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SUGGESTED ANSWERS

CA FINAL

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Answers

Case Study 1

1.1 (b)

1.2 (d)

1.3 (c)

1.4 (c)

1.5 (c)

1.6 Computation of Arm's Length Price of Products sold to J Inc. Korea by CD Ltd.

Particulars	Rs.	Rs.
Price per Unit in a Comparable Uncontrolled Transaction		16,800
Less: Adjustment for Differences-		
a) Freight and Insurance Charges	700	
b) Estimated Warranty Costs	500	
c) Discount for Voluminous Purchase	200	
d) External Commercial Borrowing (Working Note 1)	35	
e) Depreciation adjustment (Working Note 2a)	1	
f) Adjustment for under- utilisation of manpower (Working Note No 2c)	3333.29	(4,769.29)
Arms's Length Price for Cellular Phone Sold to j Inc. Korea		12,030.71

a) Computation of Increase in Total Income of CD Ltd.

Particulars	Rs.
Arm's Length Price per Unit	12,030.71
Less: Price at which actually sold to J Inc Korea	(10,000)
Increase In Price per Unit	**2,030.71**
No. Of Units Sold to J Inc. Korea	2,50,000
Increase in Total Income of CD Ltd. (2,50,000*Rs. 2,030.71)	Rs. 50,76,77,500

Working Note 1: Adjustment for External Commercial Borrowings:
Excess Interest rate provided in comparison to ECB guidelines: (7.50-6.50)% = 1%
Excess Interest cost =1% of Rs. 100 crores = 1 crore
Installed capacity = 4,00,000 units
Interest Cost per unit, based on Utilised Capacity = Rs. 1,00,00,000/(2,50,000+35,000) = Rs. 35(appx)
Capacity Utilised = 2,85,000/4,00,000 *100= 71.25%

Working Note 2:

a) Depreciation related to "idle assets" should be adjusted from Profit & Loss Account

Year Ended	Rs.
Total Depreciation charged in Profit & Loss Account	10,00,000
Add: Proportionate depreciation in relation to "idle assets" to the extent of 28.75%, since utilized capacity is 71.25% = (10,00,000*28.75%)	2,87,500
Depreciation adjusted in line with capacity utilisation	7,12,500
Depreciation adjustment per unit based on utilized capacity = 2,87,500/2,85,500 = 1.01= 1.00 (appx)	

b) Adjustment in Profit & Loss Account

Year Ended	Rs.
Net Profit as per Profit & Loss Account	8,54,000
Add: Proportionate depreciation in relation to "idle assets" to the extent of 28.75%, since utilized capacity is 71.25% = (10,00,000*28.75%), now written back	2,87,500
Adjusted Net Profit	11,41,500

c) Adjustment related to under-utilization of man-power

Steps	Year Ended	Rs.
a)	Head counts	300
b)	Maximum number of hours per employee (ie 300 days * 8 hrs per day)	2,400
C)	Total available hours (c=a*b)	7,20,000
d)	Utilisation rate	71.25%
e)	Utilised hours (=c*d)	5,1,3,000

f)	Unutilised hours (= c-e)	2,0,7,000
g)	Unutilised hours after consideration the industry unutilised rate of 10% (f/0.2875*0.10)	72,000
h)	Total Unutilised head counts (=g/2,400)	30
i)	Proportionate unutilized head counts on the basis of output provided to AE = (30*2,50,000/2,85,000)	26,316
J)	Total Employment related costs	1,00,000
k)	Proportionate employee related cost on the basis of output provided to Associated Enterprise = (1,00,000/2,85,000*2,50,000)	87,719
l)	Adjustment to total employee related Cost proportionate to output provided to AE (=k/i)	3333.29

[Marking scheme: 2 Marks for depreciation adjustment, 2 marks for man power capacity utilisation adjustment, balance 4 marks for computing ALP]

1.7 Action 6 of BEPS introduced the principal purpose test (PPT) as one of the Minimum Standards to be implemented by the countries participating in the BEPS Inclusive Framework. The PPT aims to tackle treaty abuse including treaty shopping. Tax administrations need to reasonable conclude, having taken into account all relevant facts and circumstances, that obtaining the treaty benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

1.8 The case of Melina Limited is based on paragraph 182 of the OECD Commentary (example C), which examines the case of a company, resident in state R, that is assessing alternative locations to set up a new manufacturing plant in light of its expanding business. Three states with similar economic and political environments are indentified as alternatives for this purpose. However, given that only state S has a tax treaty in force with state R, state S is chosen as the location for building the plant. In this case, even though the decision to invest in state S is taken in light of the benefits provided by the state R-state S tax treaty, the principal purpose for making the investment and building the plant are related to the expansion of the business. Therefore, it cannot reasonably be considered that one of the principal purposes for building the plant in state S is to obtain treaty benefits. The commentary further refers to the general objective of tax treaties, which is to encourage cross-border investment, assessing that obtaining the

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benefits of the state R-state S tax treaty for the investment in the plant built in state S is in accordance with the object and purpose of the provision of the tax treaty. Further, even GAAR cannot invoked in such case since conditions of section 96 are not satisfied.

