Workshop on Transfer pricing -WIRC of ICAI

Comparable Uncontrolled Price Method (CUP)
Resale Price Method (RPM)
Cost Plus method (CPM)

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Comparable Uncontrolled Price Method (CUP)

What is CUP ?

- CUP (Comparable Uncontrolled Price) is the most direct method of for calculating ALP(Arm's Length Price).
- Under this method :
  - The price charged for the product/services in the comparable uncontrolled transaction is determined.
  - Such price is then adjusted to account for the functional differences between the international transaction/Controlled transaction and the Comparable Uncontrolled Transaction which would materially affect the price in the open market.
  - The adjusted price is taken as the Arm's Length Price(ALP).

What are Controlled and Uncontrolled Transactions?

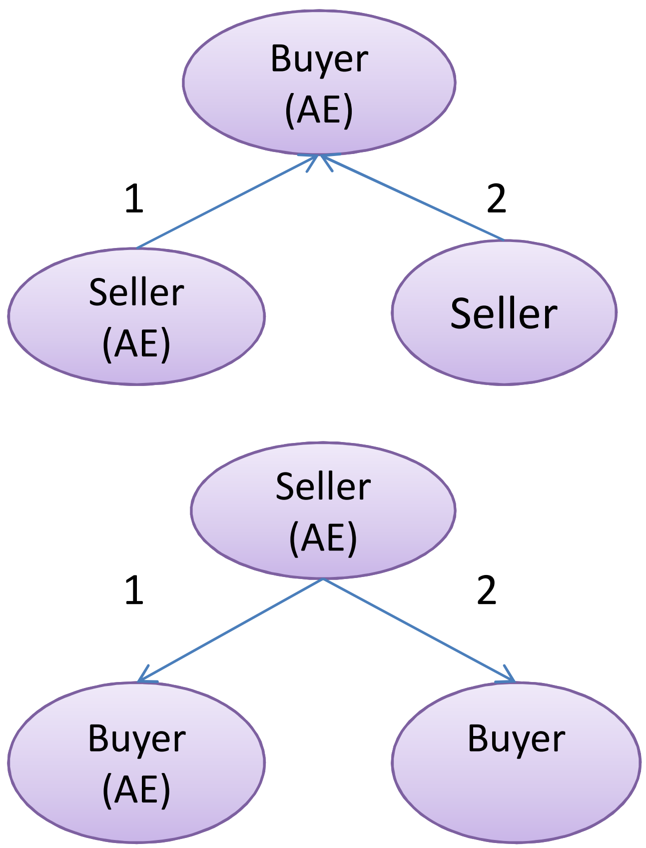
I. Controlled Transactions – Transactions between the assessee with the AE/s(Associated Enterprise/s)

II. Uncontrolled Transactions –

- Transactions between the Assessee or AEs with third parties – The prices/value of goods/services in these transactions are Internal CUP.
- Transactions between unrelated parties – The value of the goods/services in these transactions are External CUP.
- Calculating ALP on the basis of public data also comes under External CUP. While using public date the following are to be taken care of:
    - the data is widely and routinely used in ordinary course of business in the industry to negotiate prices for uncontrolled sales/services
    - data is used to set prices in the controlled transaction in the same way that it is used by uncontrolled taxpayers in the industry; and
    - the amount charged in the controlled transaction is adjusted to reflect product and service variations.

