Determination of Arm's Length Price - Application of Cost Plus Method and Profit Split Method

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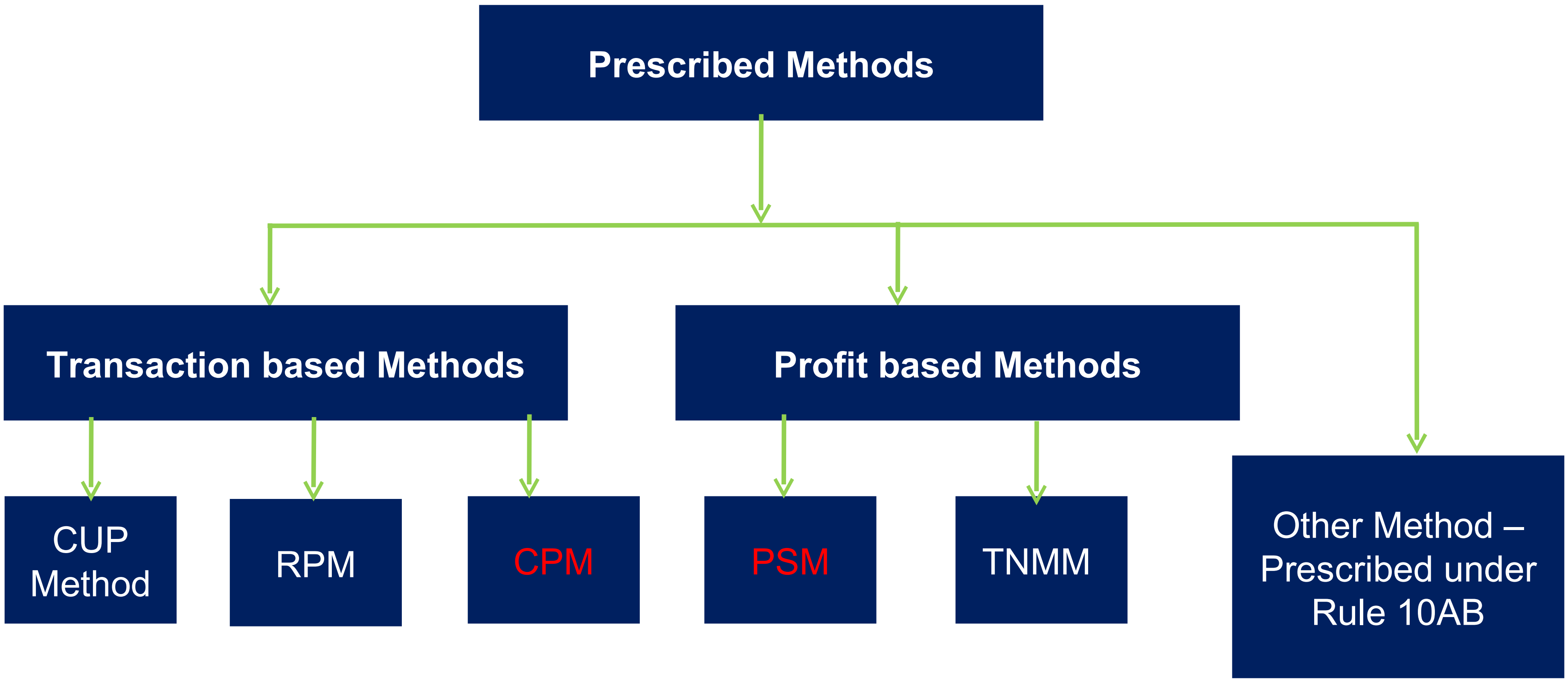
Background - Economic Analysis – Steps Involved

Step no.	Details
1.	Analysis of Functions, Assets and Risk
2.	Determination of tested party
3.	**Determination of most appropriate method**
4.	Determination of Profit Level Indicator (based on the method selected)
5.	Search for the comparable data and comparability analysis
6.	Determination of arm’s length price

Background (previous sessions' recap)

- Section 92C prescribes five methods to compute ALP along with one other method which is prescribed by CBDT by way of Rule 10AB
- Taxpayer has to select the most appropriate method (MAM), from the methods specified, for the purposes of benchmarking its international transactions
- Most appropriate method is the method which is best suited to the facts and circumstances surrounding a particular international transaction
- Bird's eye view of all prescribed methods is provided in the subsequent slide

