COMPARABLE UNCONTROLLED PRICE METHOD

Workshop on Transfer Pricing, WIRC

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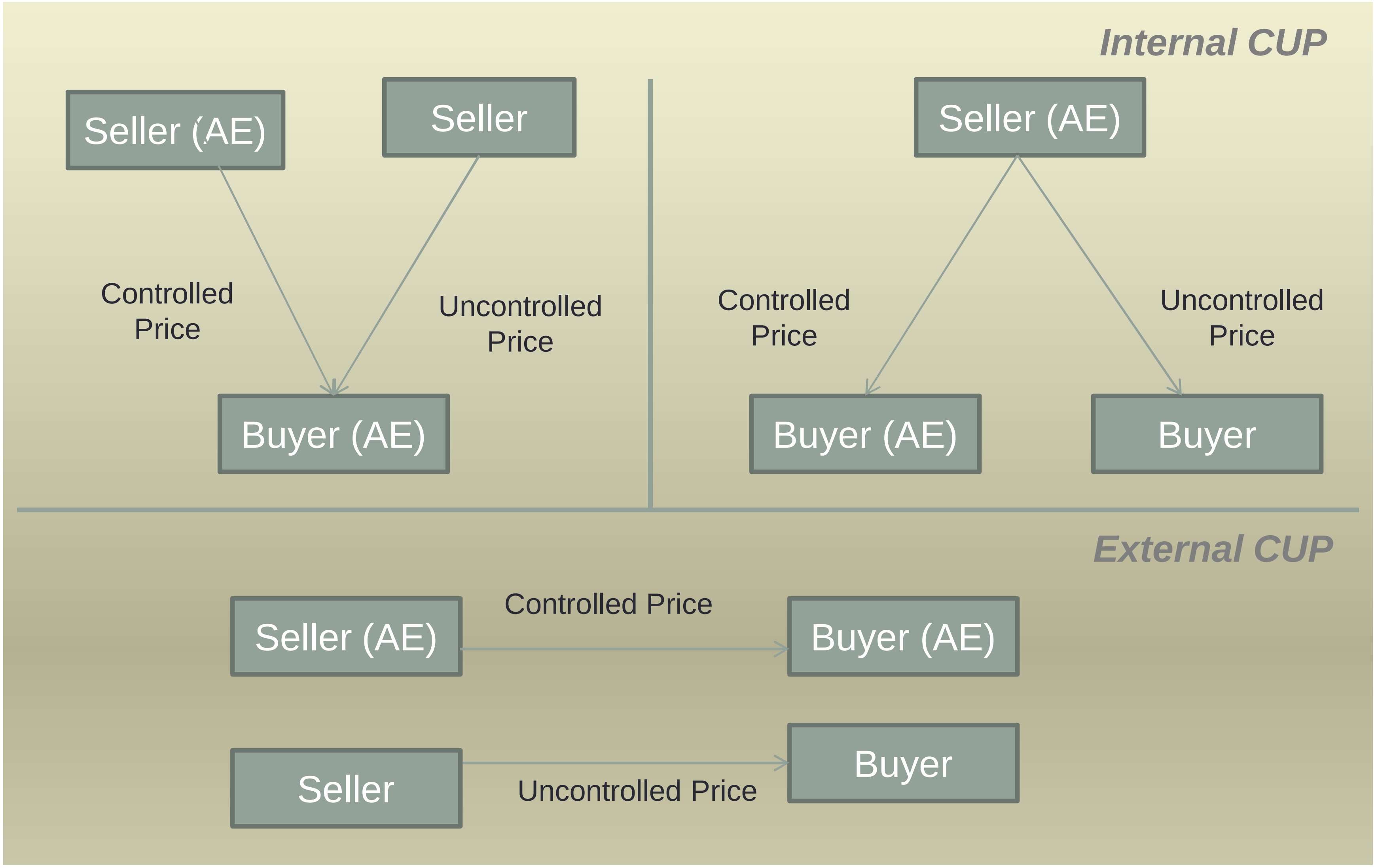
Legal framework

- Sec. 92C(1)
- *The arm's length price in relation to an international transaction or specified domestic transaction shall be determined*
- *by any of the following methods,*
- *being the most appropriate method,*
- *having regard to*
  - *the nature of transaction or class of transaction or*
  - *class of associated persons or functions performed by such persons or*
  - *such other relevant factors as the Board may prescribe*

Legal framework

- Rule 10B(1) (a) comparable uncontrolled price method—
  - *(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;*
  - *(ii) such price is adjusted to account for differences,*
    - between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions or
    - Between the enterprises entering into such transactions,
  - *which could materially affect the price in the open market;*
- OECD TP Guidelines
  - *Compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in uncontrolled transaction in comparable circumstances [Para 2.13]*

CUP – Internal & external



Comparability

- Possibilities
  - Same property & same circumstances
  - Same property & similar circumstances
  - Similar property & same circumstances
  - Similar property & similar circumstances

- Comparability if
  - None of the differences
    - between the transactions compared or
    - between the enterprises undertaking those transactions

    materially affect the price in the open market or
  - Reasonably accurate adjustments can be made to eliminate the material effects of those differences *[OECD TP Guidelines Para 2.14]*

Comparability Factors

- similarity of product
  - differences in the physical/functional features
- contract terms
  - volumes,
  - discounts,
  - interest free periods/terms of payment,
  - exchange rate exposure
  - after sales services
  - warranty
- economic/market conditions
  - geographic differences in the markets,
  - the particular time period of the contracts
  - the relative bargaining power of parties
  - strategies of buyers and sellers
    - price competition
    - marketing intangibles like brand names

Product similarity

- Product characteristics
  - Qualitative
  - Functional
  - Origin
    - OECD TP Guidelines para 2.18
- Product differentiation lead to additional cost
  - Product development
  - Manufacturing
  - Market research
  - Marketing
  - Branding

Product similarity - Examples

Example 1

One enterprise sells unbranded Colombian coffee beans to its AE. The only available uncontrolled transaction involved unbranded Brazilian coffee beans.