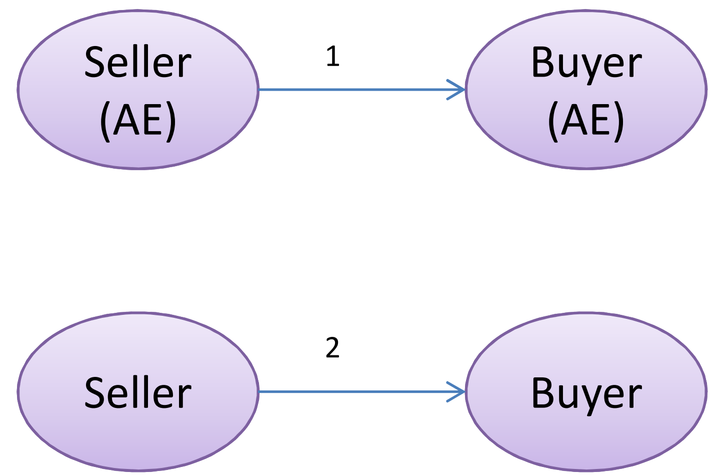
CUP – Internal & external

Internal CUP



1- Controlled Price 2 – Uncontrolled Price

External CUP



1- Controlled Price 2 – Uncontrolled Price

CUP – Internal & external

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

Comparability

- 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

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.

Functional Analysis for CUP

- 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

Adjustments

	Sale to AE	Sale Non-AE	Remarks
Price	FOB	CIF	Freight & insurance Rs. 550
Quantity discount	yes	No	1 CD of Rs. 10 each for every CD writer Plus Rs. 20 per CD writer
Credit	One month	Cash and carry	Cost of credit 1.25%
Warranty	No warranty	Six month warranty	Cost of warranty Rs. 250 /unit

- Whose CUP- Buyer's or seller's?
- Could produce wide range of potential CUPs.
  - Uncontrolled Price may range between best alternative price of seller before shipping and buyer's best price including shipping costs.

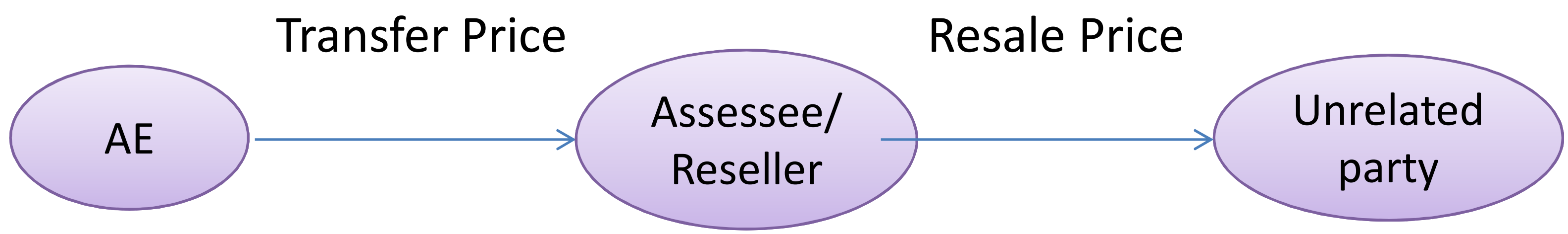
Concluding thoughts

- 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.
- Present other method (TNMM) as best method and offer CUP as a fall back method

RESALE PRICE METHOD (RPM)

What is Resale Price Method?

- RPM is a method used to determine ALP(Arm’s Length Price) only when goods purchased from AE(Associated Enterprise) are resold to unrelated parties and there is very little value addition involved by the assesee.



- If the Transfer Price > than the ALP as worked out by this work-back method the difference is disallowed in the assessment.
- ALP in this method is calculated by working back from the resale price.

Some other conditions under which RPM is the suitable method to calculate ALP

1. If an enterprise(Assessee)performs all the functions an independent distributor might be expected to perform.
2. If the reseller on-sells within a short time
3. Where the assessee is a trader, without value addition or physical alteration to the goods – Packing , repacking, labelling or minor assembly does not constitute physical alteration.
4. Reseller does not apply intangible assets to add value.

Calculation of ALP under the RSM

Resale Price	xxx
1. Less : Normal GP margin on same/similar property or service in comparable uncontrolled Transaction	xx
2. Less : Expenses in connection with purchase of property/service	xx
3. Add/Less : Adjustments for opening and closing stocks of goods purchased from Aes	xx
4. Add/Less : Functional/other differences between the transactions/enterprises	xx
ALP (Arm's Length Price)	xxx

Note : *Adjustments 1, 2, 3, & 4 have been briefly explained below*

1 - G P MARGIN / Resale Price Margin

- The resale price margin represents the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit – OECD TP guidelines.
- Gross profit margin can be determined in any of the two methods –
    1. First is the gross profit margin of the assessee itself.(Internal RPM) But when gross profit margin of the assessee itself is considered, then such gross profit margin has to be worked out excluding the purchases from the associated enterprises and sales thereof. When the purchases from the AE are proportionately very high and excluding them will give a very negligible quantity of transactions the 2^{nd} method is used.
    2. The gross profit margin taken from comparable uncontrolled transactions entered into by similarly placed concerns. (External RPM)

    The first method takes precedence over the second when comparable and appropriate internal GPM is available.