Background – Prescribed Methods



Selection of Most Appropriate Method - Recap

<u>Rule 10C(1)</u>

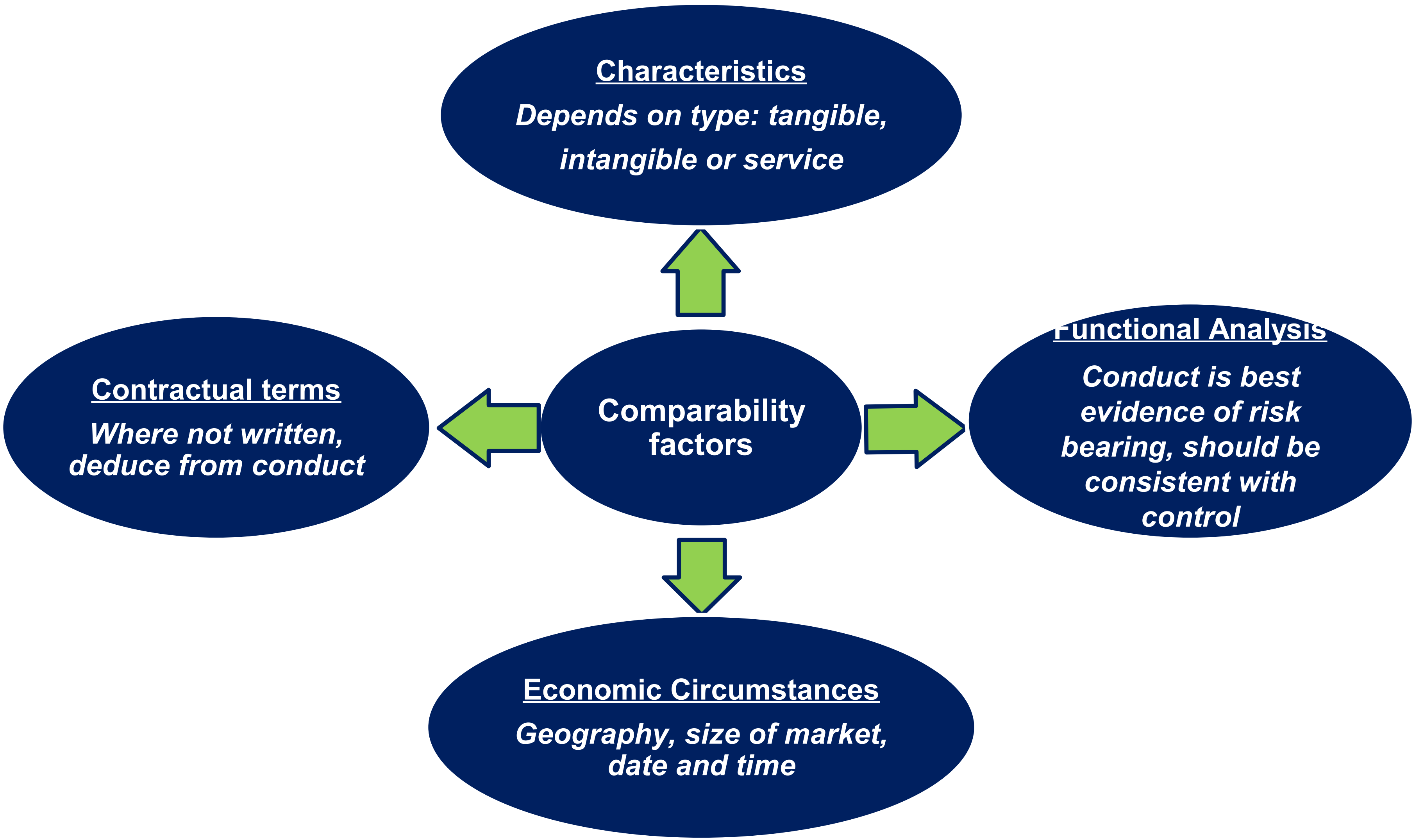
- Method which best suits to the facts and circumstances
- Provides the most reliable measures of an ALP
- Transaction wise

<u>Rule 10C (2)</u>

- <u>Factors to be considered</u>

  - ✓ Nature and class of transaction
  - ✓ Class or classes of AEs entering into transaction and their FAR analysis
  - ✓ Availability, coverage and reliability of data
  - ✓ Degree of comparability between controlled and uncontrolled transactions
  - ✓ Extent and reliability / accuracy of adjustments
  - ✓ Nature, extent and reliability of the assumptions required

Rule 10B(2) - Comparability Factors



Cost Plus Method

Cost Plus Method ('CPM')

Rule 10B(1)(c) describes the manner of applying CPM:

- the **direct and indirect costs** of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
- the amount of **a normal gross profit mark-up** to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
- the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the **functional and other differences**, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
- the costs referred to in sub-clause (i) are **increased by the adjusted profit mark-up** arrived at under sub-clause (iii);
- the sum so arrived at is taken to be an **arm's length price** in relation to the supply of the property or provision of services by the enterprise

CPM - Features

- Involves comparison of gross margins
- Compares and identifies the mark up earned on direct and indirect costs incurred with that of comparable independent companies
- Similarity of products/services transferred – not a prerequisite
- Similarity of functions is a prerequisite for applying CPM
- Applicable when an enterprise engaged in manufacturing activity or provision of services, sells such goods or renders such services to its AE
- Preferred method in case of
  - Semi finished goods sold between related parties,
  - Contract/toll manufacturing agreement,
  - long term buy or supply agreement, etc.
- Adjustments to account for functional and other differences which affect the profit mark-up in the open market

Steps under CPM

1. Identification of direct and indirect costs of production incurred in tested party transactions
2. Identification of normal gross profit with reference to uncontrolled transaction(s)
3. Normal gross profit adjusted to account for functional and other differences if any
4. Adjusted gross profit added to total costs identified in step 1
5. Sum arrived above is taken to be arm's length price

CPM – Illustration…

A Ltd. (AE)

100 man-hours @ INR 2,000 per man-hour
Total Costs incurred (INR 175,000)

C Ltd
(Third Party)

@ INR 3,000 per man-hour
GP margin earned on costs 40 %

B Ltd

B Ltd. – Software Development + onsite and offsite consultancy services

DIFFERENCES

B Ltd. derives technology support from A Ltd.

