



Transfer Pricing Methods

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Functional Analysis

What is FAR?

1. FUNCTION, ASSET & RISK ANALYSIS
2. FAR analysis is an analysis of functions performed, assets employed and risk undertaken by an enterprise
3. FAR analysis – exercise to determine and document significant economic activities performed by the enterprise and its AEs in an international transaction.
4. The allocation of these activities between those entities involved in the transaction so each entity can be fully characterized.
5. FAR analysis should be performed for all the international transactions, including management charges and financial transactions (if any) – currently, this is not the case
6. Depending on the complexity of the transaction, the nature and scope of the functions performed and sometimes the value of the international transaction, separate chapters on the major international transactions encompassing the FAR and economic analysis could be considered
7. **FAR analysis to be performed from the perspective of the international transaction in hand and not on the overall circumstances of the business of the taxpayer**

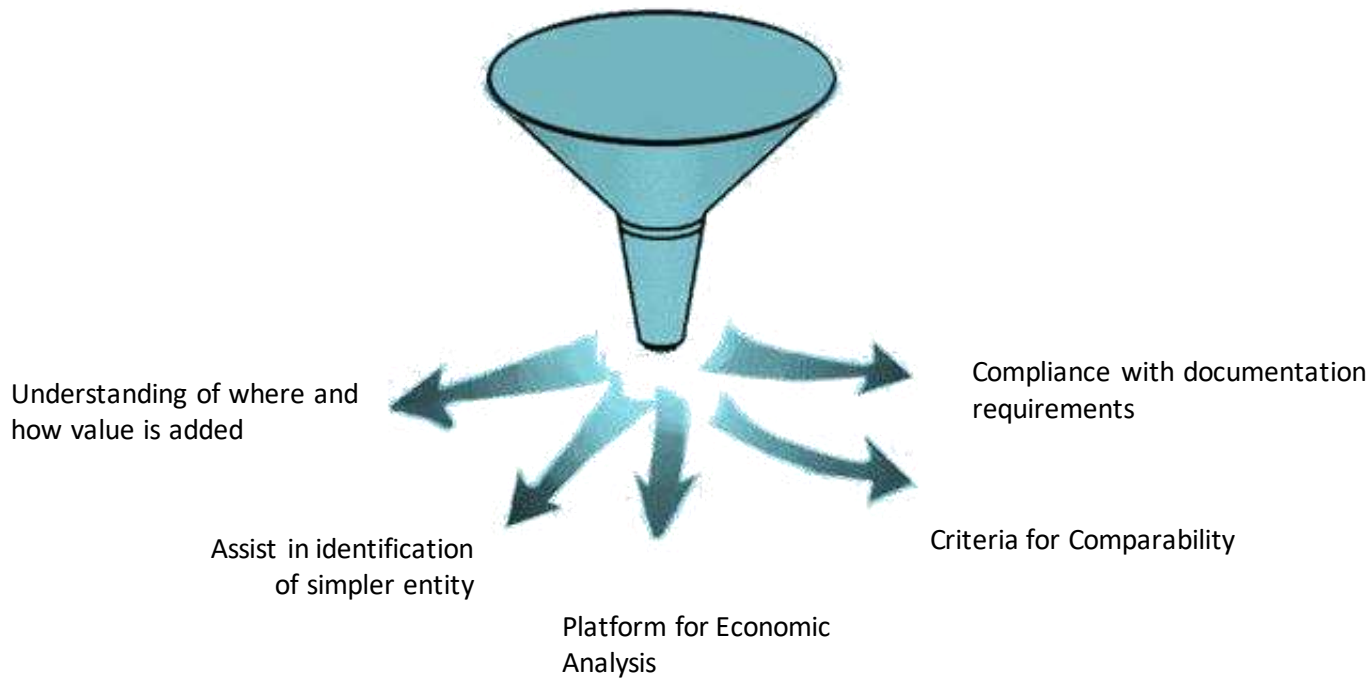
Why FAR?

1. Understanding functions performed and risks incurred by related parties is crucial to identifying an appropriate level of profit that related parties should earn with respect to intercompany transactions under review
2. The functions, risks and intangible assets associated with a related party's operations usually have a significant effect on its profitability
3. Arm's length transfer pricing is determined by a review of the relevant data (e.g. transactional or financial) for the unrelated companies with functions, risks, and intangible assets sufficiently similar to those of a related party
4. What are we trying to get from conducting functional interviews?
 - ✓ Comprehensive understanding of the intercompany transactions
 - ✓ Selection of method
 - ✓ Comparability of existing third party transactions
 - ✓ Selection of tested party
 - ✓ Selection criteria for the comparable companies
 - ✓ PLI selection
 - ✓ Financial data segmentation/aggregation
 - ✓ Unusual adjustments
 - ✓ Functional write-up

IMPORTANCE of FAR

- **Step 1 to identify MAM is functional analysis**
- Functional analysis would enable:
 - To identify and accurately delineate the intragroup transactions
 - To identify the characteristics that would make a particular uncontrolled transaction or function suitable for use as a comparable;
 - To determine any necessary adjustments to the comparables;
 - To check the relative reliability of the transfer pricing method selected; and
 - To determine if modification of the transfer pricing method is appropriate because the controlled transaction, function, allocation of risks or allocation of assets have been modified.