Important Factors that influence the Resale Price Margin

1. If the reseller	RPM
performs limited services as a forwarding agent or broker	Comparable RPM can be derived from an examination of Commission or brokerage.
takes property in the goods, assumes the business risks, warehouses and distributes them to customers	the resale profit margin applicable to a principal would be relevant
also undertakes marketing, education and other activities, assumes warranty and other risks and employs intangible assets such as a developed distribution network. (in addition to the above)	the additional functions undertaken, risks assumed and intangibles used should result in higher returns
Has exclusive right to resell the goods	The value to be attributed to such exclusive right will depend to some extent upon its geographical scope, substitute goods etc.

Important factors which influence the Resale Price Margin – contd.

2. Where the accounting practices differ from the controlled to uncontrolled transactions	**Appropriate adjustments should be made to the data used in calculating the Resale Price Margin.**
3. Time of Resale	A resale price margin is more accurate where it is realised within a short time of the reseller's purchase of the goods.
4. Value added by the Reseller/level of activities performed by the Reseller	The Margin would be higher if the value added is more and vice versa.

2 - Expenses in connection with purchase of property /service

- These expenses do not refer to the purchase price but to expenses connected with purchases - Freight , customs duty etc

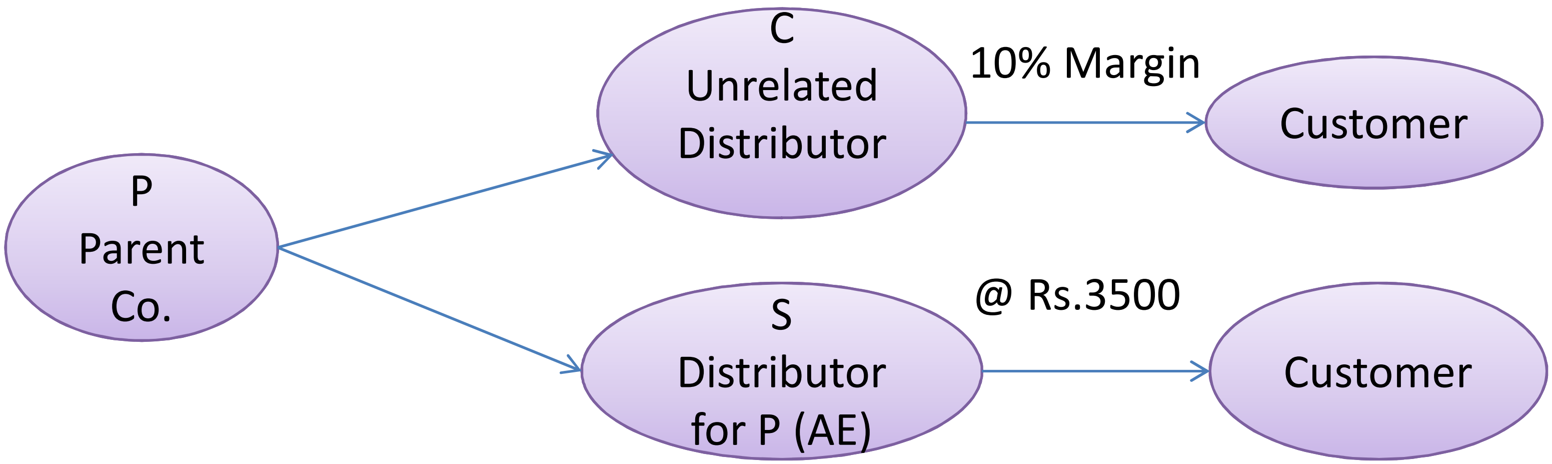
3 - Opening and Closing Stock adjustments

- Resale in any financial year may be out of the opening stock.
- Goods may remain in closing stock.
- Just reducing GP margin and expenses without adjusting for opening stock and closing stock of goods purchased from AEs will give only cost of sales and not the value of purchases.
- Therefore, closing stock of goods purchased from AEs be added and opening stock of goods purchased from AE be reduced.