[Marking scheme: Entire Marks for identifying application of GAAR / PPT]

Case Study 2

2.1 (b)

2.2 (c)

2.3 (d)

2.4 (c)

2.5 (c)

2.6 From analysis of the question, it is clear that assessee Happy Limited has considered Cost Plus Method for Computing its own margin. Further, since number of comparable companies is less than 6, we use arithmetic mean to compute the Arms' length margin as under:

Summary of Net Cost plus Mark-up of broadly comparable independent companies

No.	Company Name	March 2012	March 2013	March 2014	March 2015	March 2016	Weighted Average
1	Comparable 1	5.93%	10.8%	10.71%	4.69%	10.06%	8.61%
2	Comparable 2	28.81%	3.88%	10.71%	11.72%	16.30%	13.50%
3	Comparable 3	15.38%	8.33%	7.14%	16.67%	13.33%	12.12%
4	Comparable 4	12.64%	13.00%	4.47%	15.38%	19.80%	13.53%
5	Comparable 5	9.40%	4.85%	22.19%	8.20%	8.05%	11.10%
	Arithmetic Mean	14.43%	8.17%	11.04%	11.33%	13.51%	11.77%

Conclusion:

Since the arithmetic mean is 11.77% the transaction of Happy Limited earning margin of 10.46% is not at ALP. However, we check the tolerance band as under:

10.46 + 3% = 10.77%

10.46 – 3%= 10.15%

The Arms' length margin does not fall within the band.

[Marking scheme: 2 Marks for arithmetic mean, 2 marks for computing tolerance band, balance 1 mark for conclusion]

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2.7 Total Cost as per Income-statement = 86,000
Arms' length Margin as computed above = 11.77%
Therefore, Arms length Margin required to be earned = 10,122
Hence, ALP as per CUP = 86000 + 10122 = 96,122
Tolerance Band = 95000 +/- 3% = 92,150 – 97,850
Since ALP falls within the tolerance band, it would be advisable for Happy Limited to adopt CUP Method and demonstrate that transaction is conducted at ALP.

[Marking scheme: 2 Marks for identifying that CUP ALP, 2 marks for tolerance band, 1 mark for conclusion]

2.8 As per Article 4.3 of OECD Model Convention, where by reason of the provisions of paragraph 1 [domestic laws] a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

A determination under paragraph 3 will normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25. Such a request may be made as soon as it is probable that the person will be considered a resident of each Contracting State under paragraph 1. Due to the notification requirement in paragraph 1 of Article 25, it should in any event be made within three years from the first notification to that person of taxation measures taken by one or both States that indicate that reliefs or exemptions have been denied to that person because of its dual-residence status without the competent authorities having previously endeavoured to determine a single State of residence under paragraph 3. The competent authorities to which a request for determination of residence is made under paragraph 3 should deal with it expeditiously and should communicate their response to the taxpayer as soon as possible.

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Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

It is accordingly advisable that XYZ Limited makes an application for MAP under Article 25.1 for speedy determination of its residential status.

[Marking scheme: 2 Marks for identifying tie-breaker test, balance 3 marks for reference to MAP procedure]

Case Study 3

3.1 (d)

3.2 (d)

3.3 (b)

3.4 (a)

3.5 (d)

3.6

(i) As per section 10(6A), in the case of a foreign company deriving income by way of royalty or fees for technical services from the Government or an Indian concern under the terms of an agreement entered into before 1.6.2002 relating to a matter included in the industrial policy of the Central Government, the tax paid by the Government or an Indian concern on such income would not be included in the total income of the foreign company, Hence, such tax paid would be exempt in the hands of the foreign company.

Therefore, in the present case, the tax paid by KN will be exempt from tax in the hands of ST. In this case, section 195A is not applicable and consequently, the royalty of Rs. 50 Lacs should not be grossed up. As per section 44D, where a foreign company receives income by way of royalty from an Indian concern in pursuance of an agreement made on or after 1st April, 1976 but before 1st April, 2003, no deduction is allowable in respect of any expense or allowance under sections 28 to 44C in computing such income.

The rate of tax is 10% as per section 115A(1)(b)(A), if the royalty is received in pursuance of an agreement made after 31.3.1976.