Step 1- Functional Analysis



Step 1. a – Functions performed



- Determine functions and key activities of each group entity (e.g. manufacturing, distribution, research & development, services)
- Identify key intercompany transactions (transfer of goods, use of intangibles, provision of services, provision of finance) and pricing for these transactions
- Income distribution within the group companies to be based on economic value and activities

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Typical functions performed

- R&D
- Procurement
- Manufacturing
- Sales & distribution
- Services
- Marketing
- Warehousing
- Logistics
- Customer support
- Financing
- Intra-group services

Step 2 – Risk analysis



- Risk analysis provides risk profile for each entity
- Risk corresponds to expected financial returns (i.e. expected profitability)
- Entities are then characterized based on the following points:
 - **The more complex the functions and the more risks borne, the higher the expected return**
 - The simpler the functions and the fewer risks borne, the lower the expected return



Risks

- Market risk
- Procurement risk
- Regulatory risk
- Contractual risk
- Inventory risk
- Credit risk
- New product development risk
- Forex risk

Risks-OECD TPG

Para 1.60 of OECD lays down a six step process for identifying risk:

1. Identify economically significant risks with specificity;
2. Determine how those specific risks are allocated in contractual arrangements;
3. Use a functional analysis to determine the potential impact of those specific risks. Identify which enterprises assume and manage the risks;
4. Does 3 agree with 2? Confirm via the FA, establish who exercises control over risk and that they have the financial capacity to do so;
5. Reallocate the risk to the enterprise(s) that has/have the control over the risk and the financial capability to assume the risk;
6. Price the accurately delineated transaction taking account of the allocation of the risk.

Step 3 – Assets undertaken



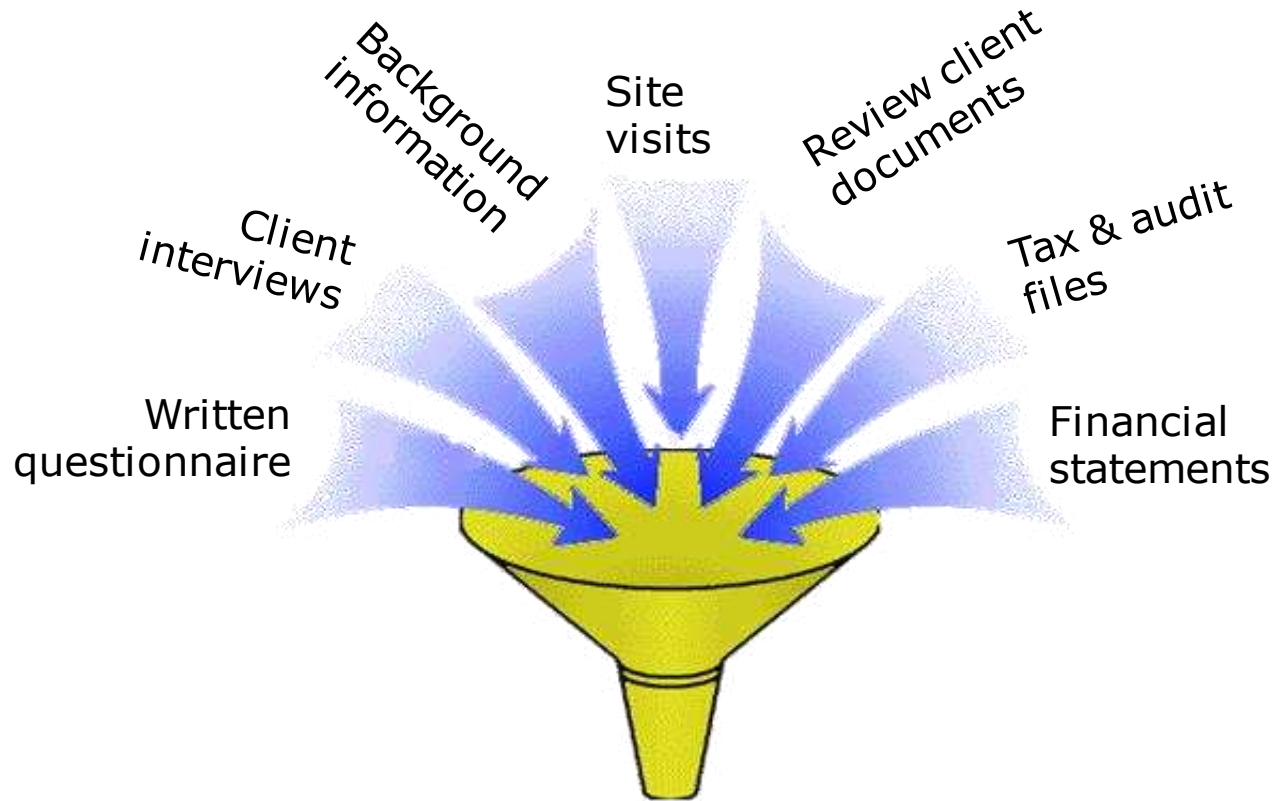
- This section assesses assets owned by the company vis a vis its associated enterprises
- One needs to identify the assets (tangible as well as intangible) used in the course of international transaction
- The study involves identification of the type of capital assets used, as well as the capital assets left idle and the nature of assets used, such as the age, market value, location, property right protections available etc., and quantify the same, whenever possible
- **It is also essential to know which entity developed the intangibles**, which has the legal ownership of the intangibles, and which receives the benefit of the intangibles.

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Assets

- Tangible assets
 - Cash
 - Trade receivables
 - Inventory
 - Property
- Intangible assets
 - Manufacturing intangibles;
 - Marketing intangibles

FAR analysis – way of conducting



FAR analysis – Conclusion

1. Correct Characterization
2. Criteria for comparability-Method selection, PLI selection, tested party selection
3. Setting an appropriate pricing
4. In depth understanding of the company and market space
5. Identifying potential risks (e.g. projects and engagement risks)
6. Determine other market factors, key value drivers and location issues
7. Platform for economic analysis

Tested Party

- Either of the AE to the international transaction;
- Least complex
- Data easily available
- Comparables easily available