4 - Functional/other differences between the transactions/ enterprises

- Some of the differences which may require adjustments are:
  a) sales and purchases accounted for inclusive/exclusive of taxes
  b) method of pricing - FOB/CIF
  c) foreign exchange fluctuations.
  d) Level of market(Wholesale, retail etc.)
  e) Contractual Terms – Warranties, credit , sales volume.
  f) AMP activities.

Example 1

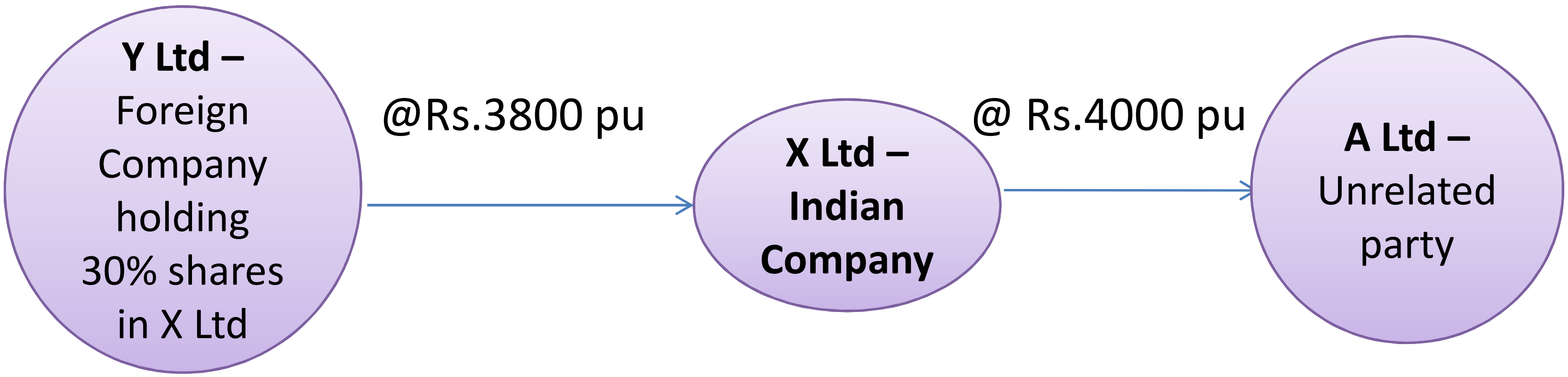


S performs promotional and marketing functions for P whereas C does not.

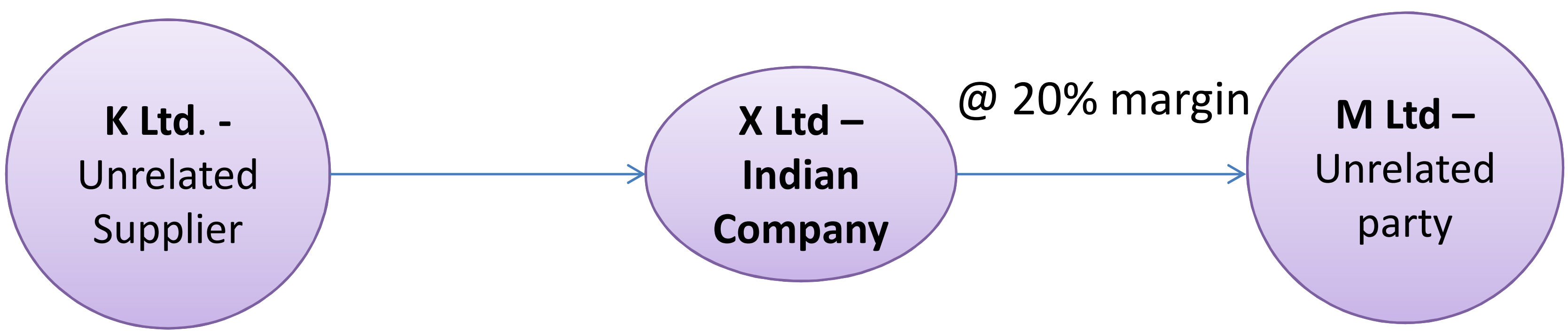
ALP : Resale Price	Rs.3500
Less: Margin based on Company C's transactions (10%)	Rs. 350
Less: Adjustment for marketing costs	Rs. 80
Transfer Price(ALP)	Rs.3070

