Income	5,35,000
Less : Deduction permissible u/s 80C	27,000
Total Income (without LTCG & STCG)	5,08,000
Tax on ₹ 5,08,000 is 1600 Tax on LTCG (20% on 1,10,000)=₹ 22,000 Tax on STCG (15% on 10,000) =₹ 1,500	
Total Tax Payable	25,100
Add: Education cess & SHEC @ 3%	753
Total Tax payable (rounded off)	25,850

b. Computation of taxable Income of Mrs. Banerjee for the A.Y 17-18

Particulars	Amount (₹)	Amount (₹)
Income from Salary Gross salary Less: Deduction	5,30,000 Nil	 5,30,000
Income from other Sources Family pension Less: Deduction u/s 56 1/3 or ₹ 15,000 whichever is less Income of minor child Less: Exemption u/s 10(32)	 1,20,000 15,000 49,000 1,500	 1,05,000 47,500
Gross total Income		6,82,500
Tax Payable		61,500
Add: Education cess & SHEC @ 3%		1,845
Tax payable (rounded off)		63,350

Note: Accumulated balance in PF and amount of gratuity received after the death of husband is exempt from tax as it is assumed to be within the limit prescribed by section 10(10).

5. a.) Rajat, a business man submits the following particulars for previous year 2016-17. **7 Marks**

Sl/No.	Particulars	Amount (₹)
1.	Income from house property (computed)	1,30,000
2.	Business Income (computed)	40,000
3.	Capital gains (short-term)	20,000
4.	Capital gains (Long-term)	80,000
5.	Income from other sources: Interest from fixed deposit with a bank (gross) 12,000 Winnings from races 3,500	15,500
6.	Deposit from PPF	12,000
7.	He pays ₹3,000 p.m as rent for his residential accommodation in Delhi. Neither he, nor his family, owns any residential accommodation.	

Compute the total income of Mr. Rajat for the A.Y 2017-18.

5. b.) Please compute the advance tax payable by Mr. Pankaj from the following estimated income for the financial year 2016-17: **8 Marks**

Sl/No.	Particulars	Amount (₹)
1	Income from salary	5,00,000
2	Interest on Government securities	6,000
3	Interest on bank deposit	2,000
4	Rent from house for the year	1,00,000
5	Winning from horse race (gross)	20,000
6	Contribution towards PPF	10,000
7	Agricultural Income	2,00,000
8	TDS by the employer on salary	30,150

Answer: a

Particulars	Amount (₹)	Amount (₹)
Income from HP		1,30,000
Business Income		40,000
Capital Gain Long term Short term	 80,000 20.000	 1,00,000
Income from other sources Interest from bank deposit Winning from races	 12,000 3,500	 15,500
Gross total Income		2,85,500
Less Deduction u/s 80C to 80U Interest from fixed deposit with bank u/s 80C 80GG as per WN1	 12,000 16,650	 28,650
Total Income		2,56,850

WN-1: Deduction u/s 80GG shall be the minimum of the following three figures;

a. Rent paid less10% of Adjusted Gross total Income (36,000-19,350) 16,650
b. 25% of Adjusted Gross total income 48,375
c. ₹ 5,000 per month 60,000

The adjusted gross total income is the gross total income less LTCG-Deduction u/s 80C to 80U except u/s 80GG = ₹2,85,500-80,000-12,000=₹ 1,93,500

b. Computation of Estimated Income:

Particulars	Amount (₹)	Amount (₹)
Income from Salary Gross Salary Less: Deduction	 5,00,000 Nil	 5,00,000
Income from House Property Rent Received Less: Deduction u/s 24 (a) @ 30%	 1,00,000 30,000	 70,000
Income from Other sources Interest on Government securities Interest on Bank Deposit Winning from Horse race (Gross)	 6,000 2,000 20,000	 28,000
Less: Deduction u/s 80C to 80U Contribution towards PPF	 10,000	 (10,000)
Total taxable Income		5,88,000

Computation of Estimated Tax payable

Particulars	Amount (₹)	Amount (₹)
Step 1: Tax on Agricultural and Non Agricultural Income (2,00,000+5,88,000)=₹ 7,88,000 Tax on winning horse race 30% of ₹ 20,000 Tax on remaining Income ₹ 7,68,000	 6,000 78,600	 84,600
Step 2: Add agricultural income to basic exemption limit (2,00,000+2,50,000)=4,50,000 Tax on 4,50,000	 20,000	
Step 3: Tax paid under step 1 – step 2 (84,600-20,000)		 64,600
Add: Education cess & SHEC @ 3%		1938
Advance tax (rounded off)		66,540

Advance tax payment schedule

Particulars	Due date	%	Amount (₹)
1st Instalment	15th June, 2016	15%	9,981
2nd Instalment	15th Sept, 2016	45%	19,962
3rd Instalment	15th Dec, 2016	75%	19,962
4th Instalment	15th Mar, 2017	100%	16,635

6. a.) The following are the particulars of the income of Sh. R, a Government servant for the year ended 31.3.2017 compute his total income and the tax payable.