Most Appropriate Method

Most Appropriate Method (MAM) for ALP

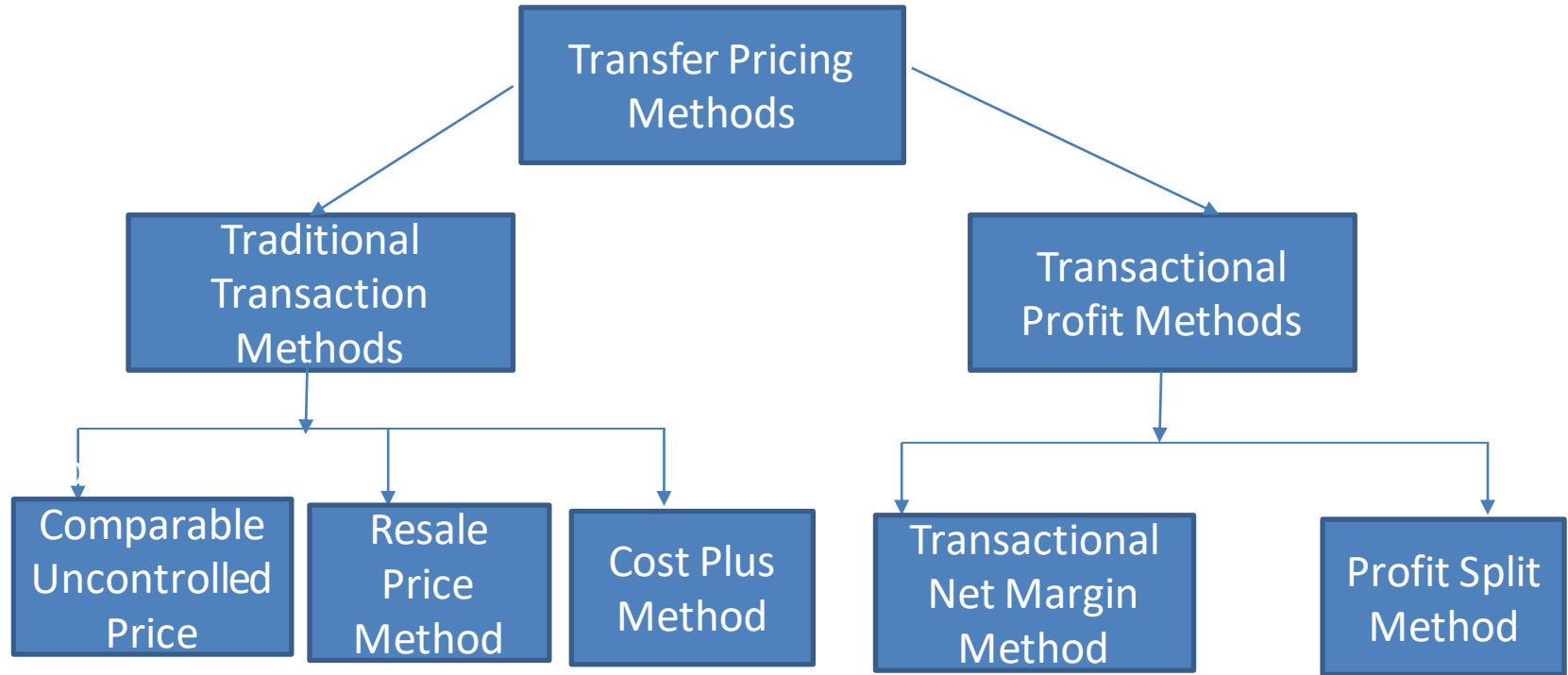
- Arm's Length Price establishes whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle.
- **MAM shall the method which is best suited to the facts and circumstances of each particular international transaction and which provides the most reliable measure of an arm's length price in relation to the international transaction.**
- Selecting the appropriate transfer pricing method is important during planning for a new transaction and during documentation stage as well.

Selecting Most Appropriate Method

- Identify Strength & Weakness of each method
- Appropriateness of each method with respect to controlled transaction
- Functional Analysis
- Availability of reliable information in respect of comparables
- Degree of comparability
- Degree of adjustments needed to eliminate differences

MAM

- **Step 1 to identify MAM is functional analysis**
- Functional analysis would enable:
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 - To identify the characteristics that would make a particular uncontrolled transaction or function suitable for use as a comparable;
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 - To check the relative reliability of the transfer pricing method selected; and
 - To determine if modification of the transfer pricing method is appropriate because the controlled transaction, function, allocation of risks or allocation of assets have been modified.

