

Finding and selection of comparables (specific focus on CUP and TNMM)

Study Course on Transfer Pricing

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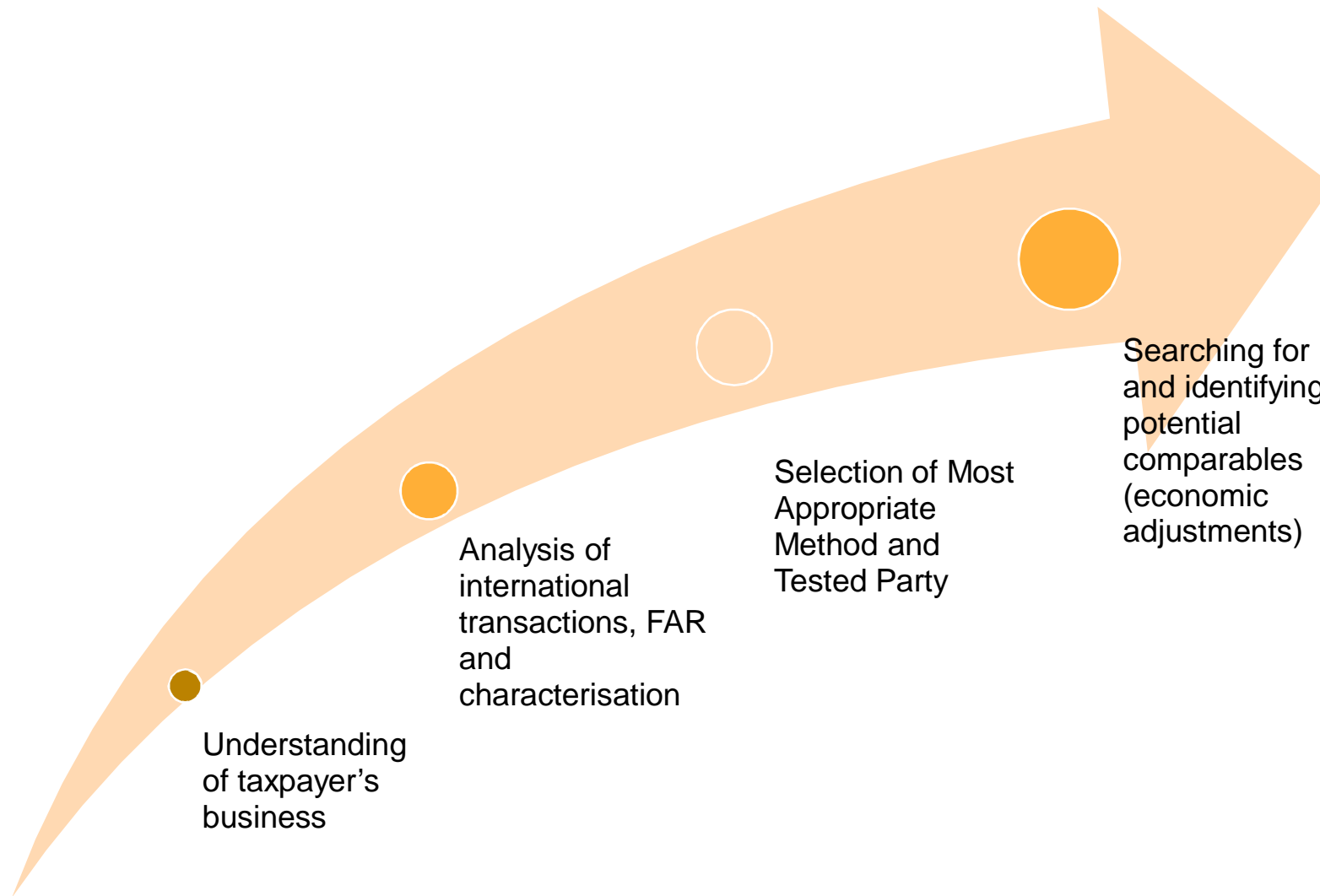
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Transfer Pricing Process



