



Arm's length principle cannot be invoked where replacement of self-declared prices of international transactions by ALP results in lowering of taxpayer's income chargeable to tax

Background

The Delhi Bench of the Income-tax Appellate Tribunal (Tribunal) in case of Mercer Consulting India Pvt Ltd¹ (taxpayer), while dealing with the applicability of Transfer Pricing (TP) provisions, observed that the application of Arm's Length Price (ALP) adjustment to Intra-Group Services (IGS) would lead to the corresponding reduction in the revenue from rendition of services. Thus, the adjustment in respect of IGS was deleted in view of the restrictions placed by Section 92(3) of the Income-tax Act, 1961 (the Act).

Brief Facts

- The taxpayer, a captive Information Technology enabled services (ITeS) provider, followed a TP policy of marking-up its operating expenses by a margin of 20 per cent for purposes of invoicing its overseas Associated Enterprises (AEs). Accordingly, for the year under consideration, the taxpayer accrued revenue in its books of account at cost-plus-twenty per cent mark-up (i.e. 100 + 20 per cent = 120; taxable income = 20).
- During the course of assessment proceedings, the taxpayer broadly faced two challenges. One, 20 per cent margin applied over operating expenses was alleged to be short of the arm's length standard. An arm's length cost-plus margin of 29.53 per cent was determined by the TPO as against the margin of the taxpayer of 20 per cent (i.e., 100 + ALP of 29.53 per cent = 129.53). Two, the cost of IGS (say, 10) received by the taxpayer from its AEs was held to be 'nil' (taxable income = 29.53 + disallowance on account of IGS 10 = 39.53).
- During the course of proceedings before the Dispute Resolution Panel (DRP), the first adjustment was deleted and mark-up rate of 20 per cent was restored since it was found to be in conformity with arm's length principle. However, DRP declined to reverse the second adjustment on account of IGS (taxable income = 20 + Disallowance on account of IGS, 10 = 30).

¹ Mercer Consulting India Pvt. Ltd. v. DCIT (ITA No.1085/Del/2016) – Taxsutra.com

Tribunal's Ruling

- On appeal before the Tribunal, the Bench did not travel into the merits of disallowance made on account of IGS. It first addressed the limited issue of whether the approach adopted by Revenue was sustainable in the eyes of the law in view of the embargo placed by Section 92(3) of the Act.
- The Tribunal expressed the view that since the mark-up rate of 20 per cent was held to be at arm's length, disallowance of costs on account of IGS (i.e. 10) would result in diminution of operating expenses by the same amount, which would trigger a correlative downward adjustment in gross revenues by a factor greater than such disallowance by 20 per cent (viz. $10 + 20$ per cent of $10 = 12$). Effectively, in Tribunal's view, for each 1 unit of disallowance in costs, the gross revenue of the taxpayer would need to be correspondingly adjusted downwards by an amount of 1.20, thereby resulting in a pro-rata net reduction in taxable income of the taxpayer in comparison to what had been reported in its income tax return.
- Section 92(3) of the Act provides that computation(s) with reference to arm's length principle cannot be carried out in a manner which is derogatory to entries recorded by the taxpayer in its books of account whereby it results in a reduction of self-declared income chargeable to tax.
- Accordingly, the adjustment on account of IGS was deleted, and taxpayer's returned position was restored.

Our comments

The ruling offered desired relief to the taxpayer. The Tribunal adopted a pragmatic view by not traveling into the merits of the disallowance relating to IGS payments, but by addressing the issue in a rudimentary context at the threshold itself.

It remains to be seen if the Revenue would be successful in having an appeal against this order admitted before the jurisdictional High Court. There may be finer nuances in terms of how the relevant provision is to be read, whereby Revenue may build a case claiming that the approach adopted by the Tribunal is not in consonance with the written letter of the law.



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