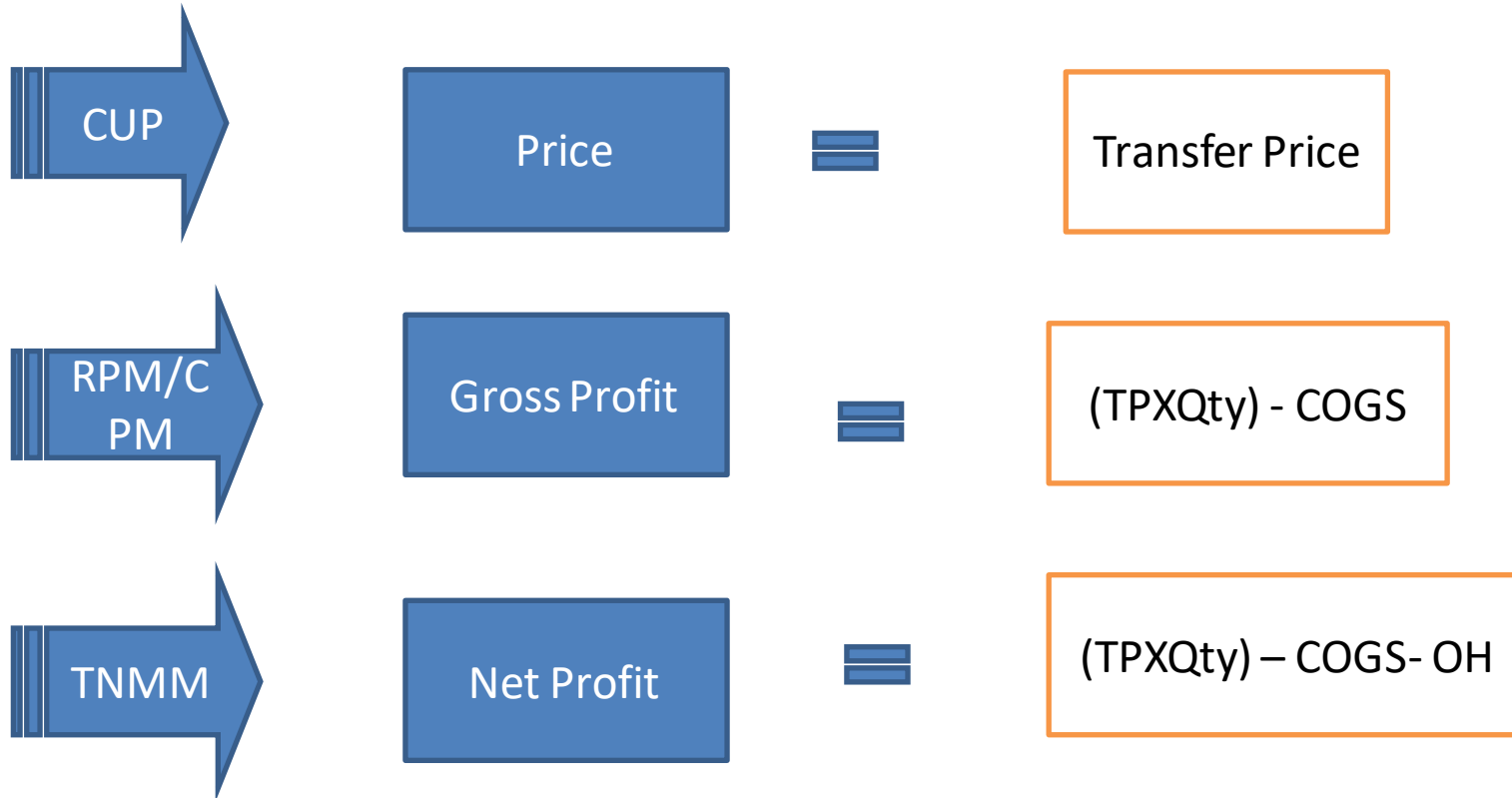


Transfer Pricing Methods

Traditional Transaction Methods	Transactional Profit Methods
Direct Methods as the comparison is far more easier, adjustments required are not that complex	These methods are useful where each of the parties makes unique and valuable contributions in relation to the controlled transaction. These are also useful in case of integrated activities.

No hierarchy of methods suggested. The taxpayer may select any of the prescribed methods as MAM, considering the facts and circumstances of the case. Moreover, each year is to be considered separately and, as such, if the circumstances warrant a change in the method in the following year, the taxpayer is entitled to do so.

Price vs Profit Testing



Difficulties in selecting MAM

- **Information** on uncontrolled transactions that may not be available at the time the controlled transactions have been entered into;
- No access to enough specific information on the **profits attributable to uncontrolled transactions** to make valid application of the transfer pricing methods; and
- A large portion of independent transactions are undertaken between privately owned companies whose **data are not available in the public domain**.



Comparable Uncontrolled Price Method

CUP Method

- The CUP method 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**.
- If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.



Typical Cases for CUP

- (a) Transfer of goods;
- (b) Provision of services;
- (c) Royalty for use of Intangibles;
- (d) Interest on loans.

Steps in CUP

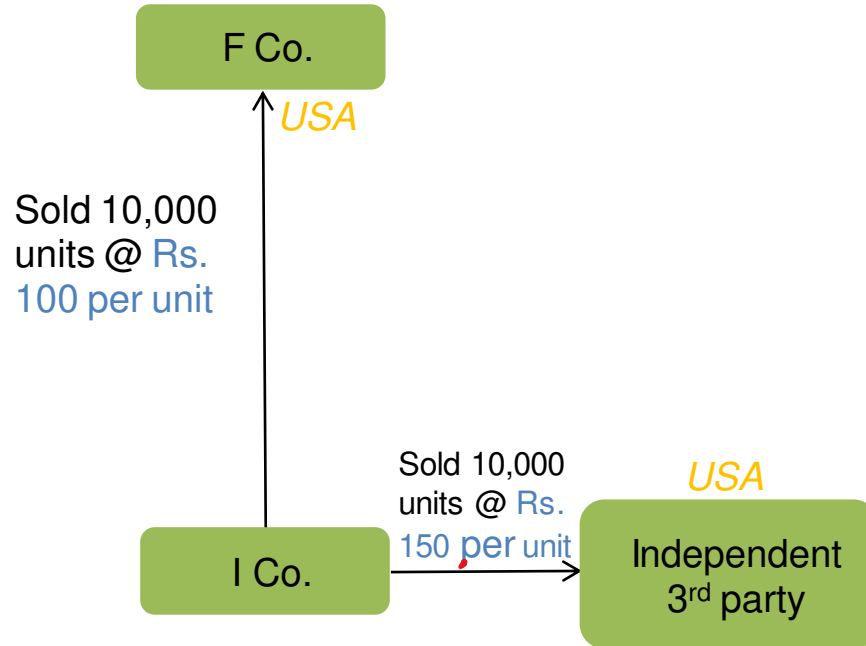
- Identify the price charged or paid in comparable uncontrolled transactions;
- The above price should be **adjusted for transaction level differences (eg FOB, CIF, quantity discount)** on the basis of functions performed, assets used and risks taken (FAR) analysis and enterprise level differences if any;
- The adjusted price is the arm's length price

CUP Method

- When it can be used?
 - a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market
 - b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.
 - c) Easy availability of comparables