Factors relevant for determination of comparability

- Specific characteristics of the property transferred or services provided
- The functions performed, the risks assumed and the assets employed by the respective parties to the transaction
- The contractual terms
- Economic circumstances; or the conditions prevailing in the markets in which the respective parties to the transaction operate
- Business strategies

Comparable Uncontrolled Price ('CUP') Method

Meaning

Rule 10B(1)(a) describes the manner of applying CUP:

- The price **charged** or **paid** for property transferred or services provided in a **comparable uncontrolled transaction**, or a number of such transactions, is **identified**;
- Such price is **adjusted** to **account for differences**, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could **materially affect the price in the open market**; and
- The **adjusted price** arrived at is taken to be an **arm's length price** in respect of the property transferred or services provided in the international transaction.

➤ Internal CUP:

- An internal CUP is available when the taxpayer enters into similar transactions with an unrelated party, as is entered into with the associated enterprise ('AE')
- An internal CUP is also available when the AE enters into similar transaction with unrelated parties, as is entered into with the taxpayer

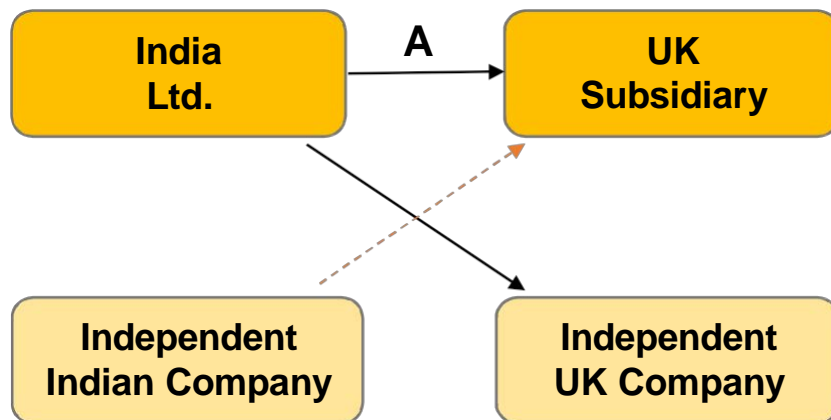
➤ External CUP:

- An external CUP is available when a transaction is entered into between two independent enterprises, where the conditions surrounding the transition are similar to the conditions surrounding the tested transaction

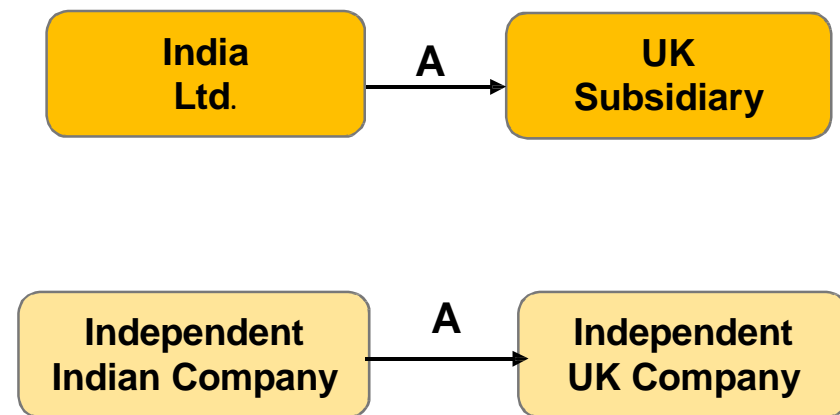
Types of CUP

(2/2)

