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Transfer Pricing Methods and Selection of Most Appropriate Method

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Agenda

Transfer Pricing – Quick background

Arm's Length Principle

Overview of Methods

Selection Most Appropriate Method

Transfer Pricing –
a quick background

Background

- Transfer Pricing in India introduced with effect from April 1, 2001.
- Any international transaction undertaken between associated enterprises would be subject to transfer pricing regulations
- The term "international transaction" is widely defined to cover almost all kinds of transactions
- Domestic TP applicable if aggregate value of specified domestic transactions ("SDT") exceeds INR 5 crores

Background

- Principles governing multinational transfer pricing:
  - Arm's length principle
  - Global formulary apportionment

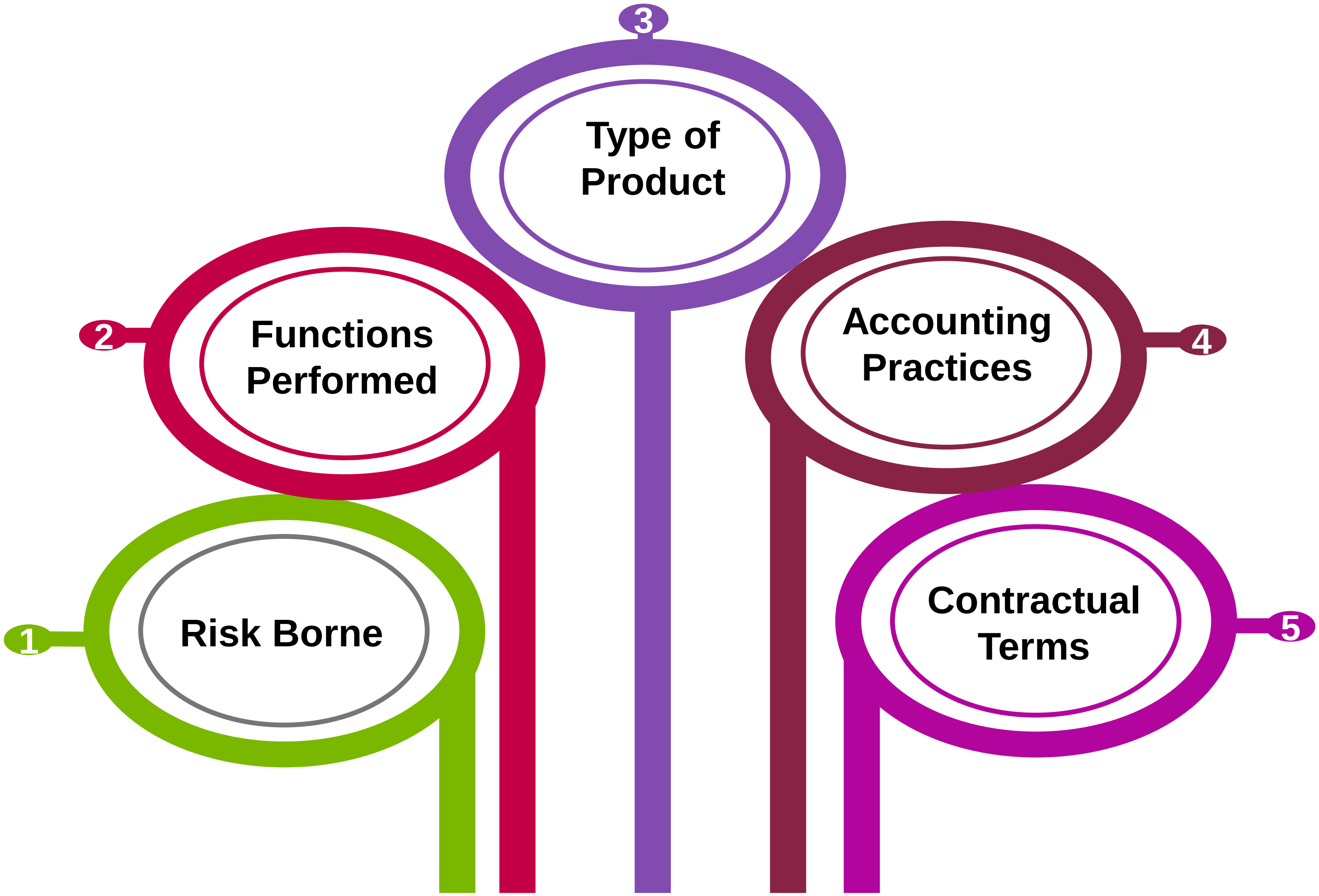
- Arm's length principle most popular globally

- Arm's length principle requires the transaction between two associated enterprises to be commercially at par with that of a similar transaction between two independent enterprises entered in uncontrolled conditions.

- Transfer pricing methods are mechanism to determine arm's length price

Background

Comparability factors for application of arm's length principle



Background

Comparability Rule

To be comparable means

- none of the differences (if any) could **materially affect** the condition being examined in the methodology (e.g. price or margin), or
- that reasonably accurate **adjustments** can be made to eliminate effect of any such differences

Plays a critical role in selection/applicability of methods

Overview of TP Methods

Transfer Pricing Methods

- Comparable Uncontrolled Price
- Resale Price Method
- Cost Plus Method
- Transactional Net Margin Method
- Other Method

Comparable Uncontrolled Price (CUP) Method

Contents

Introduction and applicability

- compares the **price charged from the a property transferred/service provided in a controlled transaction with the price charged in the comparable uncontrolled transaction**

- **adjustments are required for material differences between** the controlled and uncontrolled transactions which have the potential to affect price in the open market,

- **most direct method** and preferred by tax authorities globally

- **CUP can be exact or constructed**. constructed CUP tends to arrive at the arm's length price of a controlled transactions after several adjustments. **Quality of constructed CUP relies on the quality of adjustments**

Indian TP regulations on CUP

- **Indian regulations provide for selection of most appropriate method**
- **Various factors need to be considered to determine most appropriate method**
- **Indian regulations do not provide any preference to any particular method**
- **CUP still preferred over any other method due to direct comparability**

Rule 10B(1)(a):-

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**, 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.

iii. The adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price ("ALP") in respect of the property transferred or services provided in the international transaction