CUP Method – Examples

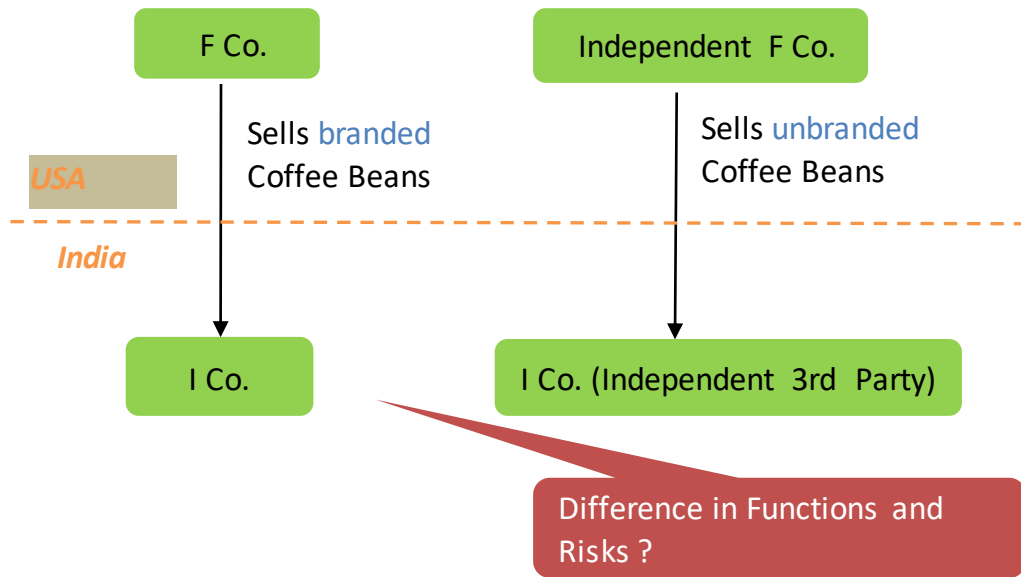
1. Internal CUP



- Relevant factors before applying CUP are:
 - Market differences (export benefits)
 - Volume differences
 - Contractual differences
- If material, reasonable and accurate adjustments are required for applying CUP

CUP Method – Examples

2. External CUP



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 - Comparability

- Product comparability should be closely examined in applying the CUP Method.
- Appropriate in case of identical or very similar goods and services.
- Although product comparability is important in applying the CUP Method, the other comparability factors should not be disregarded.
- Contractual terms and economic conditions are also important comparability factors.
- Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability”.

As per OECD even "a minor difference in the property transferred in the controlled and uncontrolled transactions could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin."

Adjustments for CUP

- The type and quality of the products (E.g. unbranded Kenyan coffee beans as compared with unbranded Brazilian coffee beans)
- Delivery terms (FOB vs CIF)
- Volume of sales and related discounts.
- Product characteristics (Modifications)
- Contractual terms (Credit vs Cash on delivery)
- Risks Incurred (E.g.: Market risk, credit risk, etc.)
- Geographical factors (E.g.: US and Kenya market cannot be compared)
- Functional profile (Wholesaler vs Reseller)
- Timing of transactions (particularly in case of commodities which are subject to price changes on periodic basis) (E.g. perishable goods, seasonal goods etc.)
- Intangible property associated with sale (E.g.: Price of branded products cannot be compared to the price of unbranded products)
- Date of transaction

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Adjustments not possible

- Unique and valuable trademarks
- Fundamental differences in the products
- Differences in Functional profile (Manufacturer vs distributor)
- Differences in entity in value chain
- (A to AE to Unrelated party C vis-a-viz A to Unrelated Party)

Case Study

- AE1 Ltd., is an Indian company. AE1 Ltd., is a manufacturer of compact disc (CD) writers and its customers, inter alia, include AE2 Ltd, and M Ltd, an unrelated party. AE1 Ltd., during the year has supplied 10,000 nos. of the product to AE2 Ltd. at a price of INR 2,000 per unit and 200 nos. of the same product to AE3 Ltd., at a price of INR 2,750 per unit. AE1 Ltd., has sold 100 units of the same product to M Ltd. at INR 3,000 per unit.

CUP – Case Study

Factors to be considered	International transaction (with AE2 Ltd.)	Comparable uncontrolled transaction (with M Ltd.)	Remarks
Terms	FOB	CIF	INR 550
Qty Disc	Y	N	Quantity discount of INR 10 per product and a free gift (CD) of 20
Credit	1 Mon	Cash	Cost of credit – 1.25% p.m.
Warranty	N	6 mon	Cost of warranty – INR 250 per unit



Resale Price Method

RPM

- The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise.
- This price (the resale price) is then reduced by an **appropriate gross margin** on this price (the “resale price margin”)
- **Consequently, under the RPM the starting point of the analysis for using the method is the sales company.**
- The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide

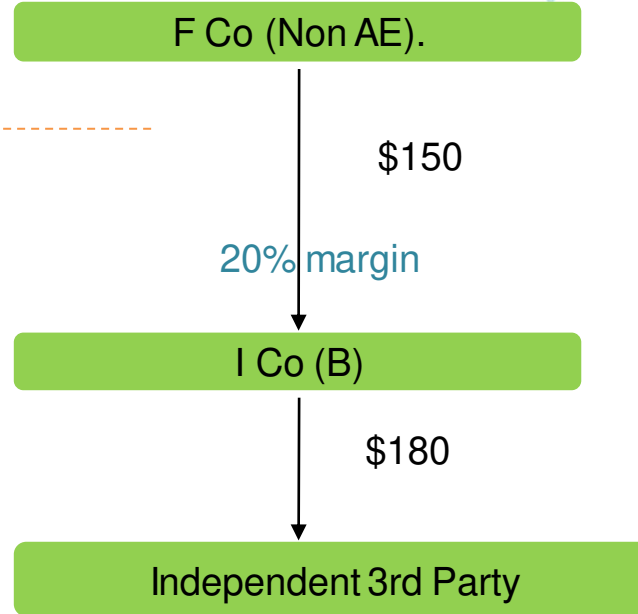
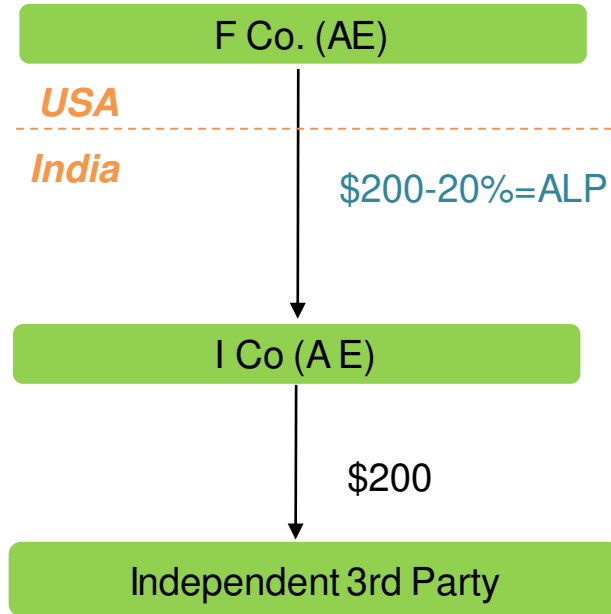
Steps in RPM

- identify the purchase price from AE
- identify the resell price to the unrelated party
- Identify the gross margin in comparable uncontrolled transaction
- Deduct the normal gross margin from the resale price
- Deduct expenses in connection with purchase of goods
- Adjustments to the gross margin
- Resultant would be ALP
- Resale in any financial year may be also out of opening stock and the goods purchased during the said year may remain in closing stock. Under the RPM, the arm's length price of purchases from AE during the financial year should be determined. The process of determination under Rule 10B(1)(b) culminates in the cost of sales rather than value of purchase during the year. This 'cost of sales' should be converted into 'value of purchase'. For this purpose, the closing stock of goods purchased from AE should be added and the opening stock of purchases from AE should be deducted.

Steps in RPM

Resale price charged to unrelated enterprise in resale of property purchased/service obtained from an AE	XX
Less: Normal gross profit margin in a comparable uncontrolled transaction whether internal or external	XX
Less: Expenses (custom duty, etc) in connection with purchase of property/service from AEs	XX
Add/Less: Functional/other differences (including differences in accounting practices, adjustments for opening & closing inventories) between the transactions / enterprises, which affect gross margin	XX
ALP	XX

RPM - Examples



RPM Suitability

- Distribution of goods involving little or no value addition
 - Ordinarily used in the cases involving the purchase and resale of the tangible property
 - Reseller has not physically altered the product or added substantial value as the contribution of original goods cannot be easily measured
 - Packaging, labelling or minor assembly are acceptable
-
- **It may not be suitable in cases where:**
 - Reseller adds substantial value to the product thereby changing the identity of the original product
 - Reseller contributes to the intangible property associated to the product
 - There is time lag between the resale of product

RPM Case Study

- AE1 Ltd., trades in compact disc (CD) writers. AE1 Ltd., procures CD writers both locally and in the international market. Its imports consist of CD writers purchased from AE2 Ltd. as well as other manufacturers (Non AEs). AE1 Ltd., during the year purchased 100 CD writers from AE2 Ltd. at 2,900 per unit. These are resold to A Ltd., an unrelated party, at a price of 3,000 per unit. AE1 Ltd., has also purchased similar products from an unrelated supplier, viz. K Ltd., and has resold the same to M Ltd., who is also an unrelated party and has earned a **gross profit of 15%** on sales.

RPM Case Study

Particulars	Sales to A Ltd.	Sales to M Ltd
Price	Ex shop	FOB Destination with cost of freight and insurance estimated at 2% of GP
Quantity discount	Yes - the cost of the same is estimated at 1% of GP	No
Free gifts	No	One CD pack for every CD writer with no change in sale price
Warranty	No	6 months warranty (without change in sale price) - cost of warranty is estimated at 250 per unit



Cost Plus Method

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 markup is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.
- The reference is to the gross profits realized in comparable uncontrolled situation
- The mark-up on direct and indirect costs
- Costs should be associated with process
- Product comparability is less important

CPM Suitability

This method probably is most useful where **semi finished goods** are sold between associated parties or **services** provided to related parties

- Contract Manufacturer
- Toll Manufacturer
- Low risk assembler

Not suitable for:

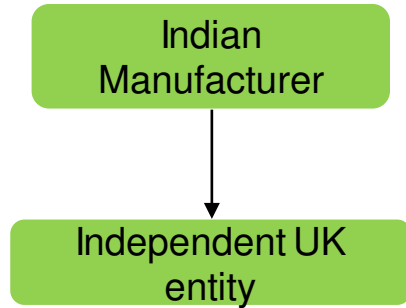
- Fully-fledged manufacturer which owns or develops unique and valuable product intangibles

CPM- Limitations

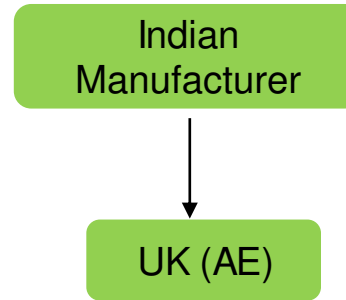
- Similar to RPM the accounting consistency is important to determine margins.
- In the case of luxury goods, the brand allows the distributor to sell the product at a much higher price than non-branded goods; therefore, even though the manufacturing cost might exceed the cost of designing and branding the product, it adds far less value to the finished product. That is the cost basis cannot always be used as a proxy for determining the value and margin to be retained.
- Inadequate data to compute gross margins accurately

$$\begin{aligned}\text{CPM} &= \text{Direct} + \text{Indirect cost of production} + \text{Margins} \\ \text{TNMM} &= \text{Direct} + \text{Indirect cost of production} + \text{operating expenses} + \\ &\quad \text{Margins}\end{aligned}$$