Example 2- ICAI Guidance Note

Controlled Transaction



Comparable Uncontrolled Transaction



Example 2 Contd….
Nature of transactions - Resale by X Ltd.

To A Ltd.	To M Ltd
Sales are Ex shop	• Sales are FOR destination. • The freight and transit insurance paid • Gross profit margin being higher by 3% • Sale price remained unchanged • **Freight and insurance is debited to Profit and Loss Account.**
Quantity Discount given due to which GP Margin lower by 2%	
	• Gift of 3 Units of Product "P" for every Unit of Product "R" • Cost debited to P&L so **GP margin unaffected**
	• Extended warranty of 6 months of Rs.500 per unit. • Costs charged to P&L **so GP margin unaffected.**

Example 2 Contd….

Nature of transactions – Purchases of X Ltd.

From Y Ltd.(Controlled)	From K Ltd(Uncontrolled)
Freight Rs.10 per unit , Customs Duty Rs.25 per unit. It is assumed that the freight charges will have a bearing on the gross profits	Only customs duty Rs.25 per unit
Quantity discount of Rs.10 per unit	
	• Extended Warranty for 6 months. Warranty costs debited to P&L
Offers Credit for 1 month – Cost of Credit 1.25 % per month .Interest cost debited to P&L.	

Example 2 -Calculation of ALP

- **Calulation of Normal GP Margin** :Comparable uncontrolled transaction is purchase from K Ltd. And sales to M Ltd whose GP Margin is 20%. This has to be adjusted suitably for differences between transactions with A Ltd.
  - GP Margin with M Ltd 20%
  - **Less :** Difference between Ex shop and FOR prices 3%
  - **Less :** Difference due to quantity discount 2%
  - Normal Profit with M Ltd. 15%
- **Calculation of ALP**

Price charged to A Ltd.	Rs.4000
Less: Normal GP Margin @15%	Rs. 600
Less: Expenses connected with purchase (freight & customs duty paid)	Rs. 35
Add: Freight incurred in case of purchase from Y Ltd.	Rs. 10
Less : Quantity discount allowed by Y Ltd.	Rs. 10
Arm's length price	**Rs. 3365**
Adjustment = = Rs.435 per unit ie for 100 units	**Rs.43500**
Rs.3800(Price paid to Y) less :Rs.3365	

Relevant points to be considered before using RPM

- What potential comparables(including any uncontrolled purchases and resales of the tested party or its affiliates) are available to apply RPM and which if any should be selected?

- When there are differences between the potential comparables and the controlled reseller and what adjustments can be made to narrow the differences?

- Should all the activities of the controlled reseller be analysed as a single grouping or should the analysis be undertaken separately for various segments of the controlled reseller? Should several entities be combined for analysis?

- Are all the data and assumptions complete and accurate?

Difficulty in application of RPM

1. The Indian databases do not provide the data on gross margins and detecting the gross margin/sales realised by third parties proves usually difficult.
2. The RPM is unlikely to lead to accurate results if there are differences in level of market , functions performed and product.
3. In theory the RPM is requires an item-by-item analysis under which the appropriate GP margin is determined for each item purchased by the reseller from the AE on the basis of its resale. In practise RPM is applied on a global basis.
4. Sometimes there will be a series of controlled sales.
5. In some cases multiyear data may be required to be used.