(a) Salary at ₹ 20,300 p.m.

(b) He contributed @ 10% to his Provident Fund to which the Government contributed an equal amount.

(c) He owns two flats one of which is let out at ₹ 1,200 p.m. and the other is occupied by him for residence, the annual rental value of which is ₹8,000. He has paid ₹ 750 as ground rent and insurance charge in respect of the first flat and ₹850 in respect of the second. The municipal taxes paid by him in respect of the two flats amounted to ₹300 and ₹325 respectively and he spent ₹300 on white washing, petty repairs in respect of both the flats.

(d) He received during the years ₹ 1,02,500 as interest on Government securities and ₹700 as dividend from an Indian company. He has insured his life and pays an annual premium of ₹7,700 on the policies. Ascertain his total income and the tax payable. **8 Marks**

6. b.) State the transactions were quoting of PAN is made compulsory. **7 Marks**

Answer: a

Computation of Total Income of Shri R for the A.Y 2017-18

Particulars		Amount (₹)	Amount (₹)
Income from Salary (20300 x 12)		2,43,600	
Less: Deduction		Nil	2,43,600
Income from House Property:			
Self occupied flats		Nil	
Rental value of flats let out (1200 x 12)	14,400		
Less: Municipal tax paid	300		
Annual value		14,100	
Less: Deduction @ 30%		4,230	9,870
Income from other sources:			
Interest on Govt. Securities		1,02,500	
Dividend from Indian Company		Exempt	1,02,500
Gross total Income			3,55,970
Less deduction u/s 80C to 80U PF plus LIP (24,360 + 7,700)			32,060
Total Income			3,23,910
Tax payable			7,391
Less: Rebate u/s 87A as below 5,00,000			5,000
			2,391
Add: Education cess plus SHEC @ 3%			72
Total tax payable (rounded off)			2,460

Answer: b

The transactions where the quoting of PAN is mandatory are enumerated below;

1. Payment to a company for acquiring debenture or bonds issued by it when amount is exceeding by fifty thousand.
2. Payment to a mutual fund for purchase of its unit when amount is exceeding by fifty thousand.
3. Payment to a hotel or restaurant against a bill or bills at any one time when amount is exceeding by fifty thousand.
4. Payment to RBI constituted u/s 3 of the RBI Act 1934 for acquiring bonds issued by it when amount is exceeding by fifty thousand.
5. Sale or purchase of a motor vehicle as defined in clause (28) of the section 2 of the Motor Vehicles Act, 1988 which requires registration by a registering authority under Chapter IV of that Act, other than two wheeled vehicles.
6. Opening an account with an banking company or a cooperative bank to which the Banking Regulation Act, 1949 applies (including any banking institution to in section 51 of that Act).
7. Payment as Life Insurance premium to an insurer as defined in clause (9) of section 2 of the Insurance Act, 1938.

7. Write a short note on the followings: **5 x 3=15 Marks**

a. Cost of Improvement.

b) Belated return

c) Clubbing of Income of a Minor Child

Answer: 7.a.

Cost of Improvement: Cost of Improvement [Section 55(1)(b)]

(i) In relation to capital assets being goodwill of a business or a right to manufacture, produce or process any article or thing or right to carry on any business or profession shall always be nil. It makes no difference whether goodwill or such right was self generated or acquired for a price

(ii) In relation to any other assets,-

(a) Where the capital asses become the property of the previous owner or the assessee before 1.4.1981, it will be all capital expenditure incurred in making any additions or alteration to the capital assets on or after 1.4.1981 by the previous owner or the assessee.

Expenditure incurred by the assessee or the previous year before 1.4.1981 is to be completely ignored, whether the assessee opts for the market value as on 1.4.1981 or not.

(b) In other cases, i.e assets acquired after 1.4.1981, all capital expenitre incurred in making any additions or alteration to the capital assets by the assessee after it become his property and where the capital assets became the property of the assessee by any mode specified in section 49(1), capital expenditure incurred by the previous owner also be treated as cost of improvement.