(ii) Since there is no term in the agreement that KN has to bear the tax liability, the benefit under section 10(6A) is not available. KN has to deducted tax at

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source on royalty payment to ST, a foreign company, as per section 195. Since in this case, KN has to pay the royalty of Rs. 59 lacs 'net of taxes' to ST, therefore, the royalty has to grossed up.

The tax liability of ST has to be computed as under: Rs.

	Rs.
Net Royalty income	59,00,000
Gross Royalty income(59,00,000*100/89.7)	65,77,480
Tax on Royalty of Rs. 65,77,480@10.30%	6,77,480

KN has to deduct this tax of Rs. 6,77,480 at source under section 195.

[Marking scheme: 2 1/2 Marks for each part of the answer]

3.7 Section 2(26) define an "Indian Company." The proviso to section to section 2(26) states that for a company to be an Indian company, the registered or principal office should be in India. In this case, since the registered office is in Singapore, XY Pvt Ltd. is not an Indian company.

A company, other than an Indian company, would be considered as resident in India only if the place of effective management is in India in that year. In this case, the POEM is not in India and therefore, XY Pvt Ltd. is not a domestic Company.

XY Pvt Ltd. is a non-resident assessee during the previous year relevant to assessment year 2020-21. As per Explanation 1(b) of section 9(1)(i), no income shall be deemed to accrue or arise in India to a non-resident through or from operations which are confined to purchase of goods in India for the purpose of export. XY Pvt Ltd., had purchased the goods in India and thereafter exported the same in total to China and accordingly no income of the non-resident company shall be subject to tax for assessment year 2020-21.;

[Marking scheme: 4 Marks for complete correct answer and identification of section 9]

3.8 Under section 44BBA, a sum equal to 5% of the aggregate of the following amount is deemed to be the profits and gains chargeable to tax under the head "Profits and gains of business or profession" in respect of a non-resident, engaged in the business of operation of aircraft-

a) The amount paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

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b) The amount received or deemed to be received in India by or behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

In the present case, the income chargeable to tax of M/s. Global Airlines is as follows

Particulars	Fare booked from India to outside India whether received in India or not (Rs.)	Fare booked from New York to Mumbai	
		If received in India (Rs.)	If not received in India(Rs.)
Fare	60,00,000 (1,25,00,000-65,00,000)	65,00,000	65,00,000 Nil
Deemed Income @5% u/s. 44BBA	3,00,000 (60,00,000*5%)	3,25,000 (65,00,000*5%)	

[Marking scheme: 3 Marks for complete correct answer]

3.9 Under clause (iva) of Explanation 2 to section 9 (1)(vi), the expression "royalty" would include any lump sum consideration for the use of or the right to use of any industrial, commercial or scientific equipment. Under section 44D, no deduction will be allowed in respect of any expenditure or allowance in computing the income by way of royalty, received from the Government or an Indian concern in pursuance of an agreement made between 01.04.1976 and 31.03.2003.

Under section 115A, income-tax payable on such royalty under an agreement entered into after 31st March, 1976 will be 10%. This will be subject to the provisions of the Double Taxation Avoidance Agreement between India and the country in which the foreign company is assessed.

[Marking scheme: 2 Marks for reference to definition of royalty, 1 mark for tax rate]

Case Study 4

4.1 (d)

4.2 (a)

4.3 (b)

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4.4 (a)

4.5 (a)

4.6 (d)

4.7 (d)

4.8 (c)

4.9 As per Article 13.2 of the OECD Model Tax Convention, Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State. Since machine is a moveable property, the resultant loss will be covered under this article. Further, such loss is allowable in the country where PE is located i.e. in USA. It is immaterial that the machines were present in UK at the time of sale or that the machine is sold to a party located in the USA.
[Marking scheme: 2 Marks for identifying correct article of DTAA< balance 2 marks for identifying jurisdiction of USA for allowing loss]

4.10 The loss arising on sale of machine is allowable in the USA being the country where PE is located. Further, in case there is no sufficient profit to absorb this loss, then such will be carried forward in the USA. However, XYZ Limited will also claim this loss in India since XYZ's global income is liable to tax in India. Accordingly, such loss will also form part of total income for set off. This double benefit is called as Double Dip Benefit. In the case of DCIT vs. Patni Computers Systems Limited (2008) 301 ITR 60 Pune, it was held that the country of residence cannot deny the benefit of set off of losses in the year in which such loss is infact incurred. However, in the subsequent years, when the loss is actually set off against taxable income in the country of source, then the country of residence must tax the entire pre-set off income in order to avoid the double dip benefit to assessee.
[Marking scheme: 2 Marks for discussion on concept, balance 2 marks for correct suggestions]

4.11 As per Article 27 of India – Maurtius Treaty, a resident of a Contracting State is deemed to be a shell / conduit company if its expenditure on operations in

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that Contracting State is less than Mauritian ` 15,00,000 or Indian ` 27,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

Such LOB clause acts as a Specific Anti Avoidance Rule appearing in the DTAA. Further, the LOB rule is based on recommendations under Action Plan 6 of BEPS.