COST PLUS METHOD
CP method

What is Cost Plus Method(CPM)?

- OECD guidelines explains CPM as follows:
  - CPM begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser.
  - An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.
  - What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

Arm's Length Price(ALP) = Direct costs + Indirect costs + Adjusted GP margin

<u>COSTS</u>

- 'Cost' in cost plus means <u>actual costs and not estimated</u> costs.

- As the terms 'direct' or 'indirect' costs are not defined in the transfer pricing provisions, a reference may therefore be made to the industry practice as well as the pronouncements of the ICAI for an industry. Any deviation made by the enterprise as compared to the industry practice or the pronouncements of the ICAI will have to be justified.

- In identifying and adopting the direct and indirect cost, the following factors would also have to be borne in mind: (*a*) utilisation of the plant; for example, if the plant has been under utilised the method of absorbing fixed costs may have to be suitably adjusted; (*b*) method of absorbing costs; absorption costing method is normally to be preferred.

Gross Profit Margin/Mark up

- The comparable gross mark-up may be determined by reference to either:
  - (*i*) the cost plus mark-up that the same supplier earns in comparable independent party transactions (internal comparable), or
  - (*ii*) the cost plus mark-up that would have been earned in comparable transactions by an independent parties (external comparable).
- The normal GP mark up should be adjusted for functional and other differences between the international transaction and the comparable or between the enterprises involved in both the transactions. **Adjustment is to be made only if such differences would materially affect GP margin in open market.**

Some significant factors which affect Gross Profit

- Significant differences in value of the products
- Difference in cost structures eg: age of plant and equipment
- Difference in business experience – phase of development that the entity is in
- Differences in management efficiency
- Accounting Practices
- Complexity of manufacturing or assembly
- Manufacturing Prduction and process engineering
- Procurement purchase and inventory control
- Testing functions
- Selling, general and administrative expenses
- Foreign currency risk
- Contractual terms

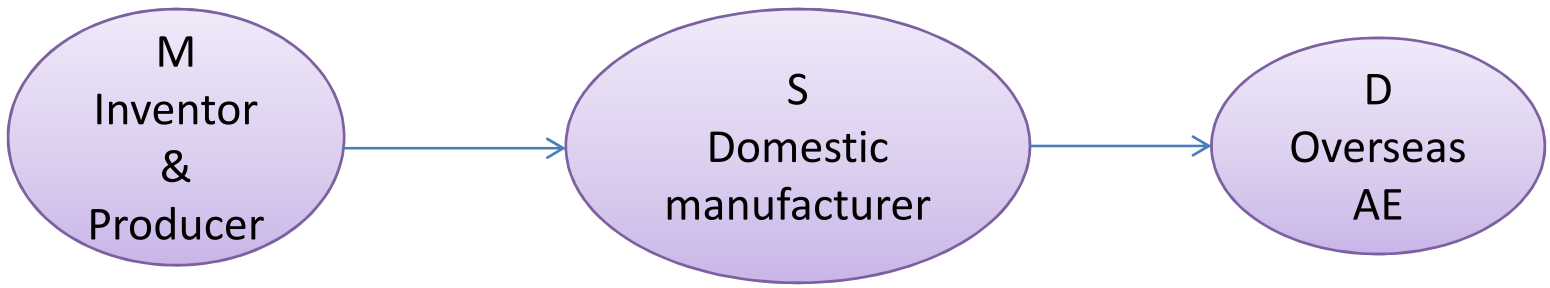
When can CPM be used ?