- Product specification
  - Difference in the coffee beans due to origin
  - For example, whether the source of coffee beans commands a premium or requires a discount generally in the open market.

Example 2

Manufacturer sells to OEMs unbranded printers and to its AE distributors same printers, though branded. As the Manufacturer reserves the right to supply consumables to his AE distributors, it sells branded printers at a discount.

- Product Specifications
  - Branding - comparable generally internal
  - After sales business - Whether quantifiable

Markets

- Markets vary in terms of
  - Geography
  - Competition
  - Customer structures
  - Time
- Markets can include multiple countries
  - Active grey market between countries may imply a single market
- Markets may be segmented
  - Customer preferences
  - Psychological price barriers

Markets

Example

A cosmetic is sold at high price to overseas AE boutiques while the same cosmetic in different packaging is sold to large supermarkets in that country at lower price.

- Comparability
  - Same product except for the packaging
  - Same market geographically
  - Sales at retail levels
  - Same time
- Differentiation
  - Different target customers
  - Different price segments
  - Bargaining power of large supermarkets

Markets

- Facts*
  - Sale by IndCo to-
    - AE in US at $ 15
    - Unrelated parties in Europe at average of $ 21
- Assessee's contentions
  - No reduction in total tax paid globally by the AEs
  - Instance of unrelated party in China to unrelated party in US lower (expert report)
  - AE sales on wholesale basis while Europe sales of smaller lots on retail basis
- TPO's Order
  - Rejected external expert report
  - Adjusted price for
    - Selling & distribution expenses & geographical differences
    - Freight differential & credit period
- ITAT Ruling
  - Global tax bill not relevant
  - Internal CUP of the TPO not valid as
    - US and countries in Europe different markets
    - Price charged at wholesale basis

**Gharda Chemicals(2009-TIOL-790-ITAT-MUM)*

Bargaining Power

- Facts*
  - Sale of extended warranties for goods sold at Taxpayer’s UK retail outlets
  - Insured with ASL, IoM (unrelated IoM Company)
  - ASL reinsured with DISL, IoM (Co related to assessee)
- Taxpayer arguments
  - Insurance/service contracts between customers and unrelated parties
  - TP regulations do not apply as transactions with unrelated parties
- Special Commissioners’ ruling
  - Advantage granted to DISL by taxpayer’s point of sale operations; DISL would have had to pay a value if it were unrelated
  - CUPs provided by taxpayer rejected
  - Differences due to relative bargaining power of taxpayer cannot be adjusted accurately
  - PSM adopted

- **DSG Retail case*

Volume Differences

Case 1

- Sale to AE distributor 1000 tons at $ 80
- (after suitable volume discount)
- Sale to unrelated distributor 500 tons at $100
- Adjustment to price based on typical volume discounts in that market

Case 2

- Sale to AE distributor 100 tons at $ 100
- Sale to unrelated distributor 1000 tons at $80
  - (after suitable volume discount)
- AE distributor makes loss due to lower volumes
  - Strategy of the Group to use AE Distributor
  - Adjustment for lower than economic volumes
- Use of CUP to be supplemented with adjustments for-
  - Market penetration strategies
  - Fewer economies of scale
  - Higher operating expenses

Public exchanges

- Comparability with tested transactions
  - Prices driven by equilibrium between supply and demand
  - homogenous nature of the product
  - availability of pricing information to both buyers and sellers

- Imperfect CUPs due to
  - Basic differences in terms and conditions of transactions
  - Complete lack of commitment of buyers and sellers other than the deal on the exchange
  - Adjustments for differences with off market transactions reduce CUP reliability
    - Buyer may lock in future purchases at fixed price because of its supply commitments at fixed price
    - Seller may prefer stability of long-term contract to volatility (and risk) of selling through exchange.
    - Buyer may need a different quality which differs from that of an Exchange

- Despite limitations, Public Exchange CUPs accepted widely by authorities.

CUP for Intangibles

- Internal CUP if a party licences the same IP to both related and unrelated parties
  - Companies rarely licence valuable IP to unrelated parties
- Party may licence brands/market related IP to unrelated distributors in countries where they do not have a presence
  - Imperfect CUP due to
    - differences in markets
    - extent to which marketing intangibles are established in different markets
- Where a Party licences IP to AE and also licences different IP from unrelated parties
  - IP not the same but
    - Provide range of royalty rates contracted by unrelated parties in the industry
    - Potential CUP

Functional Analysis for CUP

- Method not limited to identifying a price between unrelated parties
- A limited functional analysis of parties to focus on-
  - Product/intangible/service characteristics
  - Contractual terms
  - Volumes
  - Timing
  - Level of markets operated by parties
  - Long-term supply/purchase commitments
  - Buy back commitments
  - Other factors that would affect the price

Concluding thoughts

- CUP most attractive if appropriate data is available
- CUP data-specific
  - Standard for what constitutes appropriate data tends to rise with tax authorities experience
  - Revenue can question whether every detail is exactly the same like differences in timing or other factors
  - CUP method audits can become prolonged
- CUP method to have sufficient coverage and adjustments for differences
  - Prices derived from one or two ‘distress purchases’ or transactions outside their normal markets not CUP
- If potential CUP not used, an explanation why it is not used should be documented.
- Another method (TNMM) as best method and CUP as a fall back method.

Thank you