Applicability of CUP

- As per the Transfer Pricing Guidelines issued by the ICAI, typical transaction in which CUP method may be adopted are:
  - Transfer of Goods
  - Provision of Services
  - Intangibles
  - Interest on loans
- Applicable only when **controllable uncontrolled transactions is available in an comparable environment with adjustable differences.**
- Difficulty in adjusting the material differences does not prohibit the use of CUP.
- **Demands highest degree of product comparability**.
- A valid CUP must correspond to the actual price charged in a controllable uncontrolled transaction in similar economic circumstances,
- Any Other Method introduced provides for the use of catalogues, quotations and other indirect evidences

OECD Guidelines on CUP

- As per the Organization for Economic Co-operation and development ("OECD") guidelines, it is a TP method which:
  - **compares** the **price charged** for property or services transferred in a **controlled transaction** to the price charged for property or services transferred in a **comparable uncontrolled transaction** in **comparable circumstances**.
- CUP method is the most **direct** and **reliable** way to apply the arm's length principle.
- Comparable uncontrolled transaction can be used as CUP if one of the following two conditions is met:
  - **none** of the **differences** (if any) between the **transactions** being compared or between the enterprises undertaking those transactions could **materially affec**t the **price in the open market**; or
  - **reasonably accurate adjustments** can be **made** to **eliminate** the **material effects** of such differences.

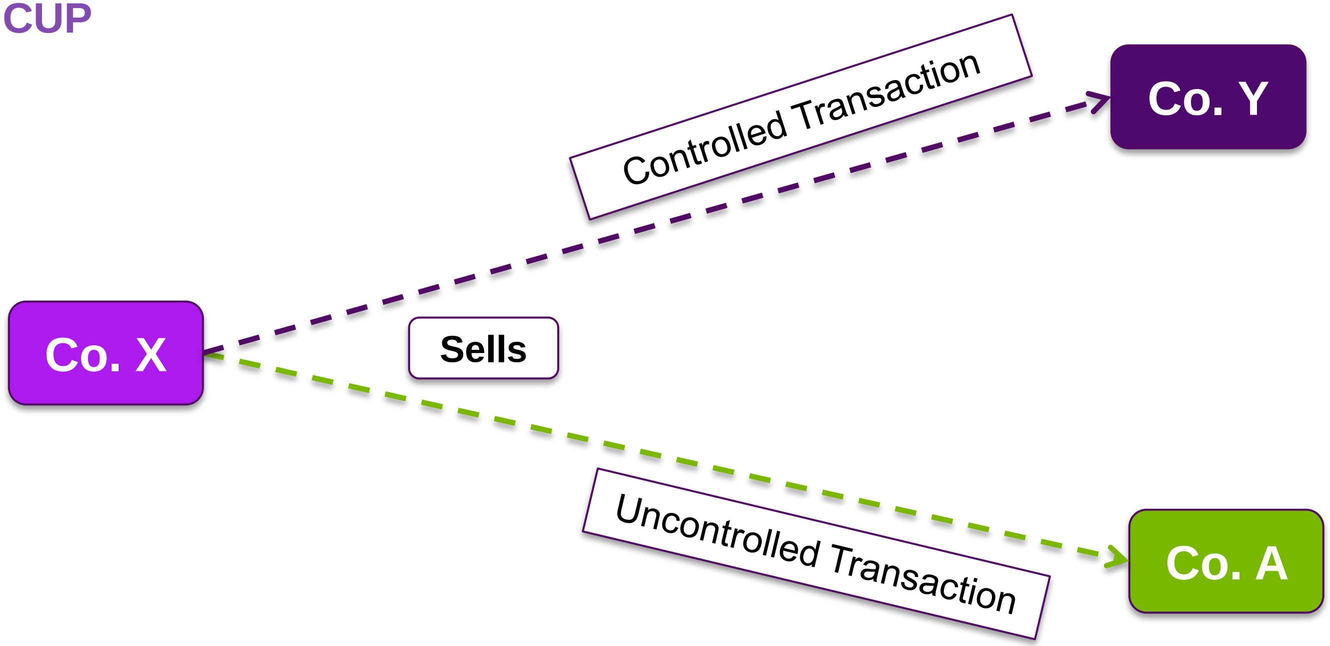
Comparability Factors

Factors to be considered while selecting comparable uncontrolled transaction

- Type of Product
- Market levels
- Geographical Market
- Period of Transaction
- Contractual terms
- Economic Conditions
- product similarity

Types of CUP

Internal CUP

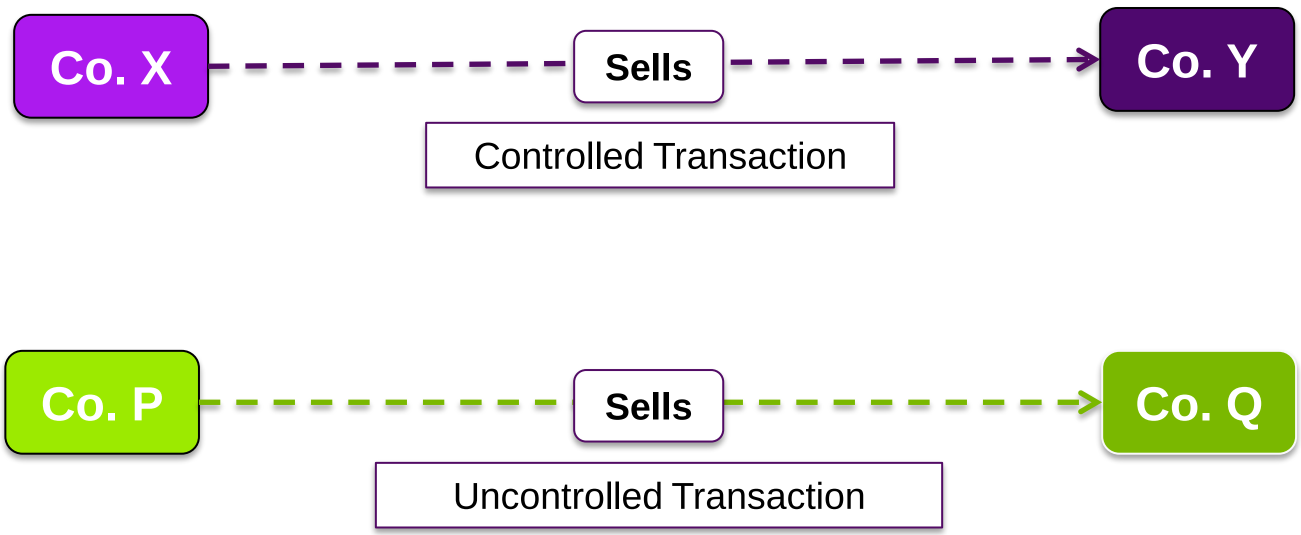


Co. X & Co. Y are associated enterprise (AE) and Co. A is an unrelated party. X sells a common product to both AE as well as to the non related party.