- This method is to be adopted only in cases of supply of property or services to an associated enterprise.
- Generally this method is used where:
  - some semi-finished goods are sold between related parties
  - in respect of joint facility agreements
  - long-term buy and supply arrangements of provisions of services
  - the controlled transaction is the provision of services

Relevant points to be considered while using CPM

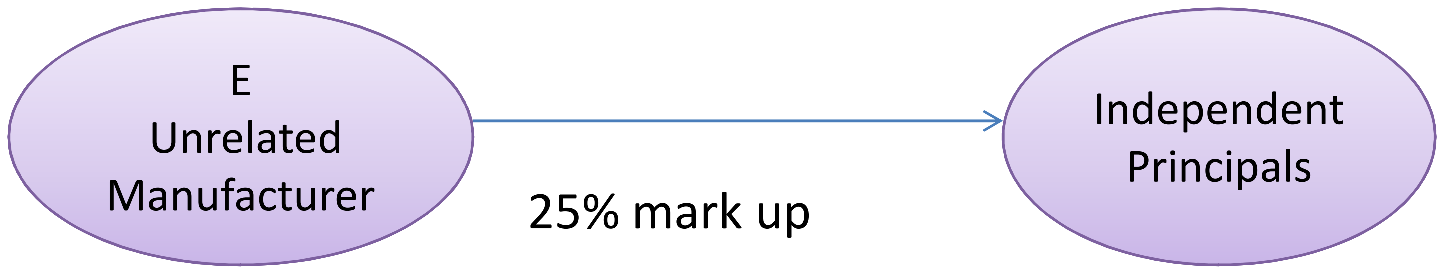
- This method is ***not to be applied*** when the enterprise procures ***property or services*** from an associated enterprise.
- Products, which are functionally comparable, are good enough for benchmarking under Cost Plus Method. There is no necessity to benchmark with such product, which is 100 per cent identical.
- FAR analysis is critical in identifying functionally similar comparable transactions.
- The application of CPM has to be on transaction basis rather than on global basis
- Apply a comparable mark up to a comparable cost basis. For instance, if the supplier to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets.

Example 1



- Company D provides all the know-how used in the manufacturing of the drug and undertakes to acquire a fixed output from S every month.
- Payment is to be made based on the costs incurred by S, along with a mark-up to reflect a profit element for S.
- Based on S's financial statements, the cost incurred to manufacture one unit of the drug is Rs.70.