Internal CUP

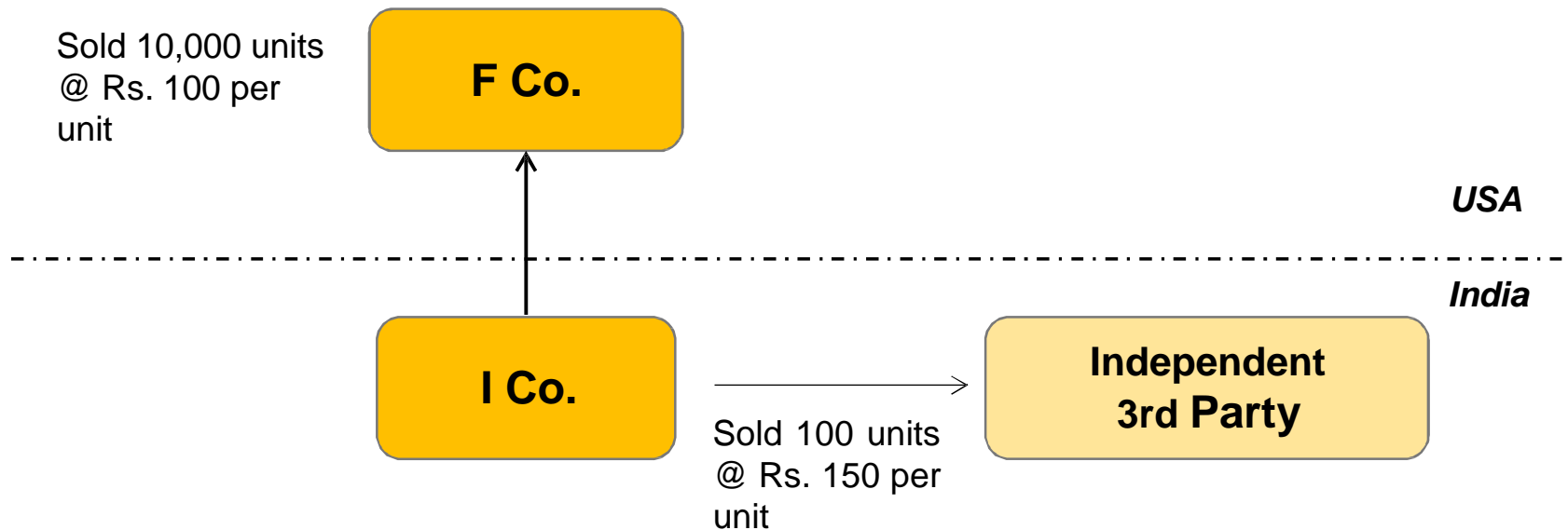


External CUP



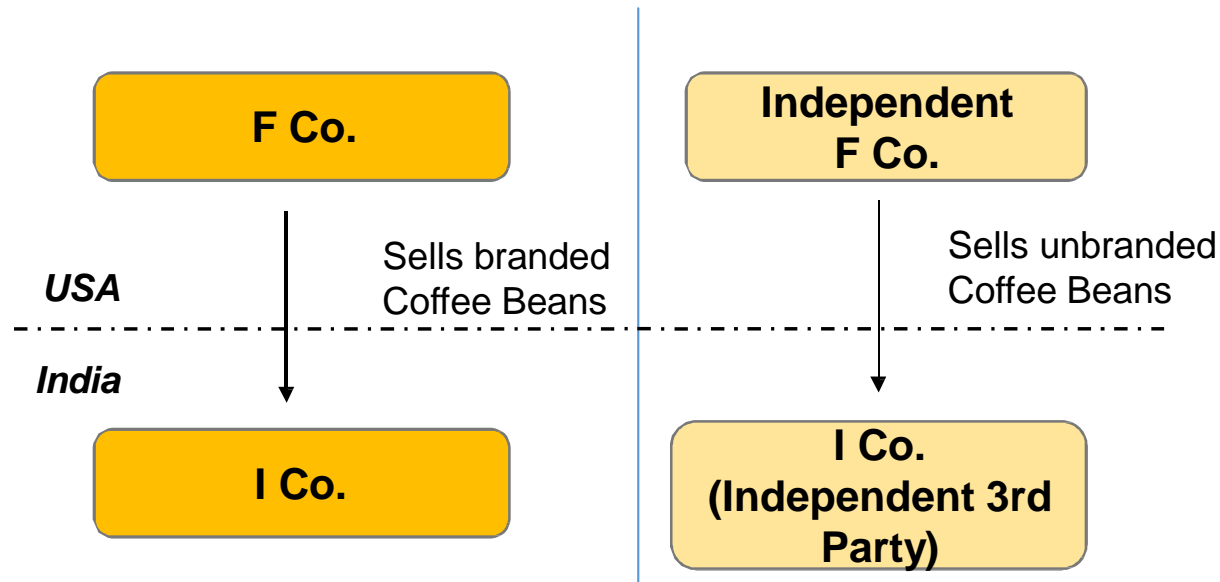
Internal CUP is preferable

Internal CUP - Illustration



- Relevant factors before applying CUP are:
 - Market differences
 - Volume differences
 - Contractual differences
- If material then reasonable and accurate adjustments are required for applying CUP

External CUP - Illustration



- Relevant factors before applying CUP are:
 - Effect of brand