In this case internal CUP can be applied by comparing the price charged from Co. Y with the price charged from Co. A. However any contractual difference between the two sale contracts must be adjusted

Types of CUP

External CUP



Co. X is engaged in sale of a particular product to its AE, i.e. Co. Y. An unrelated entity, co. P sells the identical product to Co. Q.

In this case external CUP can be applied by comparing the price charged by Co. X with price charged by Co. P. However adjustments must be made with regard to any differences in volume, geography contractual terms

Resale Price Method (RPM)

Contents

Introduction

- The resale price method is most appropriate in a situation where the **seller adds relatively little** value to the goods.
- The greater the value-added to the goods by the functions performed by the seller, the more difficult it will be to determine an appropriate resale margin.
- This is especially true in a situation where the seller contributes to the **creation or maintenance of an intangible property**, such as a marketing intangible, in its activities.
- While resale price method may require less product comparability, it is a fact that closer comparability of products will produce better results.
- The **factors** to be considered in this method are level of costs, value addition at each stage, time-frame of resale, computation of gross margin, etc.

Applicability of RPM

- Property purchased or services obtained from a related party and resold to an independent party
- No major value addition to goods purchased or services obtained from associated enterprises
- No intangible assets is applied to add value to the goods resold
- Most useful in the case of traders & distributors
- Can easily be applied when no significant value addition is there
- Not applicable when Goods purchased from AE also sold to AE

Indian TP regulations on RPM

Rule 10B(1)(b) :-

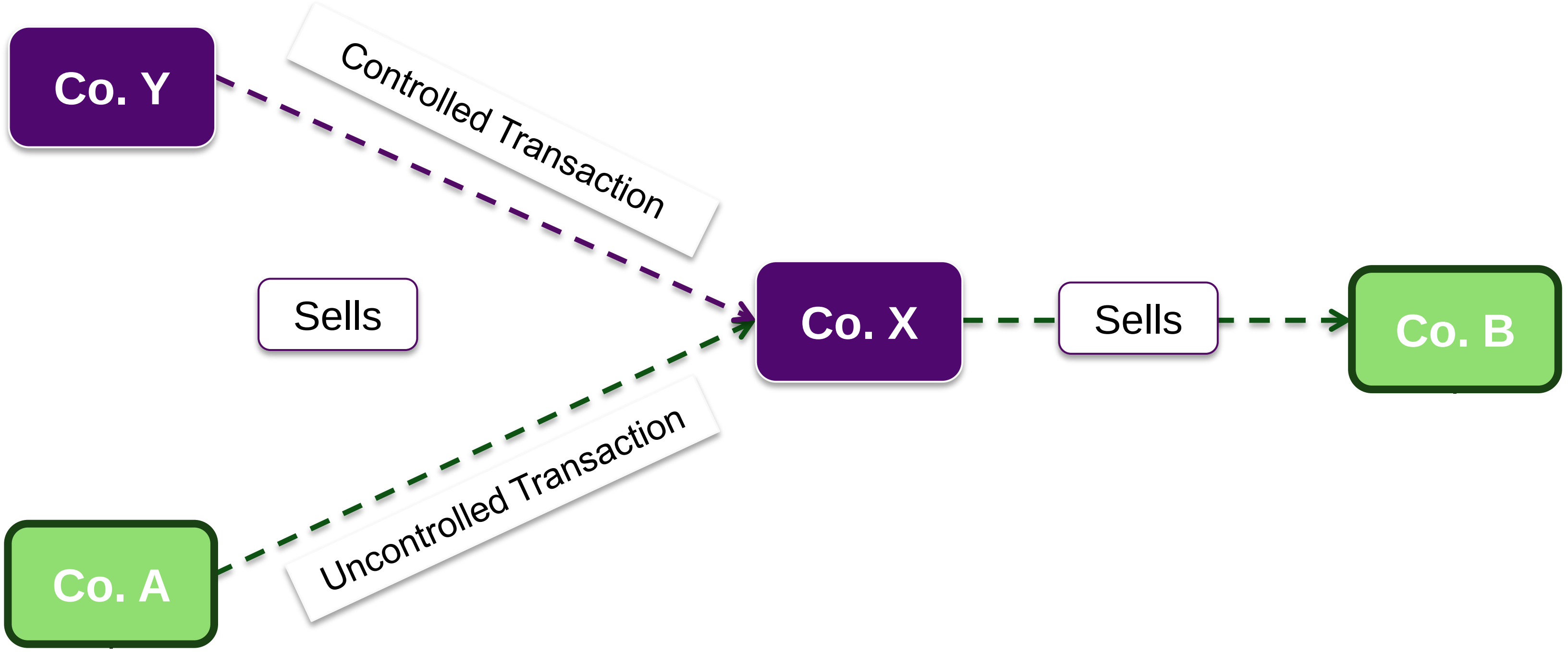
- The price at which property **purchased or services obtained** from an AE is resold or provided to an unrelated enterprise is identified.
- Such resale price is reduced by the amount of a **normal gross profit margin**…,
- in a comparable uncontrolled transaction
- The price so arrived is further **reduced by the expenses incurred by the enterprise** in connection with the purchase…
- The price so arrived at is adjusted to take into account **the functional and other differences**, including differences in accounting practices, if any, which could materially affect the amount of gross margin in the open market…

RPM – Possible Adjustment

- Inventory Level
- Contractual Terms
- Accounting Practices
- Sales, Marketing, Advertising Programs, and Services
- The Level of the Market
- Foreign Currency Risks

Illustration - Internal RPM

Internal RPM may be applied when the same reseller is engaged in trading of similar goods in both controlled and uncontrolled circumstances.



In the illustration above Co. X resells the similar goods procured from a related party (Co. Y) and an unrelated party (Co. A) to an unrelated party (Co. B).

Internal RPM can be applied by comparing the gross profit margin realized on goods procured from Co. Y with the gross profit margin realized on goods procured from Co. A

Illustration - External RPM

External RPM may be applied when an independent party is engaged in trading of similar goods as traded by tested party in uncontrolled circumstances.