(20 percent of normal GP)

Marketing Risks associated with services rendered to customers other than A Ltd
(10 percent of normal GP)

B Ltd. offered one month's credit to A Ltd.
(1.5 percent GP)

Arm's Length Price for transaction between B Ltd and A Ltd?

CPM – Illustration

Direct and Indirect Costs (INR)	175,000
G.P mark-up in comparable uncontrolled transaction (A)	40 %
Less:	
Adjustment for Technology Support from A Ltd. (20% of 40%)	(8%)
Risk adjustment – no market risk as regard trades with A Ltd. (10% of 40%)	(4%)
Sub-total (B)	(12%)
Add:	
Cost of credit to A Ltd.	1.5%
Sub-total (C)	1.5%
Arm's length GP mark-up = (A) – (B) + (C)	29.50%
Arm's length Income (INR) (175,000 + 29.50%)	226,625
Increased Income INR (226,625 – 200,000)	26,625

CPM - Issues

- The terms “direct” or “indirect” costs are however not defined
- Differences in accounting policies, hence limited usage
- Difficult to make adjustments on account of functional and other differences
- Internal comparables preferred
- Difficulties in adjusting costs pertaining to unused capacity

Profit Split Method

Profit Split Method ('PSM')

Under the Rules, the PSM is described as under [Rule 10B(1)(d)] :

- the **combined net profit** of the associated enterprises arising from the international transaction in which they are engaged, is determined ;

- **the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated** on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in the similar circumstances;

- the **combined net profit** is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);

- the profit thus apportioned to the assessee is taken into account to arrive at an **ALP** in relation to the international transaction;

PSM

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be **partially allocated** to each enterprise so as to provide it with a **basic return** appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the **residual** net profit remaining after such allocation may be **split** amongst the enterprises in **proportion to their relative contribution** in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction

PSM - Features

- PSM is a contribution analysis, rather than comparability analysis
- Appropriate for transactions which are not capable of being evaluated separately
- Calculates the combined operating profit resulting from a whole inter-company transaction based on the relative value of each associated enterprise's contribution to the operating profit
- The contribution made by each party is determined on the basis of a division of functions performed, valued, if possible using external comparable data
- Applicable for analysing tangible, intangible or services issues, when intangibles exist in transactions and profit arising to the group cannot be assigned to one of the entities of the group

Implications of new CBDT circulars

- Circular no. 2 – Application of PSM
- Circular no. 3 – Conditions relevant to identifying development centers engaged in contract R&D services with insignificant risk

Steps under PSM

1. Determination of combined net profit of the associated enterprises arising out of international transaction
2. Evaluation of relative contributions by each enterprise on the basis of functions performed, risks assumed and assets employed
3. Splitting of combined net profit amongst enterprises in proportion to their relative contributions
4. Profit thus apportioned to the tested party is used to arrive at the arm’s length price

PSM Illustration

Particulars	INR	INR
Combined Group Profits		500
Basic return assigned to each entity		
• UK Entity	170	
• Indian Entity	100	
• German Entity	80	350
Residual profit		150
Contribution analysis (based on relative contribution of the entities)		
• UK Entity		90
• Indian Entity		60

PSM – Issues

Strengths

- Relies more on Internal financial data of group and can be used where no direct no direct independent comparables are available
- Offers flexibility of taking into account specific, unique facts and circumstances of the controlled tax payers that are not present in independent enterprises
- Takes into account all the parties of the MNE group involved in the transactions and analyzes the contributions made by the parties in respect of the intangible property employed for allocation of profits
- Considers the business from an end-to-end perspective, and is thus akin to the real life situation and therefore more closely grounded to the economic realities of conducting business

Weaknesses

- External market data considered in valuing contribution are less closely connected to the controlled transactions than in case of other methods
- Getting an external data to value contribution itself creates an issue on applicability of PSM because the division of combined or residual profit, as the case may be, may not always be comparable to a third party outcomes
- Requires measuring combined costs and revenues of all the parties in the controlled transactions, which would entails restating the books and records on a common basis and making adjustments in accounting practices and currencies

Questions??

Thank You

Glossary

- AE – Associated Enterprise
- ALP – Arm's length Price
- AO – Assessing Officer
- CPM – Cost Plus Method
- FAR – Functional, Assets, Risks Analysis
- FMV – Fair Market Value
- MAM – Most Appropriate Method
- PSM – Profit Split Method
- TPO – Transfer Pricing Officer
- TPR – Transfer Pricing Regulations