[Marking scheme: 2 Marks for correct discussion, balance 1 mark for identifying BEPS AP = 6]

4.12

(A) Whether to pay dividend to its shareholders or buy back its shares or issue bonus shares out of accumulated reserves is a business choice of the company. Further, at what point of time a company makes such a choice is its strategic decision. Such decisions cannot be questioned under GAAR.

(B) As discussed above, the choice of providing dividend or not is a business decision which cannot be questioned under GAAR. The fact of treaty benefit should be interpreted as incidental to the main transaction. Further, the company is also satisfying the condition for availing treaty benefit [i.e. SAAR]

(C) No dividends were distributed by X Limited since 01.04.2003, the date on which DDT came into force. Subsequently, X Limited obtained tax benefit by not declaring dividend and passing this on as exempt capital gains in the hands of connected company Y Limited. The buy back of shares was accepted only by Company Y Limited and not by other shareholder companies D Limited and E Limited. D and E would have invited capital gains tax by accepting the offer. This appears to be a dubious method and there may not be genuine commercial reasons for D&E in not accepting the buy-back offer. Therefore, the revenue may examine the arrangement under GAAR.

[Marking scheme: 1 Mark for identifying whether GAAR applicable, balance 1 mark for discussion and logic]

Case Study 5

5.1 (c)

5.2 (c)

5.3 (c)

5.4 (a)

5.5 (c)

5.6 It is obvious that there was no commercial necessity to create a separate firm except to obtain the tax benefit. The firm was only on paper as the man power was drawn from the company. The firm did not have any commercial substance. Moreover, it is a case of treaty abuse. Hence, GAAR may be invoked to disregard the firm and tax payment for architectural services as fee for technical services. However, the rate of tax on such payment shall be applicable under the treaty, if more beneficial.

[Marking scheme: 2 Marks for identifying applicability of GAAR, balance 2 marks for logical discussion]

5.7 It is not clear as to which property is being transferred. In case the property is land or building, then irrespective of the agreement value, the FVOC shall be Stamp Duty Value, being higher than the agreement value. Further, it is also not clear whether the recipient has attracted provisions of section 56(2)(x) of the Act. Both these provisions are SAARs. In case such SAARs are not attracted or if they fail, and the Y Limited has set off losses against the capital gains, then it may be reasonably concluded that GAAR will be invoked. Further, it may be a reasonable argument to prevent GAAR, by demonstrating the commercial substance behind the transaction, if any.

[Marking scheme: 2 Marks for identifying applicability of GAAR, balance 2 marks for logical discussion]

5.8 Separate payments made towards drawings and designs (described as "engineering fee") are in the nature of fees for technical services [Aeg Aktiengesllschaft v. CIT (2004) 267 ITR 209 (Kar.)]. Fees for technical services payable by a resident (Super Thermal Power Ltd., an Indian company, in this case) would be deemed to accrue or arise in India under section 9(1)(vii) in the hands of the non-resident recipient (Techno Engineering GMBH, the German company).

The payment made is not in respect of services utilized for a business or profession outside India or for the purpose of making or earning income from any source outside India and, therefore, is deemed to accrue or arise in India as per section 9(1).

Further, as per Explanation to section 9, where income is deemed to accrue or arise in India under section 9(1)(vii), such income shall be included in the total income of the non-resident German company, regardless of whether it has a residence or place of business or business connection in India, and even if such services are rendered from outside India.

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Accordingly, in this case, payments towards drawings and designs would taxable in India in the hands of Techno Engineering GMBH, the German company.

[Marking scheme: 3 Marks for correct discussion and answer]

5.9 A careful reading of the definition of royalty reveals that payment towards 'imparting of information' shall be treated as royalty provided it is in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property or in respect of technical, industrial, commercial or scientific knowledge, experience or skill. In the given question, imparting of information is in respect of sale of machinery and therefore, not covered under definition of royalty. The contention of Assessing Officer is incorrect. [DIT v. Haldor Topsoe [2014] (369 ITR 453) (Bombay HC)]

[Marking scheme: 2 Marks for identifying relevant portion of royalty definition, balance 2 marks for logical discussion]

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