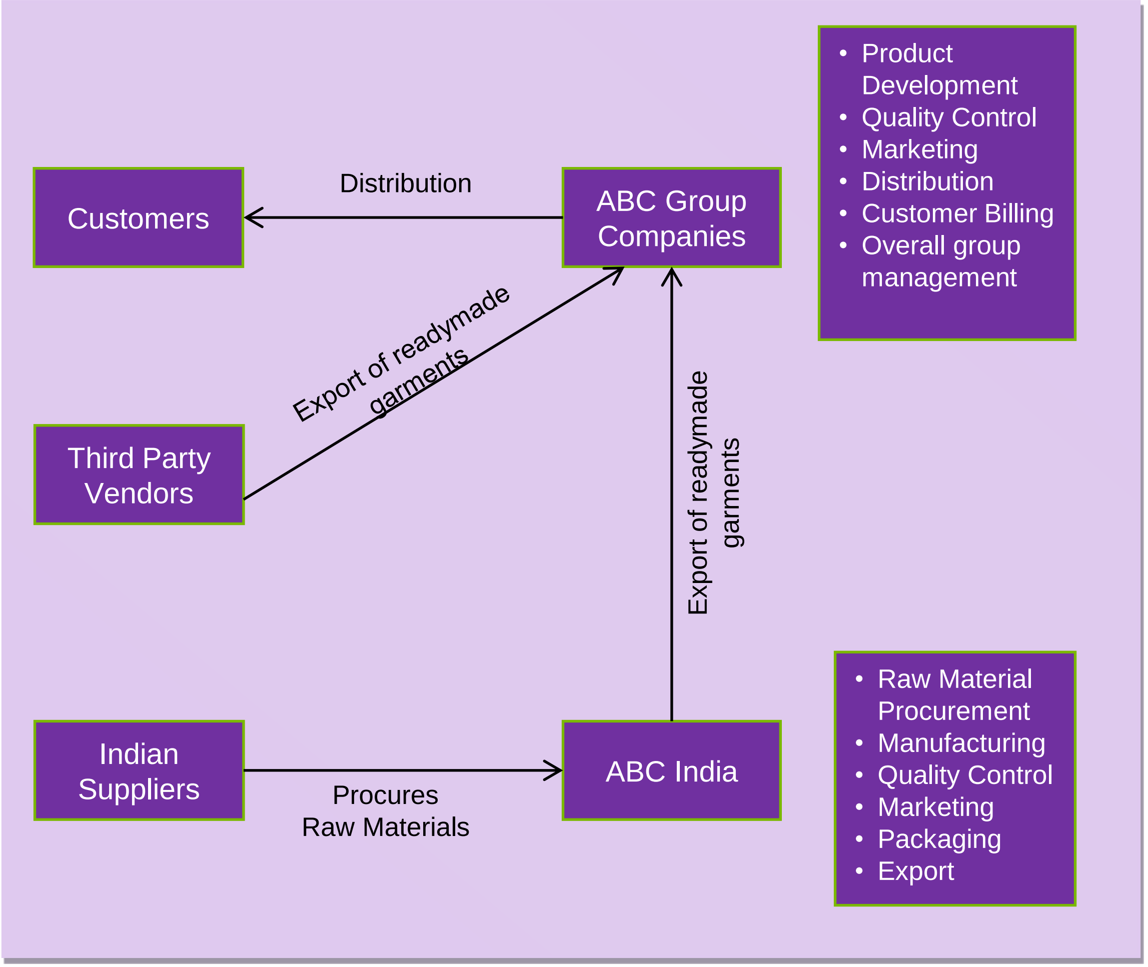
Controlled Transaction

In the illustration company X resells the goods procured from related party, Co. Y while company P is reselling the similar goods procured from Co. Q, an unrelated party.

In this case external RPM may be applied by comparing the gross margins realized by Co. P vis-a-vis the gross margins realized by Co. X

Uncontrolled Transaction

Case Study



Facts:-

ABC Group

- Manufacture and sale of readymade garments
- Its subsidiaries also produce and sell of readymade garments under ABC brands, licensed brands, private labels, and store brands.

ABC India

- Joint Venture of ABC US and Indian third parties
- Manufacturing and Exporting garments to ABC Group Companies
- ABC India exports primarily to ABC Group co's.
- **It has net level losses**

Case Study

International Transactions

1. **Manufacturing and Exports of readymade garments**

Economic Characterization

ABC India :- Routine manufacturer operating independently

ABC US :- ABC US acts as a distributor. ***(Principle risk bearing entity, carrying business activities involving sales and marketing of garments)***

Case Study

Most Appropriate Method

Internal Resale Price Method

Approach

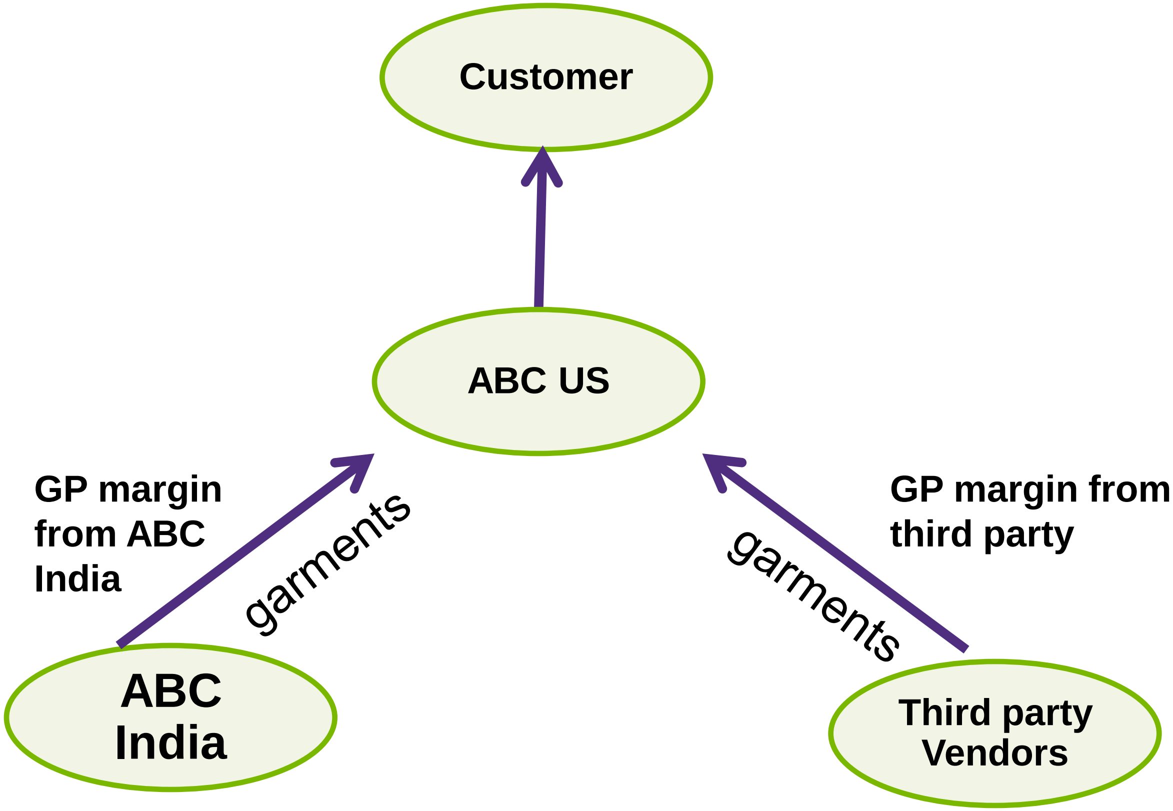
ABC US as a tested party

Comparison of Gross Profit margin of ABC US earns from the following transactions:

- ABC US and ABC India
- ABC US and third parties in Asia

Case Study

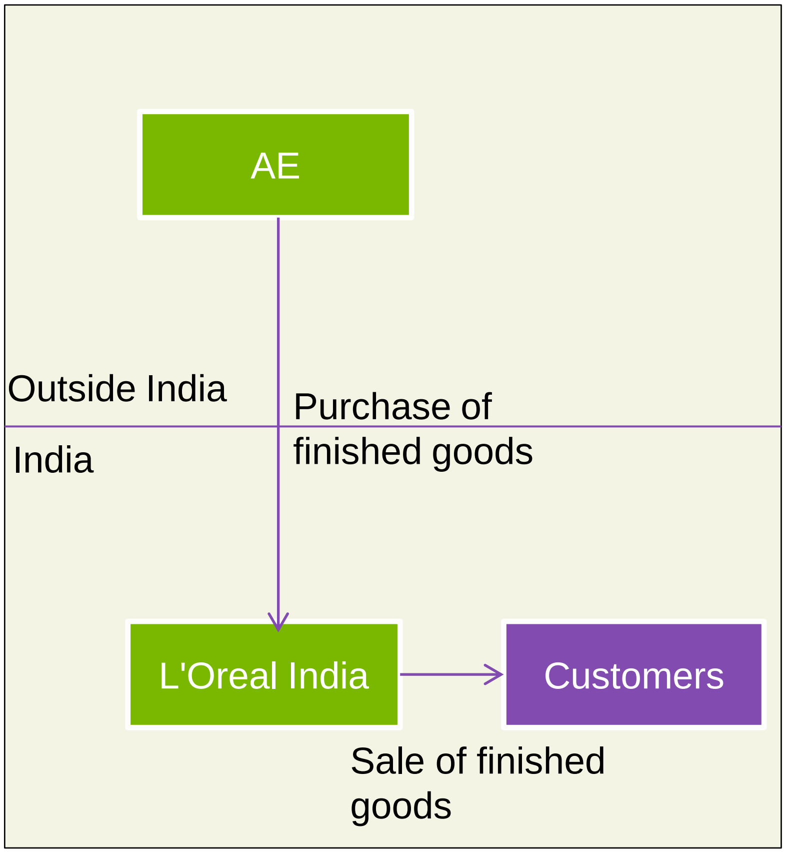
Internal RPM



GP margin from India <= GP margin from third party = ALP

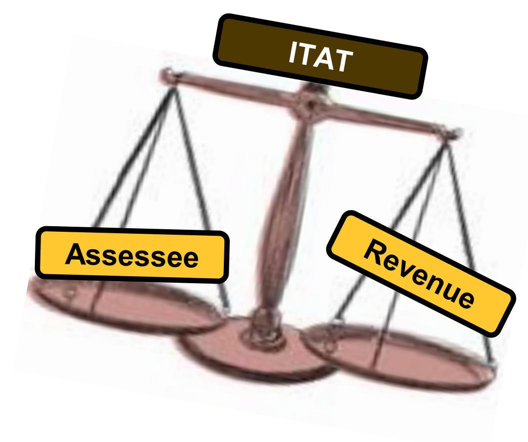
Judicial Precedent

ITO vs. L'Oreal India P. Ltd (5423/Mum/2009)



Facts of the case

- L'Oreal India is engaged in the business of manufacture and distribution of cosmetics and beauty products.
- L'Oreal India had two business (i) manufacture and (ii) ***distribution***.
- L'Oreal India adopted RPM to benchmark its international transaction pertaining to purchase of finished goods for distribution in India.



RPM – Key Judgment

TPO's Contention

- The TPO rejected the RPM adopted by L'Oreal India, on the grounds that L'Oreal India's pricing policy is not at arm’s length since it is consistently incurring losses.
- He proposed an adjustment by applying TNMM
- The TPO also observed that the comparable's gross margins cannot be relied upon because of product differences, and that the FAR comparison of L'Oreal India vis-à-vis comparable companies is sufficient only for application of TNMM and not RPM.

CIT's Contentions

- The CIT(A) deleted the entire addition made by the TPO and considered taxpayer’s contentions
- Reliance was placed on the OECD guidelines and guidance note issued by ICAI.

RPM – Key Judgment

ITAT Judgment

- The Tribunal agreed with the CIT(A) that there is no order of priority of methods to determine ALP.
- The Tribunal observed that RPM, being one of the standard methods, is the most appropriate method for distributing and marketing activities when the goods are purchased from AEs and resold to unrelated parties.
- The Tribunal also noted that this view was supported by OECD guidelines.

RPM – Key Judgment

The main grounds before the High Court and its verdict are as under:

Whether the Tribunal erred in holding that RPM was the most appropriate method for determining ALP in respect of imports of finished goods

There no distinguishing features were noted, the Tribunal did not err in holding that RPM was the most appropriate method for determining ALP in respect of imports of finished goods.

Whether the Tribunal erred in not appreciating that the substantial value addition made to the goods has changed the degree of similarity in the functions performed thereby making RPM non applicable in the instant case

The High Court observed that the Tribunal, in its order, has noted that RPM can be adopted in case of distribution or marketing activities when the goods are purchased from associated entities and there are sales effected to unrelated parties without any further processing. The same view is also supported by OECD guidelines and accordingly, the Tribunal did not err in holding that RPM is the most appropriate method for the international transactions in respect of import of finished goods.