Answer: 7.b.

Belated return:

Any person who has not submitted his return of income on or before the due date mentioned under section 139(1), he can still file the return of income. Such a return is called belated/late return. Belated return can be filed at any time:

(a) before the the end of the relevant assessment year, or

(b) before the completion of the assessment, whichever is earlier.

For example, for a company assessee the last date for filing the return of income for previous year 2016-17 (assessment year 2017-18) is 30.9.2017; but a late return may be filed at any time on or before 31.3.2018 (i.e. before the end of the relevant assessment year 2017-18) or before the assessment is completed, whichever is earlier.

Completion of the assessment: The word used in section 139(4) will refer only to assessment under section 144 *i.e.* Best Judgment Assessment as there can be no other assessment unless a return of income is furnished. Further, completion of assessment means the date on which the order of assessment was *passed* and not the date of service upon the assessee. Thus, a return of income submitted after the assessment completed but before the notice of demand is served would be invalid. *[Balchand* v *ITO* (1969) 72 ITR 197 (SC)].

Answer: 7.c.

In computing the total income of an individual, there shall be included all such income as arises or accrues to his minor child. Therefore, the income of a minor child is to be clubbed in the hands of either of his parents.

The income shall be clubbed in the hands of that parent whose total income (excluding the income of the minor) is greater. If the marriage of his parents does not subsist, the income shall be clubbed in the hands of that parent who maintains the minor child in the previous year.

Where any income is once included in the total income of either parent, any such income arising in any succeeding year [shall not be included in the total income of the other parent, unless the Assessing Officer is satisfied, after giving that parent an opportunity of being heard, that it is necessary so to do.

Where the income of a minor child has been included in the total income of a parent, such parent shall be entitled to an exemption to the extent of such income or ₹ 1,500 whichever is less, in respect of each minor child whose income is so included.

Certain incomes of minor child taxable in the hands of minor child only. The following income of a minor shall not be clubbed and will be taxable in the hands of the minor himself:

(i) Any income of a minor child suffering from any disability of the nature specified in section 80U like physically disabled, totally blind, etc.

(ii) Such income which accrues or arises to the minor child on account of any manual work done by him.

(iii) Such income which accrues or arises to the minor child on account of any activity involving application of his skills, talent or specialized knowledge and experience.

Section-B (20 Marks)

International Taxation and Transfer Pricing

Answer question No. 8 which is compulsory and any one from Question No.9 and 10

8. a) Fill in the blanks: [4 x 1=4 Marks]

a. Section 92BA shall apply where the aggregate of all transactions from specified domestic transaction entered by assessee in the previous year exceeds a sum of ₹ ____________.
b. __________ u/s 91 on foreign income is allowed to a person resident in India.
c. Arm length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in ____________ conditions.

d. Any income arising from an international transaction shall be computed having regard to ___________.

8. b) Select the suitable answer: **[4 x 1=4 Marks]**

a. _________ approval for advance pricing agreement will be void ab initio if it has been obtained by the person by fraud or misrepresentation of facts.
   i. CBDT
   ii. A.O
   iii. Central Government
   iv. None of the above

b. The advance pricing agreement is valid for _____ years.
   A. 1 yrs
   B. 2 yrs
   C. 3 yrs
   D. 5 yrs

c. An enterprise is said to be associated enterprise when one hold ____ voting power in other enterprise.
   A. 21%
   B. 25%
   C. 26%
   D. 51%

d. The determination of reasonable profit in case of combined profit of the associated enterprise is on the basis of which method.
   A. Resale price method
   B. Profit split method
   C. Transaction net margin method
   D. Comparable uncontrolled Price method

Answer: 8.a

a. 20 Crore
b. Unilateral relief
c. Uncontrolled
d. Arm's Length price

Answer: 8.b

a. C
b. D
c. C
d. B

9. a. Discuss in brief Transaction Net Margin Method (TNMM) **6 Marks**

9. b. i. What do you mean by Associated Enterprises?
ii. What do you mean by Cross border Transactions? **6 Marks**

Answer: 9.a

Transaction Net Margin Method (TNMM):

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.

Answer: 9.b

Associated Enterprises:

The term 'associated enterprise' has been defined in a broad manner. Based on the same, the following Illustrate the definition when Enterprise X ("X") would be the associated enterprise of Enterprise Y ("Y"):

X participates, directly or indirectly, or through one or more intermediaries, in the management, control or capital of Y and one or more of the requisites enlisted below are fulfilled; or

The same persons participate in the management, control or capital of X, as also that of Y and one or more of the requisites enlisted below are fulfilled.

