

SUBJECT : **Margin allowed in Transfer Pricing Transaction**

DATE : **March 27, 2009**

Transfer pricing provisions were introduced in India by the Finance Act 2001 so as to protect its rights to collect fair share of tax in respect of cross border transactions. Accordingly an international transaction entered into between associated enterprises at a price which doesn't conform to the arms length principles, and which results in understatement of income in India will be hit by transfer pricing provisions.

Margin allowed in Transfer Pricing Transaction

Where the assessing officer is of the opinion that the prices charged in international transactions have not been determined on arms length principles, the Assessing Officer may determine the arms length price himself or, under specified circumstances, by making reference to transfer pricing officer. Where the arms length price determined by the Assessing Officer is different than what the taxpayer has disclosed, the Assessing Officer will compute the taxable income of the taxpayer on the basis of arms length price determined by him. Determination of arms length price often presents practical difficulties because the said price can be calculated on the basis of several specified methods.

The Central Board of Direct Taxes realising practical difficulties has issued a circular (Circular No.12 of 2001 dated 23/8/2001) which states, "This is a new legislation. In the initial years of its implementation, there may be room for different interpretations leading to uncertainties with regard to determination of arm's length price of an international transaction. While it would be necessary to protect our tax base, there is a need to ensure that the taxpayers are not put to avoidable hardship in the implementation of these regulations."

The Board has also prescribed rules 10A to 10E in the Income-tax Rules, 1962, giving the manner and the circumstances in which different methods would be applied in determining arm's length price and the factors governing the selection of the most appropriate method. The Board has also allowed a margin in the adjustment to the arms length price. Which reads as: "The Assessing Officer shall not make any adjustment to the arm's length price determined by the taxpayer, if such price is up to 5 per cent. less or up to 5 per cent. more than the price determined by the Assessing Officer. In such cases the price declared by the taxpayer may be accepted." The margin of 5 per cent is to be applied to the arm's length price determined by the A.O, and not to the margin of profit calculated by him. Thus, if arms length price determined by A.O is 100, the tax-payer is entitled to take arm's length price in the range of 95 to 105.

The above issue arose in a recent case of ACIT Vs SDRC India Private Ltd. decided by ITAT Delhi on 6/3/2009 in respect of transactions between SDRC USA and its Indian subsidiary. In the said case, the Indian subsidiary earned income on account of software development services rendered by it to its parent company.

The agreement between them provides that in consideration for the software development services the US company shall pay the Indian company an amount equal to the cost of providing development services plus a mark up of 5 per cent. The Assessing officer did not accept the mark up of 5 per cent, he made an addition to income by increasing the mark up to 10 per cent. The Hon'ble Tribunal relying on the CBDT circular no.12 held that the addition made by the Assessing Officer by increasing the mark up to 10 per cent was not correct and accordingly the addition made by Assessing Officer was deleted. The aforesaid decision will provide an authority that an Assessing Officer should not make any adjustment to the arms length price determined by a the taxpayer if such price is upto 5 per cent less or upto 5 per cent more than the price determined by the Assessing Officer. The circular of the Board is clear that in such cases the price declared by the taxpayer should be accepted.