Cost Plus Method

Contents

Cost Plus Method

- CPM is applicable in the case of manufacturers or service providers engaged in supply of a property or provision of services to its related party

- CPM compares the gross profit mark-up on the costs incurred by the tested party in the supply of property or provision of services to the related party with the gross profits realized on supply of similar property or provision of similar services by the tested party/comparable entities in uncontrolled transactions

- Under CPM Arm's Length Price ("ALP") is computed as:

ALP = Direct and indirect cost of production in respect of property transferred or service provided
(+) Gross profit mark-up earned in comparable uncontrolled transaction
(+) / (-) Adjustments for differences which would materially affect the gross profit margins in open market

Indian TP regulations on CPM

Rule 10B(1)(c)

i. 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;

ii. 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

iii. 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;

iv. the costs referred to in sub-clause (*i*) are increased by the adjusted profit mark-up arrived at under sub-clause (*iii*);;

v. 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;

Applicability of CPM

- Supply of a property or provision of services to a related party
- Most useful in the case of transfer of semi finished goods, where long term arrangements have been entered between related parties, provision of services
- Not applicable in the case of receipt of a property or receipt of services from related party

Key Aspects in application

There must be a consistency in cost base between controlled and uncontrolled transactions, specially in the circumstances where costs have the effect on the size of mark-up

As the term direct and indirect costs of production are not defined anywhere, it may be difficult to determine the costs especially for the comparable uncontrolled transactions

Accounting inconsistencies must be eliminated between controlled and uncontrolled transactions.

Key Aspects in application

concentrates on functional similarities. Risk profile must be similar between controlled and uncontrolled transactions. Internal comparables more reliable

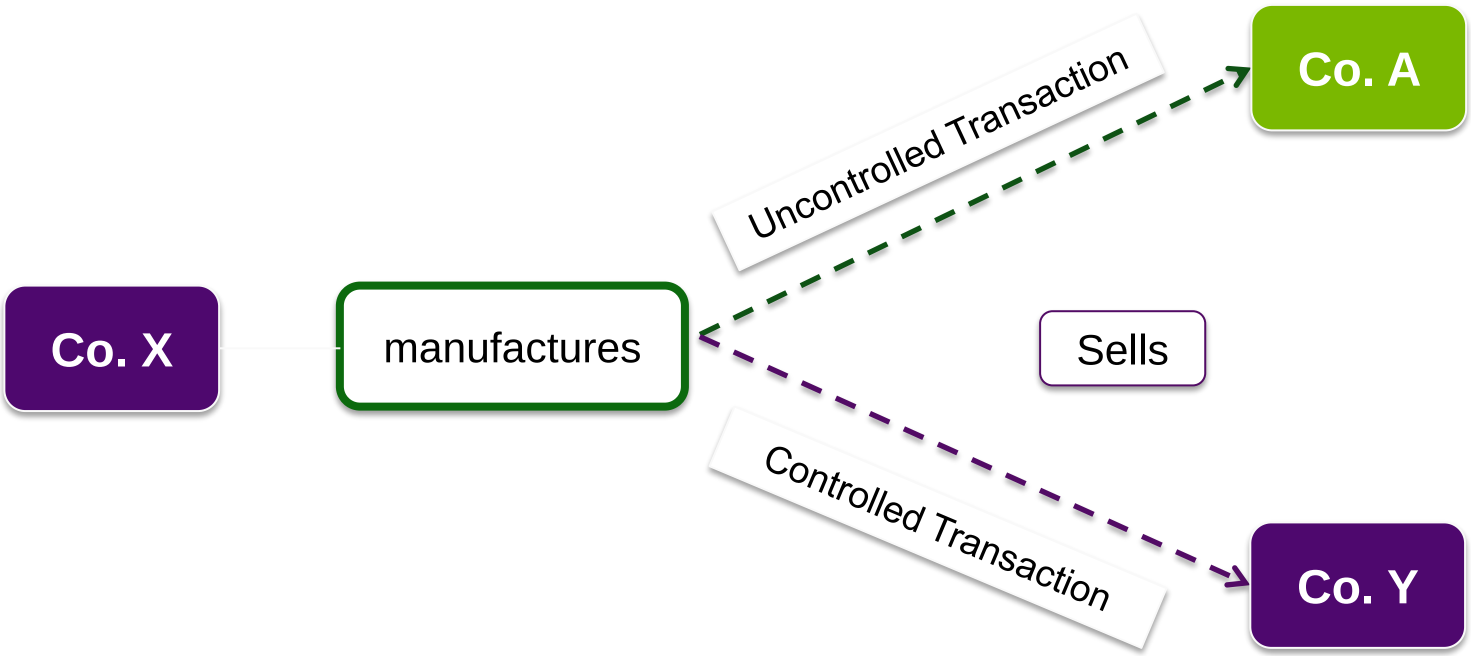
Fewer adjustments required on account of product differences than CUP. Less vitiated by indirect expenses

Key Aspects in application

- Appropriate adjustments required to eliminate material differences
- Some illustrative adjustments:
  - **Inventory levels and turnover rates;**
  - **Sales, marketing and advertising programs;**
  - **level of market**
  - **Accounting practices**
  - **contractual terms**
  - **tangible and intangible assets**

Types of CPM – Internal CPM

Internal CPM may be applied when the same reseller is engaged in trading of similar goods in both controlled and uncontrolled circumstances.



In the illustration above Co. X manufactures a certain commodity and supplies the same both to the related party (Co. Y) and unrelated party (Co. A)