 - Source / Quality of Beans
- If material then reasonable and accurate adjustments are required for applying CUP

CUP Method - Application

Issues

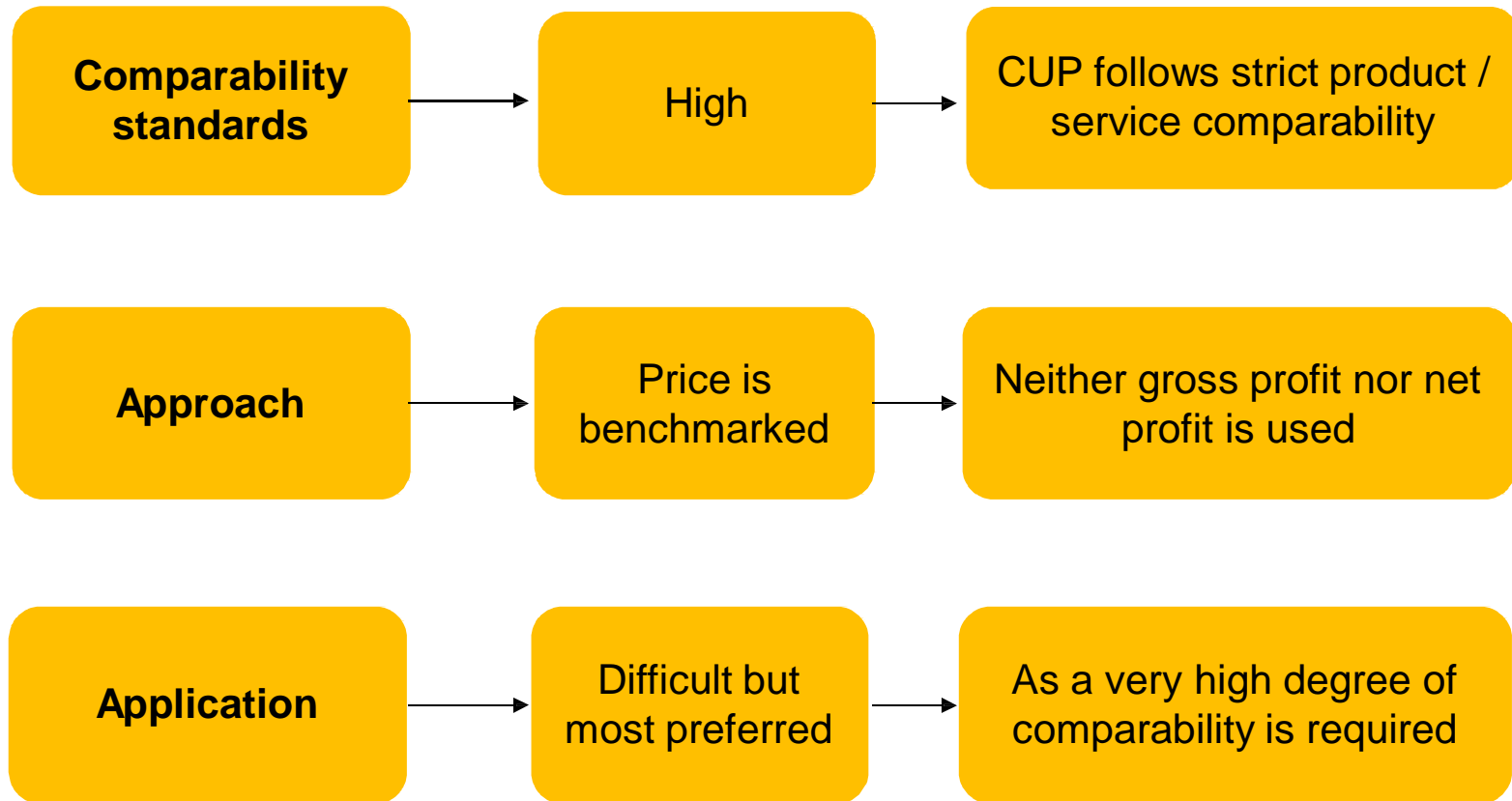
- Require strict comparability of product / service, contractual terms, economic terms etc;
- Insufficient data for use of external CUP;
- Adjustment to be made on the uncontrolled price for differences which could materially affect the price in the open market.

