Introduction To Transfer Pricing

Presenter:
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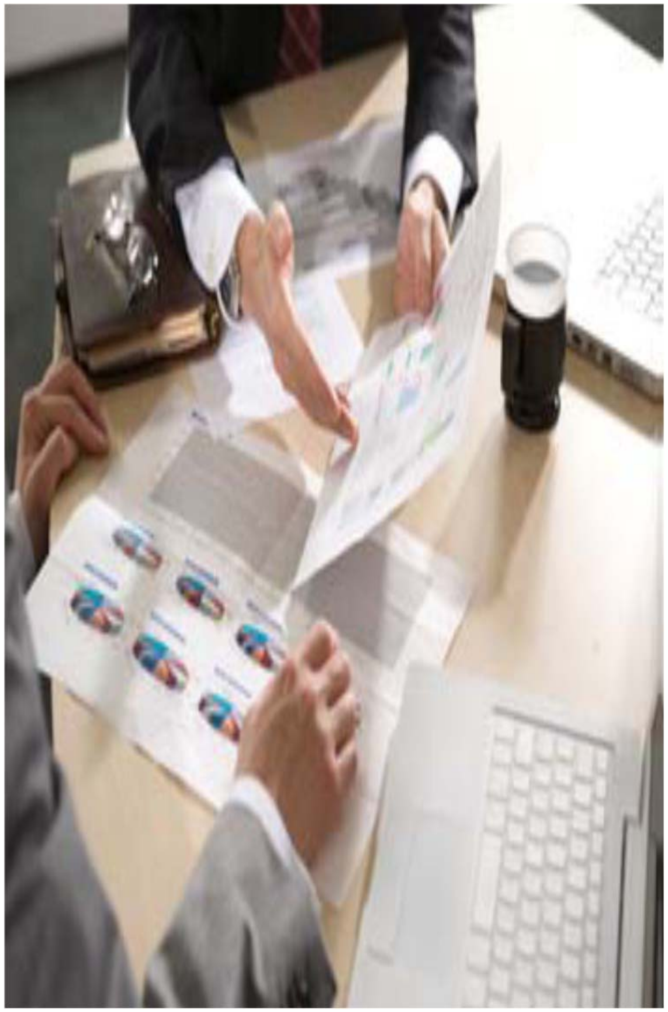
Agenda



Transfer Pricing – Why, What and How?

Key Concepts

Transfer Pricing - Compliances

Why Transfer Pricing?

Finance Minister's speech on the rational for introducing Transfer Pricing Regulations

"The presence of multinational enterprises in India and their ***ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions*** has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations."

- Mr. Yashwant Sinha Finance Minister, Government of India
February 28, 2001

- *Transfer pricing Regulations introduced in Indian Finance Bill 2001 w.e.f April 1st 2002 in relation to international transactions between Associated Enterprises.*

Why Transfer Pricing?

Situation I - Manipulated Price

Parent Co. India

Expenses		Income	
Cost	60	Sales	80
Profit	**20**		
Tax @ 30% = INR 6			

Sale to Sub Co. Dubai at INR80

Sub Co. Dubai

Expenses		Income	
Cost	80	Sales	140
Profit	**60**		
Tax @ NIL = NIL			

Sale by Sub Co. to customer INR140

3rd Party Customer

Overall tax burden of Group is INR 6

Situation II - Arm's Length Price ('ALP')