CPM - Examples



Particulars	Rs.
Net Sales (3rd Party)	200
Costs of goods	160
Gross Profit	40
Cost Plus Mark-up	25%



Particulars	Rs.
Cost of goods	100
Mark-up (25%)	25
Transfer Price	125

CPM examples

- AE1 Ltd., is an Indian company. AE1 Ltd., an unrelated party, develops software for various customers, who include AE2 Ltd. and M Ltd. AE1 Ltd., during the year billed AE2 Ltd. INR 2,00,000. The total cost (direct and indirect) for executing this work was INR 1,75,000. AE1 Ltd., provided similar services to M Ltd., and earned a **gross profit (GP) of 50% on costs.**

Particulars	Transactions with AE2 Ltd	Transactions with M Ltd.
Technology support received	Yes	No - value of technology support incurred by AE1 Ltd., is INR 17,500
Discount offered	Yes – Discount offered is INR 8,750	No
Expenses incurred by AE1 towards Marketing	No	Yes – expenses incurred INR 13,125
Credit	Yes – Cost of credit is estimated at INR 2,625	No

CPM Examples

- GP through sales to M Ltd. has to be adjusted for following differences:
- Value of technology support of INR 17,500 received from AE2 Ltd. is 10% of cost.
- Discount offered to AE
- Marketing spend
- Cost of credit

CPM Practical Considerations

- Term direct and indirect costs are not defined. This results in difficulty in applying CPM for the external comparables.
- Computation of gross margins may pose difficulty as there is no uniformity in accounting convention or accounting principles
- Using total cost plus as PLI under TNMM may be a better approach



Transactional Methods

Transactional Profit Method

- TNMM
- PSM
- Differ from traditional methods as in this case the analysis is not necessarily based on particular comparable uncontrolled transactions involving comparable products.
- The analysis is based on the net return (generally, the earnings before interest, tax and extraordinary items, i.e. EBIT) realized by various companies engaged in a particular line of business



Transactional Net Margin Method

TNMM

- The TNMM **compares the net profit margin** (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions
- Here the focus is on **the net profit margin relative to an appropriate base such as sales or assets or costs.**
- The TNMM looks at third party comparables that carry out similar activities to the tested party and measures their profitability.
- TNMM is a more indirect method than the cost plus/resale price method that compares gross margins.
- It is also a much more indirect method than the CUP method that compares prices, because it uses net profit margins to determine arm's length prices.
- Therefore, TNMM is **less affected by product & functional comparabilities**



When to use TNMM

- TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions.
- TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods. (eg accounting differences)

Profit Level Indicators

- A PLI **is a measure of a company's profitability** that is used to compare comparables with the tested party. Eg Operating margins, net profit margin
- The denominator should be focussed on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed.
- The **denominator should be reasonably independent from controlled transactions**
- For instance, when analysing a transaction consisting in the purchase of goods by a distributor from an associated enterprise for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which consistency with the arm's length principle is being tested.
- Where the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an associated enterprise), caution should be exercised to ensure that said controlled transaction costs do not materially distort the analysis and in particular that they are in accordance with the arm's length principle.

RPM/CPM and TNMM

- The application of the TNMM is similar to the application of the CPM or RPM, but the TNMM involves comparison of NP margins.
- The unavailability of reliable data for comparables in case of gross profit based methods such as CPM and RPM may pose difficulties in selecting them as the most appropriate method.

Sale Price = \$10,000

COGS = \$?

GP = \$?

Operating Exp = \$2,000

Net Profit = \$500 (based on comparables)

CPM/RPM

TNMM

TNMM – Practical considerations

- **TNMM is not method of last resort**
- Though, TNMM is **more tolerant to differences** in the product comparability as compared to the traditional methods, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect the net margins.
- contractual terms and conditions, functions performed, risks assumed and assets employed, pricing mechanism, availability of the comparable data, etc.
- Capacity utilization
- NP margins are ascertained at segment level where segment data are available.
- Where segment data are not available, net profit is normally determined at enterprise level.



TNMM Adjustments

- Difference in the working capital level
- Difference in the capacity utilisation level
- Risk adjustments

Strengths of TNMM

- **Net margins are less affected by transactional differences than price** and less affected by functional differences than gross margins. Product and functional comparability are thus less critical in applying the TNMM
- **Less complex functional analysis is needed**, as the TNMM is applied to only one of the related parties involved
- The results resemble the results of what could be referenced as a modified Resale Price Method or Cost Plus Method of analysis

TNMM - Examples

Particulars	Manufacturing	Trading	Total
Sales	2,00,000	3,00,000	5,00,000
Manufacturing expenses/ cost of purchases	90,000	2,10,000	3,00,000
Royalty and technical fees	10,000	-	10,000
Employee cost	30,000	24,000	54,000
Administrative expenses	24,000	15,000	39,000
Selling and distribution cost	16,000	24,000	40,000
Depreciation	16,000	12,000	28,000
Total Cost (TC)	1,86,000	2,85,000	4,71,000
Operating profit (OP)	14,000	15,000	29,000
OP/ Sales	7%	5%	

TNMM - Examples

Comparable companies	OP/ Sales
A ltd	16.21
B Ltd	6.95
C Ltd	9.52
D Ltd	3.46
E Ltd	1.59
F Ltd	12.83
G Ltd	6.57
H Ltd	-7.54
Median	6.76
35th Percentile	4.86
65th Percentile	8.36

Companies engaged in similar trading activities

Aggregation v. Transaction approach

- Aggregation principle seeks to combine all functionally similar transactions wherein the arm's length price can be determined for a number of transactions taken together.
- The grouping should essentially be done in those circumstances, where it is impractical to analyse the pricing or profitability of each transaction separately, or where such transactions are so interrelated that it is not feasible to benchmark the transactions individually.