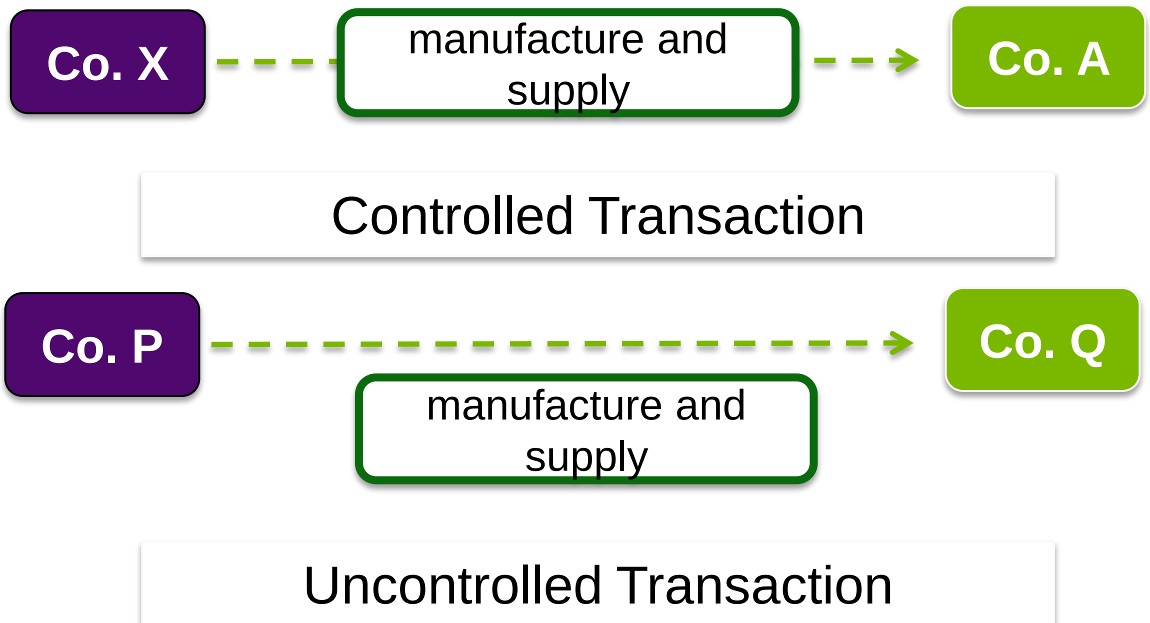
Internal CPM can be applied by comparing the gross profit margin realized on goods supplied to Co. Y with the gross profit margin realized on goods supplied to Co. A

Types of CPM – External CPM

External CPM may be applied when an independent party is engaged in manufacture and supply of similar products as supplied by tested party in uncontrolled circumstances.

In the illustration company X is supplying the goods to related party, Co. Y while company P is supplying the goods to Co. Q, an unrelated party.

In this case external CPM may be applied by comparing the gross markup realized by Co. P vis-a-vis the gross markup realized by Co. X



Profit Split Method (PSM)

Contents

Introduction

- PSM determines arm's length profit based on combined profits derived by related parties
- PSM is relevant
  - where different related parties are doing typical activity in value chain and external
  - comparable with similar FAR is difficult to apply
- Sharing of non-routine assets or entrepreneurial risks

Indian TP regulations on PSM

Rule 10B(1)(d)

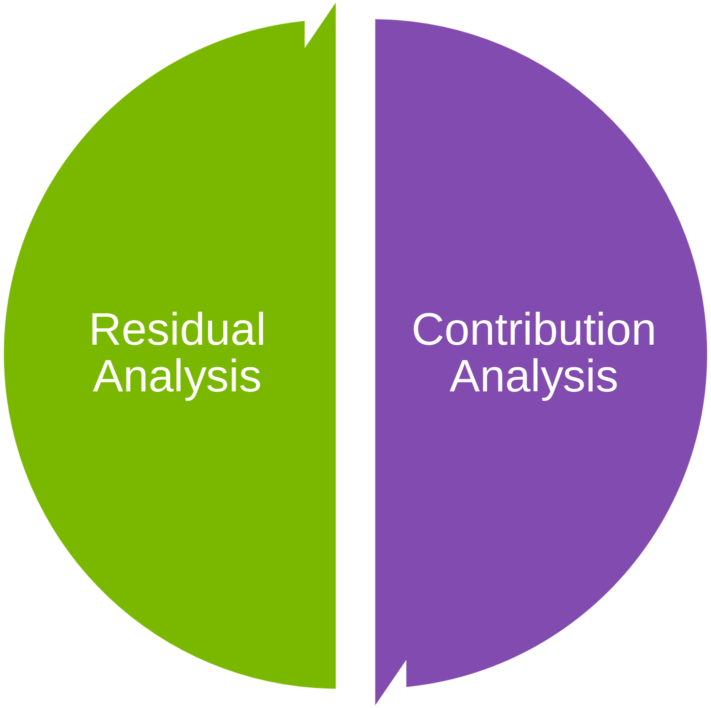
i. the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

ii. 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 similar circumstances;

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

iv. the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction

Types of PSM



Types of PSM

Residual Profit Split Method

- The residual profit, i.e., portion of the profit attributable to the entrepreneurial, non-routine or residual functions is split based on the profit split principles.
- There is a characterization of functions, risks and assets to routine and non-routine, wherein the routine functions are considered to be relatively simple and for which the comparable market data is easily available.
- The profit is attributed to the routine functions and the arm's length character is first applied to this part of the profit.
- The residual profit, if attributable to the non-routine / entrepreneurial functions is split on the basis as considered appropriate depending on the character of the profit
- A common issue with this method is that there is often a very thin line between routine and nonroutine functions, risks and assets.
- This method is the most commonly used profit split method, particularly popular in automotive, consumer electronics and financial services industries.

PSM – Strengths and weakness

Strengths

- Offers solutions for integrated operations not offered by one-sided methods
- Helps share profits for unique intangibles contributed
- Less dependant on comparables
- Less likely to leave any party to the transaction with extreme profitability as both parties are evaluated

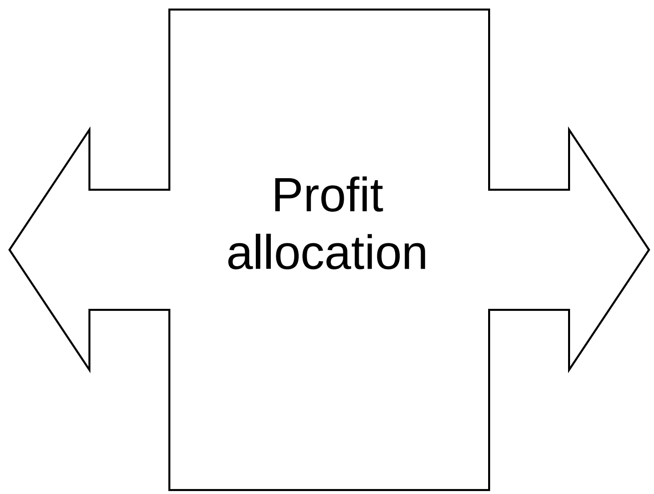
Weakness

- Difficulty in application
- Necessitating application of similar accounting policies and standards
- Allocation of costs
- Reluctance of tax authorities to accept
- Voluminous data

Judicial precedents-global

GSK settles largest tax dispute in history for $3.1bn

US - marketing subsidiaries



UK - developer and manufacturer

How much of the product's value should be attributed to each jurisdiction?