Parent Co. India

Expenses		Income	
Cost	60	Sales	120
Profit	**60**		
Tax @ 30% = INR 18			

Sale to Sub Co. @ ALP = INR120

Sub Co. Dubai

Expenses		Income	
Cost	120	Sales	140
Profit	**20**		
Tax @ NIL = NIL			

Sale by Sub Co. to customer INR140

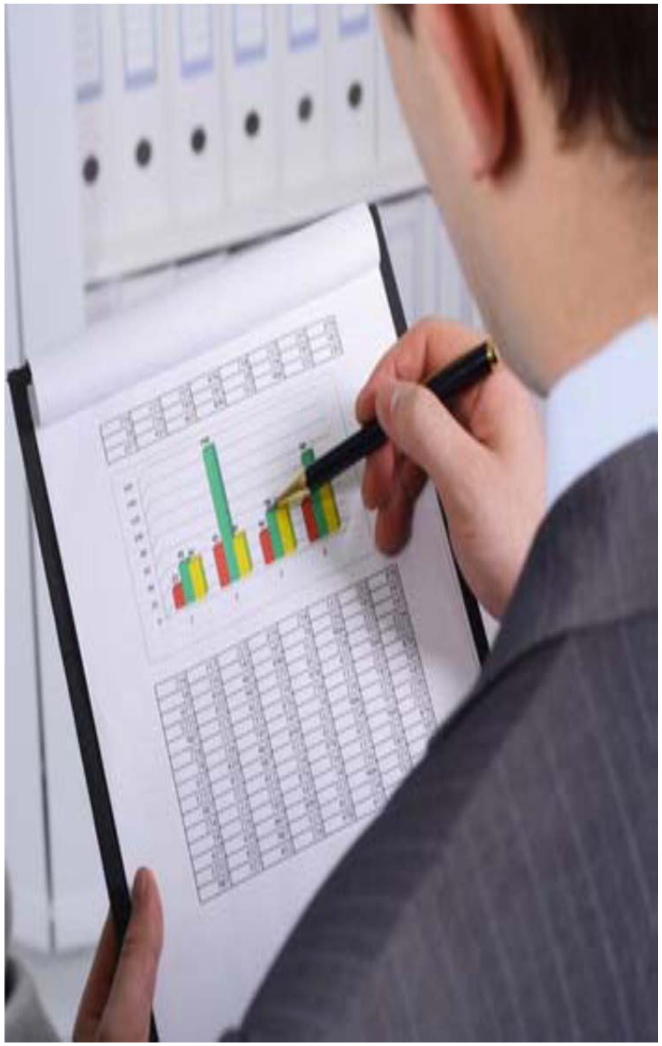
3rd Party Customer

Overall tax burden of Group is INR 18

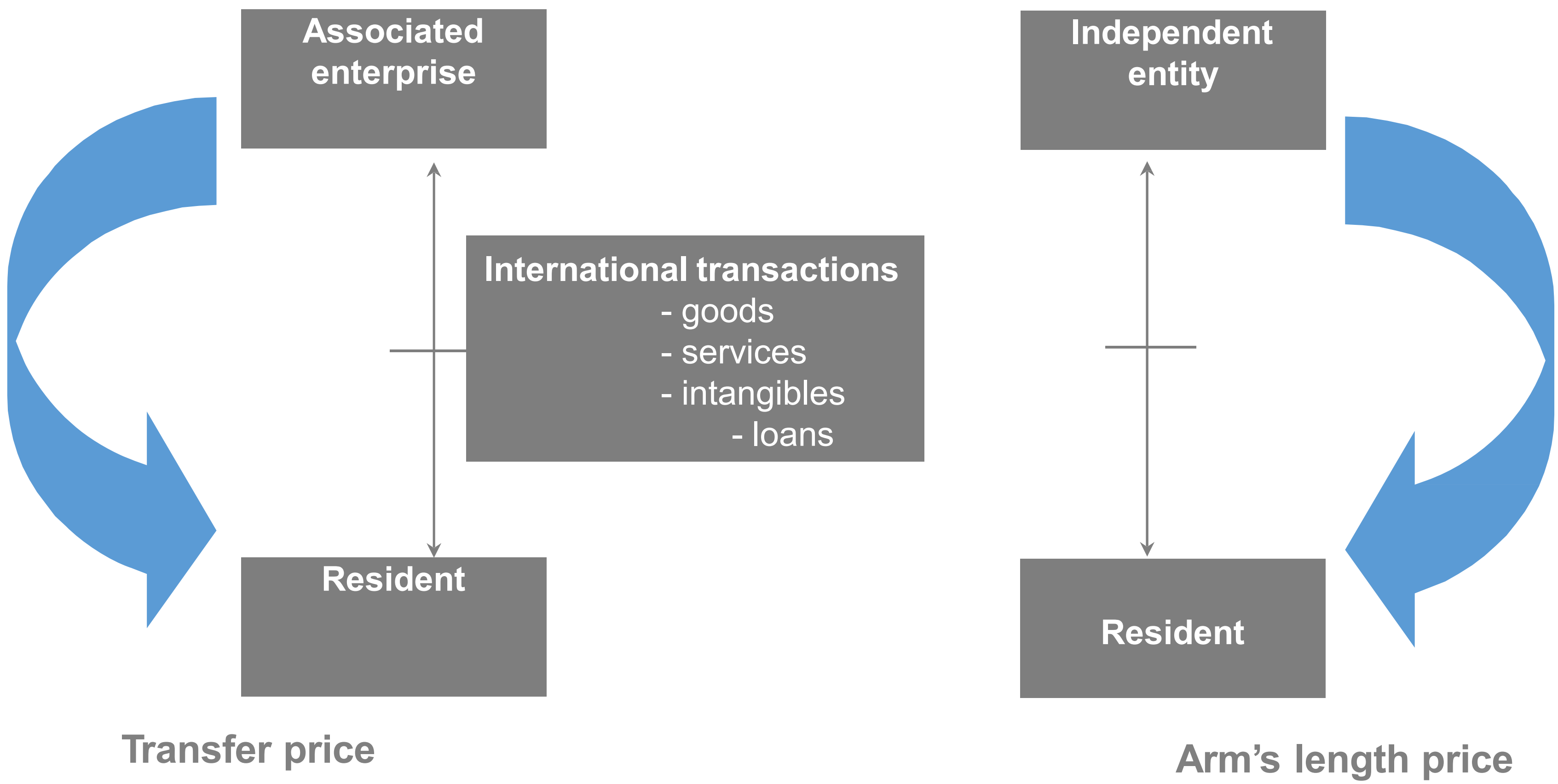
To Prevent Shifting of profits by manipulating prices

What is Transfer Pricing?

- **A mechanism for pricing** the transfer of goods and services between related entities:
  - Tangible Goods - Raw materials, Components, Spare-parts, Semi-finished/ Finished goods, Assets, etc.
  - Intangible Goods - trademarks, trade-names, patents, etc.
  - Services - IT/ IT Enabled, Management, , Marketing Support, Engineering, After Sales Services, etc.
- A mechanism which provides the conceptual framework for pricing intercompany transactions.