Example 1 - Contd

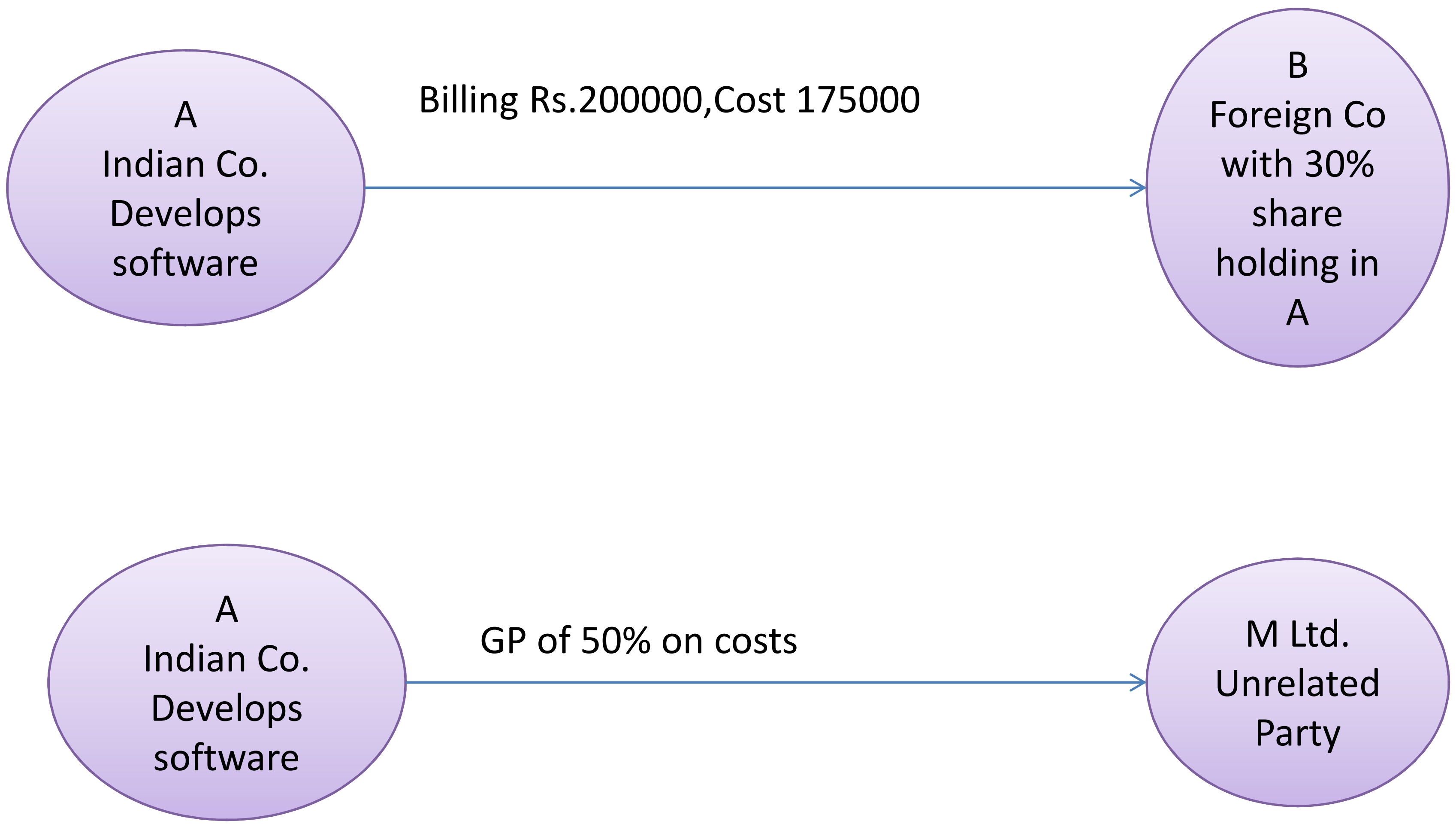


- Company E has been identified as a potential comparable company.

ALP :

Direct and indirect cost incurred by S	Rs.70.00
Arm's length mark up (25% x 70.00)	Rs.17.50
Transfer Price(as per CPM)	Rs.87.50

Example 2- ICAI Guidance Note



<u>Example 2</u>
<u>Analysis of Transactions</u>

With B Ltd	With M Ltd
Technology support of value Rs.17500 received from B**<u>(10% of cost)</u>**	No technology support received from M Ltd.
Discount offered to B Rs.8750**<u>(5% of cost)</u>**	No discount offered
Value of Business and marketing risks assumed by B Rs.13125**<u>(7.5% of cost)</u>**	No
Credit given to B cost of which is estimated at Rs.2625**<u>(1.5% of cost)</u>**	No credit given to M Ltd.

Example 2
Calculation of ALP

Step 1.Calculation of GP Margin

• G P Margin of M Ltd.		50%
• Less: Tech Support from M Ltd (1)		10%
• Less: Discount given to B		5%
• Less: Marketing functions performed by A for M Ltd	7.5%	
• Add: Cost of credit given to B	1.5%	
• Adjusted GP Margin		29%

Step 2. Calculation of ALP

• Costs incurred	Rs.175000
• GP on the costs (29%)	Rs.50750
• Arm's Length Price	Rs.225750(A)
• Price charged to B	Rs.200000(B)
• Income Increases by	Rs.25750(A-B)

Issues in application of CPM

- In cases where there is a well-recognised Trade Mark the GP Margins may be significant as it will vary for each good produced.
- Not enough guidelines with regards to the inclusion of certain costs like depreciation , finance costs etc.
- Should costs related to third party service provider, which could otherwise be received by the service recipient directly , be included in the costs for calculating the mark up for the CPM?- Pass thru costs.
- Availability of information on costs of comparable uncontrolled parties.

Comparison - RPM with CPM

RPM	CPM
The resale price method starts from the final selling price and subtracts an appropriate gross margin to arrive at a purchase price.	The cost plus method starts by computing the cost of providing the goods or services and adds an appropriate mark-up.
This method is used for **purchases from AE and resale to unrelated parties.** No substantial value added by purchasers or resellers.	CPM is used in respect of **property transferred or services provided to an AE.**

Thank You

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