Transactional Net Margin Method

Contents

Introduction

- Generally the default method for use in the absence sufficient info for other methods
- Comparison at operating margin level
- Comparison at transactional level, where possible
- Test the simplest party
- Broad level of similarity of FAR
- Selection of the right comparables and PLI are critical factors
- Most preferred and practical method

Indian TP regulations TNMM

Rule 10B(1)(e)

i. the **net profit margin** realized by the enterprise from an **international transaction** entered into with an **associated enterprise** is computed **in relation** to **costs incurred or sales effected or assets employed or to be employed** by the enterprise or having regard to any other relevant base

ii. 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**.

iii. 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.

iv. 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*)**

v. 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.

Applicability - TNMM

- No specific guidance is provided on when this method is reliable except rule 10C(2)
- However typical transactions in respect of which the Transactional Net Margin method may be adopted are:
  - Transfer of goods
  - Provision of services
  - Purchase of goods
- Factors of Comparability to be considered while selecting TNMM
  - Functions Performed (taking into account assets used and risks assumed)
  - Contractual terms
  - Conditions prevailing in the markets, location, laws in force etc.
  - Business Strategies

Applicability - TNMM

How it is applied?

Nature of International Transactions

↓

FAR Analysis

↓

Characterization of entities, selection of tested party, selection of Most Appropriate Method, functional and product characteristics of the uncontrolled comparable companies

↓

Economic Analysis and arriving at net margin of CC

↓

Adjustment of the above net margin for transaction level / company level differences on the basis of FAR analysis

↓

Adjusted net margin is used for Benchmarking International Transactions

If two or more Comparable Companies are selected, arithmetic mean would establish the arm's length price.

TNMM – Strength and Weakness

Strengths

- Net profit indicators are **less affected by transactional differences** than is the case with price, as used in the CUP method.
- Net profit indicators are also more **tolerant to some functional differences** between the controlled and uncontrolled transactions than gross profit margins.

Weaknesses

- **Information on uncontrolled transactions may not be available at the time** of the controlled transactions.
- **Difficulties** in determining an **appropriate corresponding adjustment** when applying the transactional net margin method.

Other Method

Other Method

- Any method which takes into account:
  - the price which has been charged or paid,
  - *or would have been charged or paid*,
  - for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts

The Methods - Snapshot

Turnover

(Cost of sales)

Gross profit

(administration, Marketing, Selling and Distribution expenses)

Operating profit

Price charged / paid or proposed

Comparable Uncontrolled Price

Resale Price Method

Cost Plus Method

TNM Method

Profit Split Method

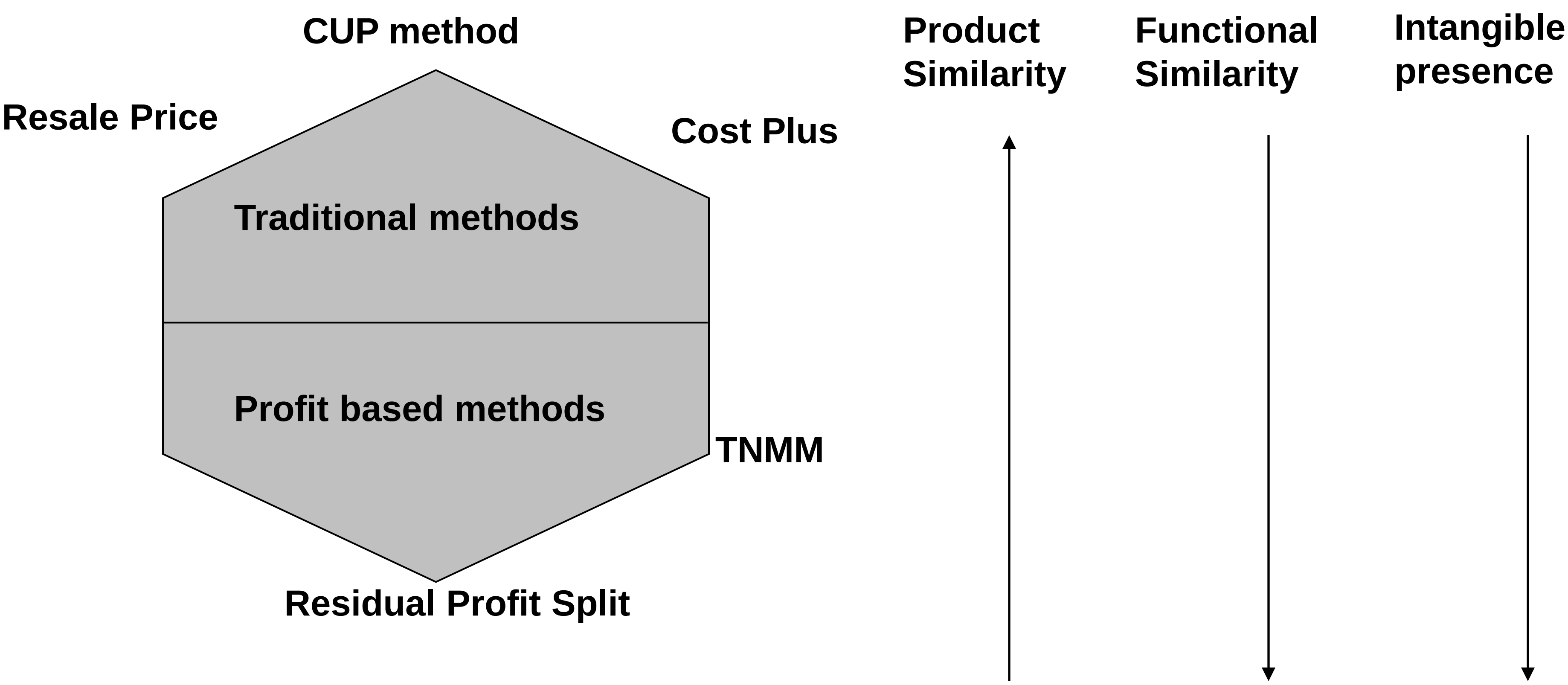
Selection of Most Appropriate Method

Most Appropriate Method

- ‘Most appropriate method’ is method best suited to facts and circumstances, providing most reliable measure of ALP

- ‘Most appropriate method’ to be selected having regard to the following factors:
  - Nature and class of international transaction
  - Functions performed, assets utilized, risks assumed
  - Availability and reliability of data
  - Degree of comparability between controlled and uncontrolled transactions
  - Possibility to make reliable and accurate adjustments
  - Nature, extent and reliability of assumptions required

Choice of Transfer Pricing Method: Economic determinants



Questions and Answers

Thank you