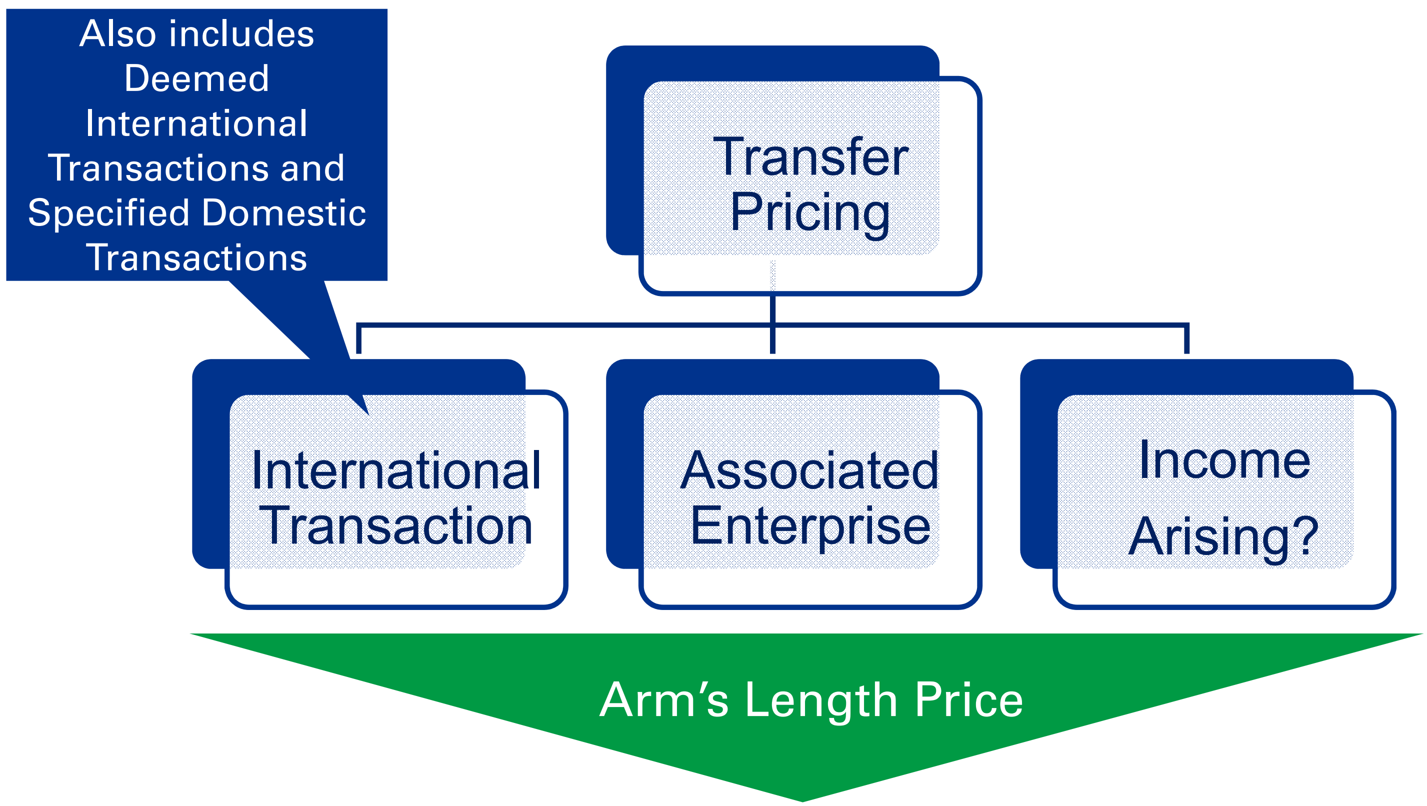


Concepts of Transfer Pricing



Concepts of Transfer Pricing

Sec 92 (1) - Any income (or expense or interest) arising from an international transaction with associated enterprises shall be computed having regard to the Arm's Length Price



Sec 92 (3) - The provisions are not intended to be applied in case determination of arm's length price reduces the income chargeable to tax or increases the loss as the case may be

Scheme of Transfer Pricing Regulations in India...

Relevant Provisions under **Section 92**
Computation of Income

International Transaction	Section 92B
Specified Domestic Transaction	Section 92BA
Associated Enterprises	Section 92A
Arm's Length Price	Section 92C + Rule 10B/ 10C
Documentation and Certificate	Section 92D and Section 92E

… Scheme of Transfer Pricing Regulations in India

Scrutiny

Power of AO and TPO	Section 92CA
Dispute Resolution Panel	Section 144C
Penalties	Section 270 , 271AA, 271BA, 271G

Other relevant provisions

Advance Pricing Agreements	Section 92CC and CD+ Rules 10F to 10T
Safe Harbour	Section 92CB + Rules 10TA to 10TG

Applicability of Transfer Pricing - In Nutshell (1/2)

- The provisions of Section 92 to 92F of the Act are applicable only if:
  - There are two or more enterprises (defined in Sec 92F)
  - The enterprises are <u>Associated enterprises</u> (defined in Sec 92A)
  - The enterprises enter into a transaction (defined in Sec 92F)
  - The transaction is an <u>International transaction</u> (defined in Sec 92B)
- Provisions do not apply in certain cases (Section 92(3))
- Further w.e.f. 1 April 2012, TP provisions shall also apply to specified domestic transactions (SDT) (defined in Sec 92BA)

Applicability of Transfer Pricing - In Nutshell (2/2)

- Consequences of these provisions:

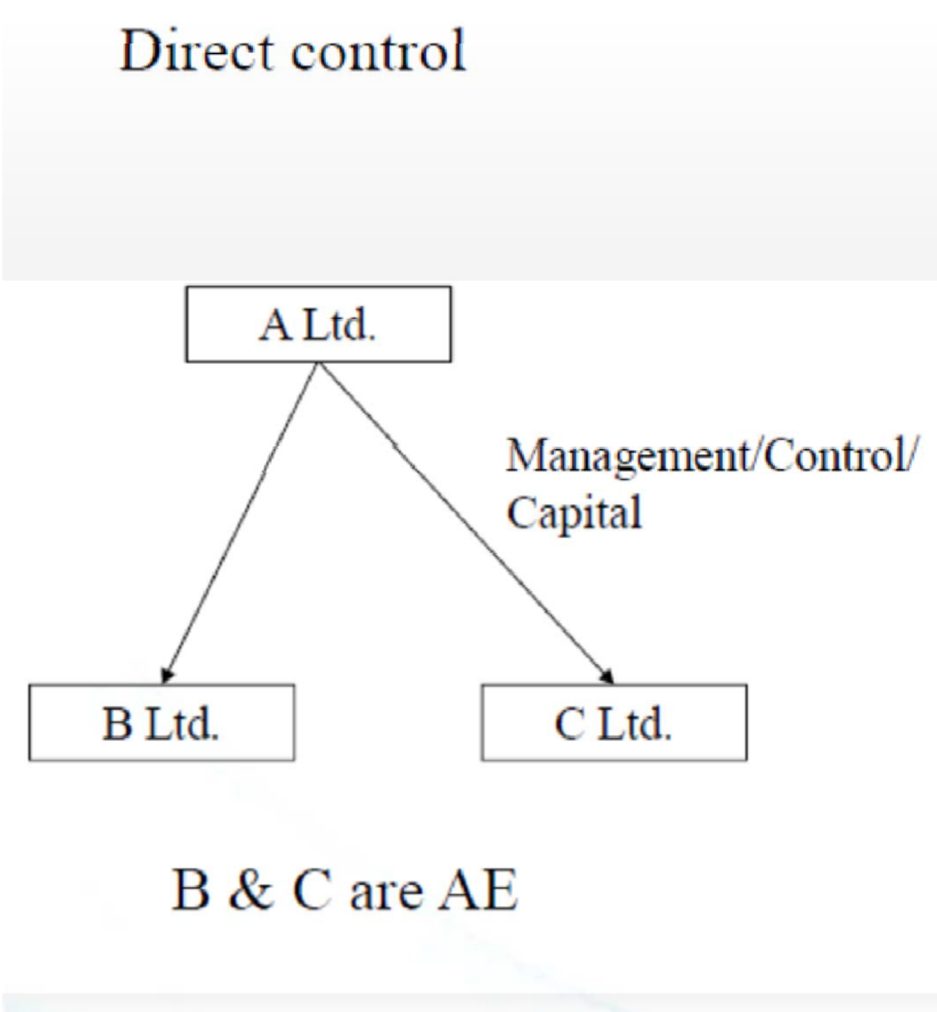
  - Computation of income/ expenses having regard to the Arm's length price (Section 92(1))