Profit Split Method

PSM

- The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.
- PSM can be applied when
- Both the parties have unique and valuable contributions
- High level of integration in the business operations
- Assumption of significantly economic risks



PSM steps

- Identify the profits to be split from the controlled transactions
- Splits them between the AE on an economically valid basis that approximates the division of profits that would have been agreed at arm's length.
- Split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed



Unique & Valuable contributions

- Contributions will be “unique and valuable” in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations.’
- The PSM looks at the overall value generated by the efforts of all the transacting related parties and provides an arm's length apportionment of the profit based on the value each party contributes to the business on the basis of its functional and risk profile.

PSM

- **Method 1: Contribution Analysis**
- The profit split starts with identifying the profits to be divided between the associated parties from the controlled transactions.
- Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions.
- External market data (eg, profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution when possible

PSM

- **Method 2: Residual analysis.**
- RPSM first allocates comparable functions' profits, which then leaves a residual profit to be split amongst the more difficult to price functions such as intangibles.
- In the first step an allocation of arm's length profit to each related party is implemented to provide a basic compensation for routine contributions
- The routine compensation is determined based on the returns earned by comparable third party enterprises, which (ideally) work in a similar industry or that carry out comparable functions and exhibit a similar low risk profile.
- The TNMM is usually employed to determine the appropriate routine returns for the first step in the RPSM.
- Once all routine functions have been remunerated, the residual profit is then split to account for non-routine activities, which are usually associated with a higher risk profile.
- Non-routine profits can also be loss

Example

- Company X manufactures components using unique and valuable intangibles and sells these components to a related party, Company Y. Company Y then uses the components, together with its own unique and valuable intangibles, to manufacture final products, which it sells to independent customers. The first step of the residual analysis would allocate a basic, 'routine' or benchmarkable arm's length return to Company X for its manufacturing function, and a basic, 'routine' or benchmarkable arm's length return to Company Y for its manufacturing and distribution functions. The relevant profits from the transactions, less the amounts of the basic or 'routine' returns to Company X and Company Y, will be the residual profit. This residual profit is then split between the parties based on the relative value of their respective unique and valuable contributions. This second step of splitting the residual profits need not, and typically does not, depend on the use of comparables.

PSM

Factors that can be used for profit splitting include relative value of

- expenditure on assets,
- capital employed,
- marketing spend,
- incremental sales,
- Employee remuneration,
- head count
- time spent.

Strengths of PSM

- It can provide a solution in cases where one-sided methods are not appropriate because each party to the transaction makes a unique and valuable contribution which cannot be benchmarked
- It can be used where the level of integration, or the sharing of risks between the related parties means that the contribution of each party cannot be evaluated in isolation from those of other parties
- It is able to deal with returns to synergies between contributions or profits arising from economies of scale

Weakness of PSM

- Complex
- Splitting of costs & revenues
- Availability of independent enterprise information
- Information from the AEs
- PSM and in particular the RPSM require a higher level of reviewing, testing and sensitivity checking when using allocation keys, which do not necessarily generate arm's length results.
- PSM and the RPSM are highly dependent on having access to quality information and data from group affiliates.

Case Study

- XYZ India Ltd is an Indian investment banking company. XYZ India Ltd in association with its AE, XYZ USA, assists clients with foreign acquisitions.
- XYZ India Ltd is approached by M Ltd for identifying potential target companies for acquisitions in the United States. In order to serve M Ltd, XYZ India Ltd and XYZ USA have each contributed integrally to identification of potential targets and assisting M Ltd with the acquisition process. For the above, a consideration of USD 50,000 was received from M Ltd.
- Based on the FAR analysis and the benchmarking analysis, the basic cost plus returns for XYZ India Ltd and XYZ USA are determined to be 15% and 10% respectively.
- Furthermore, on the basis of the FAR analysis, the relative contribution may be taken as 70% for XYZ India Ltd and 30% for XYZ USA.

Case Study

	XYZ India	XYZ USA
Actual Revenue in books	30,000	20,000
Cost	20,000	8,000
Profit	10,000	12,000
Combined profit	22,000	

Contribution analysis

	XYZ India	XYZ US
Cost plus return	15400 @ 70%	6600 @ 30%
Actual profit	10000	12000
Arms length revenue	15400+20000	6600+8000

Residual analysis

	XYZ India	XYZ US
Basic cost plus return (A)	3000 @15% of 20000	800 @10% of 8000
Residual	18200	
Contribution @70% & 30% (B)	12740	5460
Total return A+B	15740	6260
Arm's length revenue	15740+20000	6260+8000



Summary

Method	Strength	Weakness
CUP	- Reliable when the same product is sold in the same circumstances by independent parties. - Adjustments are possible for certain differences	- Difficulty in finding comparable transactions between independent enterprises. - Too many adjustments make CUP unreliable.
RPM	Looks at gross margins	- Differences in functional analysis will affect reliability. - Based on gross margins so reliant on accountancy consistency
CPM	Looks at gross margins	Based on gross margins so reliant on accountancy consistency.
TNMM	Net margins are less affected by accounting inconsistencies. More tolerant of functional differences.	Difficulties in segregation of information relevant to controlled transaction
PSM	Suitable for highly integrated activities. Also where both parties have unique and valuable IP.	It may be difficult to access information on foreign affiliate.



Method	Used for
CUP	Loans, service fee, transfer of tangibles, sale and purchase of goods
RPM	Distributors not adding any value
CPM	Provision of services, sale of raw materials or semi-finished goods
TNMM	Manufacturing, Sale of goods, provision of services
PSM	Existence of unique intangibles

Queries



YOUR
QUESTIONS
PLEASE !!!



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