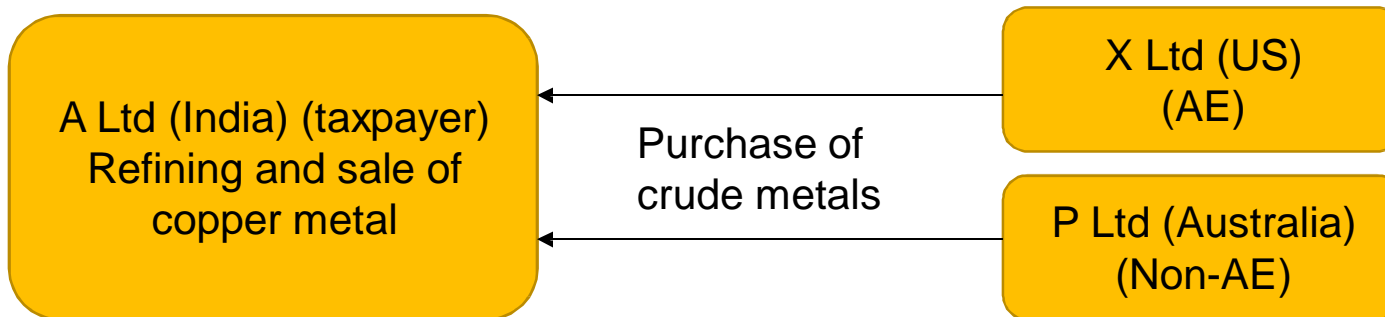
Eg: (a) difference in volume / quality of product (b) difference in credit terms (c) risks assumed (d) geographic market

Practical Experience

- Prevalent use in financial services sector;
- Interest on lending and borrowing;
- Purchase and sale of securities (equity broking);
- Commodities trading;
- Royalty

CUP Method - Nuances





- Purchase from X Ltd (AE) at a price of INR 30,000 per MT;
- Purchase from P Ltd (non-AE) at a price of INR 40,000 per MT; and
- Quantity discount of INR 500 per MT is offered by X Ltd (AE)

CUP – Illustration

(2/3)

➤ Analysis of terms of the transactions:

Terms	International transaction (with X Ltd) (AE)	CUP (with P Ltd) (third party)	Particulars
Price (per MT)	30,000	40,000	
Quantity discount	Yes	No	Quantity discount INR 500 per MT

CUP – Illustration

(3/3)

➤ Computation of ALP

Particulars	Price per MT (CUP with P Ltd)
Price (per MT)	40,000
Adjustments:	
Less: Quantity discount	(500)
Arm's Length Price (per MT)	39,500



Transactional Net Margin Method (‘TNMM’)

Rule 10B(1)(e) describes the manner of applying TNMM:

- The **net profit margin** realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to the costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base
- The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base
- The net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market