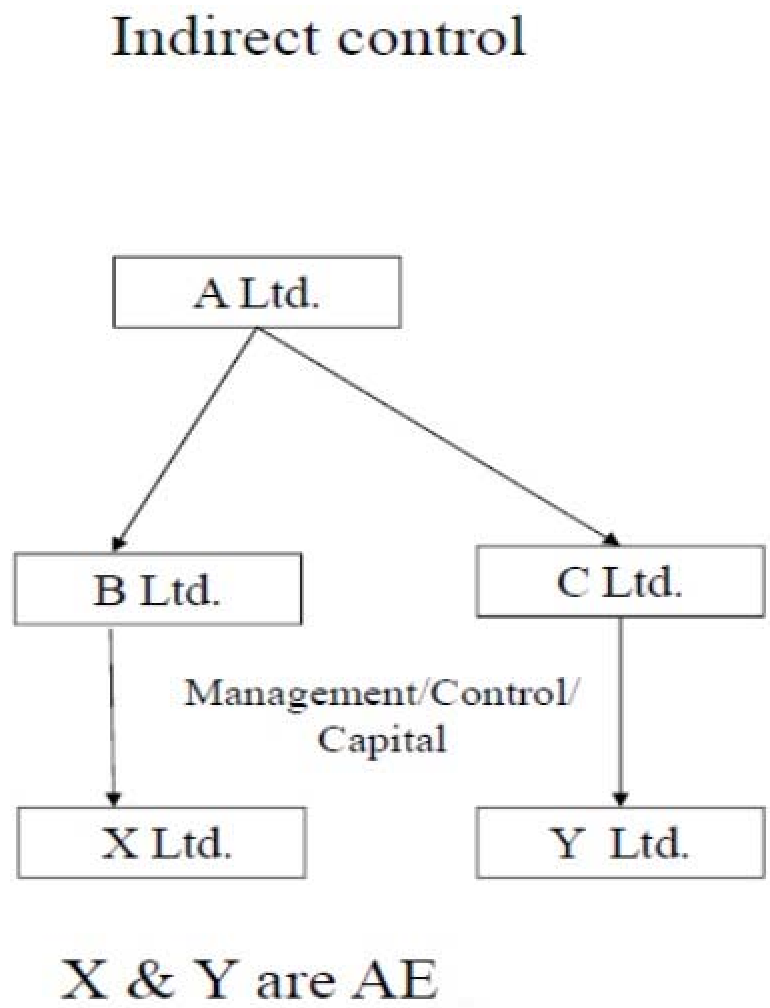
  - Maintenance of prescribed Documentation (Section 92D read with Rule 10D)

  - Obtaining of Accountant's report (under Form 3CEB) (Section 92E)

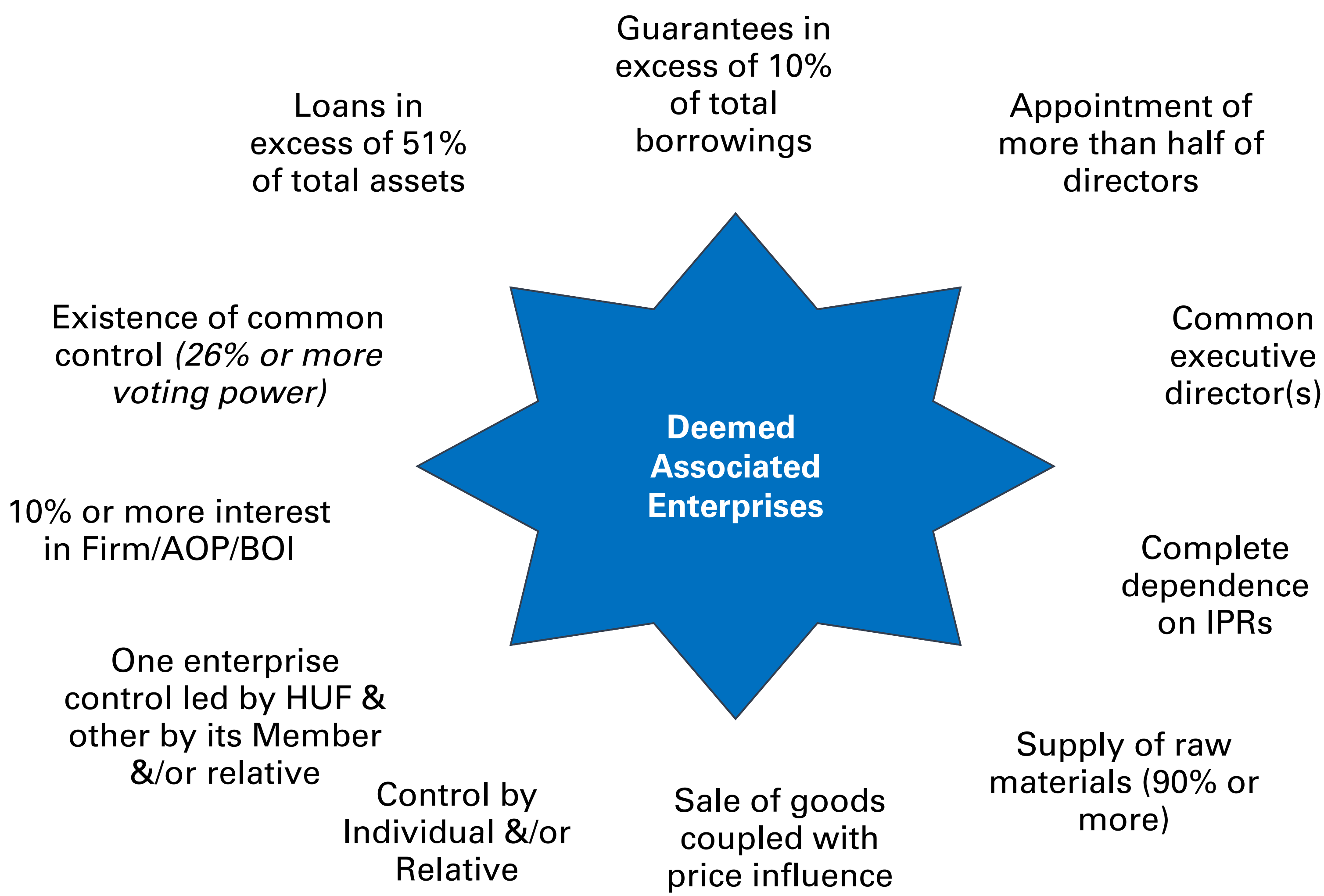
  - To ensure compliance with the arm's length principle, stringent Penalties have been prescribed