X and Y would be deemed to be associated enterprises if at any time during the previous year:

X holds directly or indirectly shares carrying at least 26% voting power in Y or vice versa;

Any person holds directly or indirectly shares carrying at least 26% voting power in both X and Y;

A loan advanced by X to Y amounts to atleast 51% of book value of the total assets of Y or vice versa;

X guarantees at least 10% of the total borrowings of Y or vice versa;

More than half of the directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of X are appointed by Y or vice versa;

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 X and Y are appointed by the same person(s);

The manufacture / processing of goods/articles by, or business of, X, is wholly dependent on use of intangibles or any other commercial rights of similar nature, or any data, documentation or drawing etc., owned by Y or for which Y has exclusive rights; or

Atleast 90% of raw materials for the manufacture or processing of goods or articles required by X are supplied by Y or persons specified by Y under commercial terms influenced by Y or;

Goods / articles manufactured / processed by X are sold to Y or persons specified by Y, and Y influences the commercial terms relating to the sale or;

X is controlled by Mr. A and Y is controlled by Mr. A or relative of Mr. A either individually or jointly;

X is controlled by a Hindu Undivided Family, and Y 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

X is a firm, association of persons or body of individuals, and Y holds atleast 10% interest in such firm, association of persons or body of individuals; or

There exists, between X and Y, any relationship of mutual interest, as may be prescribed (no such relationship has yet been prescribed).

Cross border Transactions: Cross border transaction means any transaction which involves two or more countries. When there is cross border transaction, the persons involved should follow the provision of FEMA, 1999 and Income – tax Act, 1961. All income in course of cross Border Transaction to tax in India.

10. a. Raj solutions Inc. a USA Company sells Laser printing Cartridge drums to its subsidiary quality printing ltd at $ 15 per drum. Max Solutions Inc. has other takers India for its Cartridge drums for whom the price is $ 25 per drum. During the year Raj solutions had supplied 12,000 Cartridge drums to Swapna printing ltd. Determine the Arm's length price and taxable income of Swapna printing ltd if its income after considering the above is ₹ 45 lakh. Compliance with TDS provisions may be assumed and rate per USD is ₹68. **6 Marks**

10. b. Why arm length pricing? Discuss the difficulties in applying Arm's Length principle. **6 Marks**

Answer: a.

Computation of total income of Swapna Printing Ltd.

Particulars	Amount (₹)	Amount (₹)
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 [12,000 x $ 20 x ₹ 68]	12,240,000	
Amount actually paid to Doc Solutions [12,000 x $ 25 x ₹68]	1,62,00,000	
Incremental Cost on adopting ALP U/s 92(3), Taxable Income cannot be reduced on applying ALP. Therefore, difference on account of ALP is ignored.	20,400,000	
Total Income of Swapna Printing Ltd		45,00,000

Answer: b.

The basic object of determining Arm's Length Price is to find out whether any addition to income is warranted or not, if the following situations arises:

(a) Selling Price of the Goods < Arm's Length Price
(b) Purchase Price > Arm's Length Price

Particulars	Amount (₹)
Total Income as disclosed by an Assessee	XXXX
Add: Understatement of profit due to overstatement of purchase price Add: Understatement of profit due to understatement of selling price	XXX XXX
Total Income after Assessment	XXXX

Difficulties in applying the arm's length principle:

The arm's length principle, although survives upon the international consensus, does not necessarily mean that it is perfect. There are difficulties in applying this principle in a number of situations.

a) The most serious problem is the need to find transactions between independent parties which can be said to be exact compared to the controlled transaction.

b) It is important to appreciate that in an MNE system, a group first identifies the goal and then goes on to create the associated enterprise and finally, the transactions entered into. This procedure obviously does not apply to independent enterprises. Due to these facts, there may be transactions within an MNE group which may not be between independent enterprises.

(c) Further, the reductionist approach of splitting an MNE group into its component parts before evaluating transfer pricing may mean that the benefits of economies of scale, or integration between the parties, is not appropriately allocated between the MNE group.

(d) The application of the arm's length principle also imposes a burden on business, as it may require the MNE to do things that it would otherwise not do (i.e. searching for comparable transactions, documenting transactions in detail, etc).

(e) Arm's length principle involves a lot of cost to the group.