- The net profit margin realized by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii)
- The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction

Types of TNMM

➤ Internal TNMM:

- The net profit margin of the taxpayer in the controlled transaction is compared with the net profit margin that the same taxpayer earns on the same services in the comparable uncontrolled transaction

➤ External TNMM:

- The net profit margin of the taxpayer in the controlled transaction is compared with the net profit margin earned by an independent third party in a comparable uncontrolled transaction

Tested Party

- Selection of Tested Party is to be consistent with the FAR analysis / characterization
- Usually, Tested Party is the least complex entity (in 'FAR' terms) for which reliable comparable data is available
- Tested Party is to be selected for Resale Price Method, Cost Plus Method and **TNMM** for which a financial indicator is tested

TNMM - Applicability

Distributor (Independent)	INR	Distributor (AE)	INR
Sales	75,000	Sales	100,000
Cost	41,250	Transfer Price (Balancing figure)	60,000
Gross Profit	33,750	Gross Profit	40,000
Admin & Distribution	30,000	Admin & Distribution	35,000
Operating Profit	3,750	Operating Profit @ 5%	5,000
OP/Sales	5%		

Comparison - Entity level or transaction level? (1/2)

- Taxpayer to maintain segmental accounts separately for transactions with AEs and non AEs
- Various expenses to be allocated between AE and non AE segment using appropriate allocation keys:
 - Direct expenses are to be allocated between various segments on actual basis
 - Indirect expenses are to be allocated based on appropriate keys likes sales, headcount, time spent, area occupied, etc

Comparison - Entity level or transaction level? (2/2)

Illustrative Profit & Loss A/c

(Rs. in '000)

Particulars	Non AE	AE	Total
Sales	150	90	240
Purchases	105	52	157
Other Expenses	30	20	50
Royalty	4	10	14
Operating Profit	11	8	19
OP/Sales	7.33%	8.89%	7.92%

Comparability standards under TNMM

- Broad functional comparability
 - Net margins are more tolerant to functional differences
- Broad product comparability
- Various adjustment such as risk adjustment, working capital adjustment, capacity utilisation adjustment etc can be made to iron out the difference if any between the taxpayer vis-à-vis the comparables

Practical challenges

- Data availability
- The comparability of the companies selected by the taxpayer vis-à-vis the revenue authorities is highly litigated matter (eg BPO vs KPO)
- The impact of quantitative (turnover etc) and qualitative factors on the comparability is also a highly litigated matter

Approaches to running a search

(1/2)

➤ Additive Approach

- A list of companies that are believed to be potentially comparable is drawn up
- This list can be collated from multiple sources (e.g. databases, industry publications etc) thereby forming a broader list
- Information is then collected on the potential comparables to confirm whether they are acceptable comparables in terms of the factors of comparability listed above

➤ Deductive Approach

- A wide set of companies operating in the same sector or line of business is taken typically through a search on database(s) of companies (e.g. Prowess or Capitaline Plus)
- The list is then refined in accordance with the factors of comparability through a quantitative and qualitative analysis in order to obtain a set of comparable companies.

Criteria for selection / rejection of companies

- Size criteria, in terms of sales, assets, number of employees
- Intangible-related criteria
- Criteria to exclude special situations such as a start-up or company under liquidation
- Criteria related to export sales

Steps for running the search

- *Step 1:* A broad-based search by business segment etc. is conducted on corporate databases
- *Step 2:* Quantitative analysis of the broad set of companies selected
- *Step 3:* Qualitative analysis of the companies shortlisted
- *Step 4:* Finalisation of final set of comparables
- *Step 5:* Computation of margins and carrying out of adjustments
- *Step 6:* Computation of arithmetic mean

Information and Documentation in Selection and Rejection of Comparables

- Reliance on Authentic Documents
- Data relating to the Financial Year of the International Transaction
- Contemporaneous Data
- Documentation of Information
- Source of Reliable Information
- Importance of Documentation

Questions?

THANK YOU