Associated Enterprise (Source Definition) (Sec 92A (1))



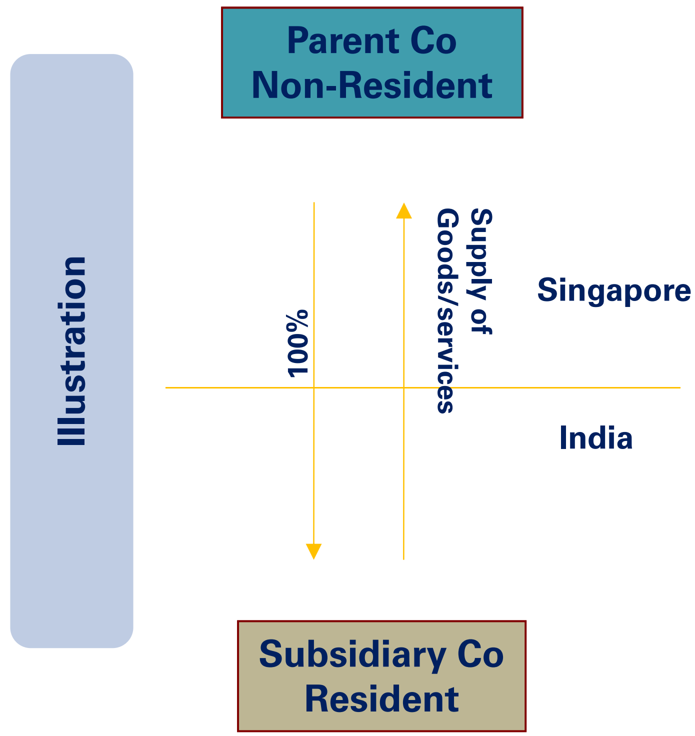


Deemed Associated Enterprises (Deemed Definition) (Sec 92A (2))

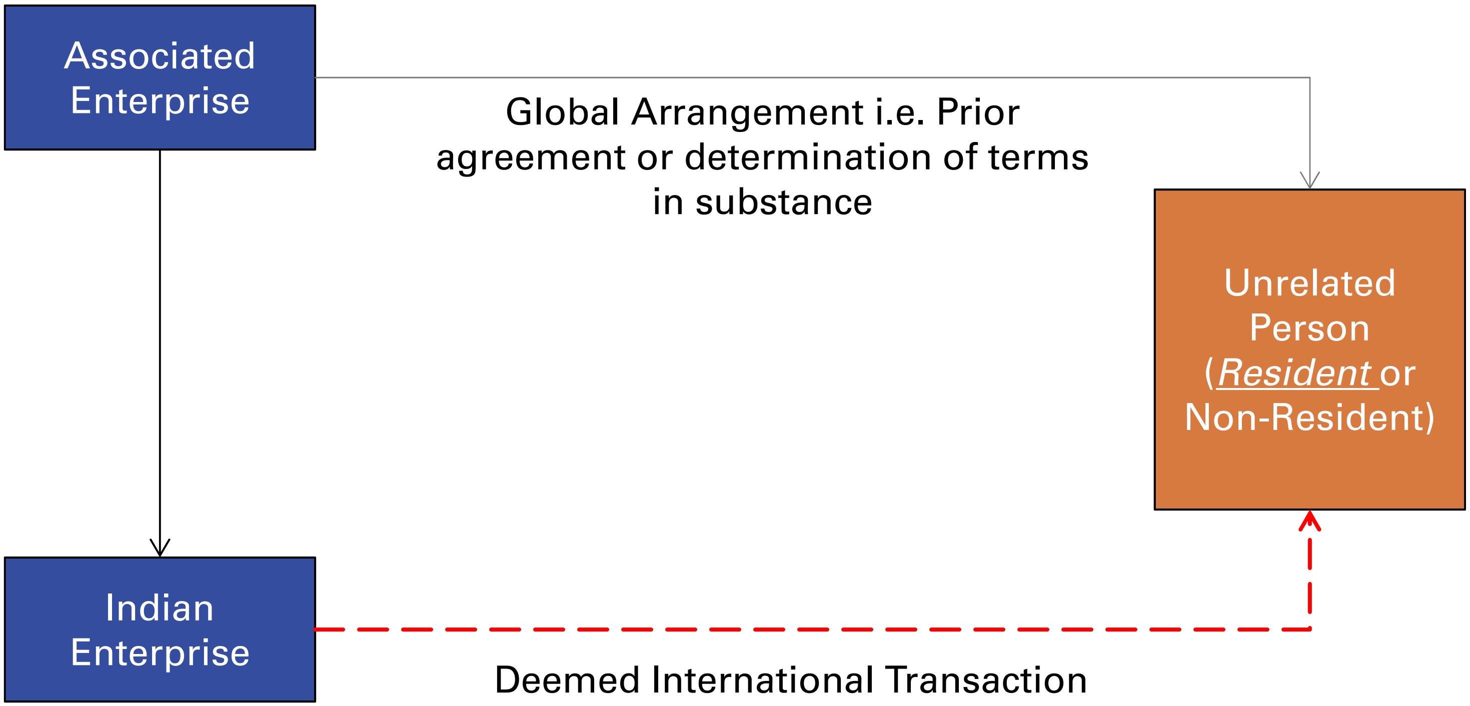


International Transaction (Sec 92B(1))

- Transaction between two or more associated enterprises, **either** or **both** of whom are non-residents
- In the nature of -
  - Purchase, sale or lease of tangible or intangible property, or
  - Provision of services, or
  - Lending or borrowing money, or
  - Any other transaction having a bearing on the profits, income, losses or assets of such enterprises,
  - Any mutual agreement or arrangement on allocation or apportionment or any contribution of cost or expenses



Deemed International Transaction (Sec 92B(2))



Transactions with unrelated parties whether resident or non-resident to be reported as Deemed International Transactions under Section 92B(2) of the Act

Specified Domestic Transactions ('SDT') (Sec 92BA)

Section 40A(2)

Any expenditure in r[redacted]spect of [redacted]

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Tax Holiday Unit ("THU")

Transactions of Tax Holiday Unit:

- Inter-unit transfer of goods or services
- Business transacted between the THU and closely connected person

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Other Transactions

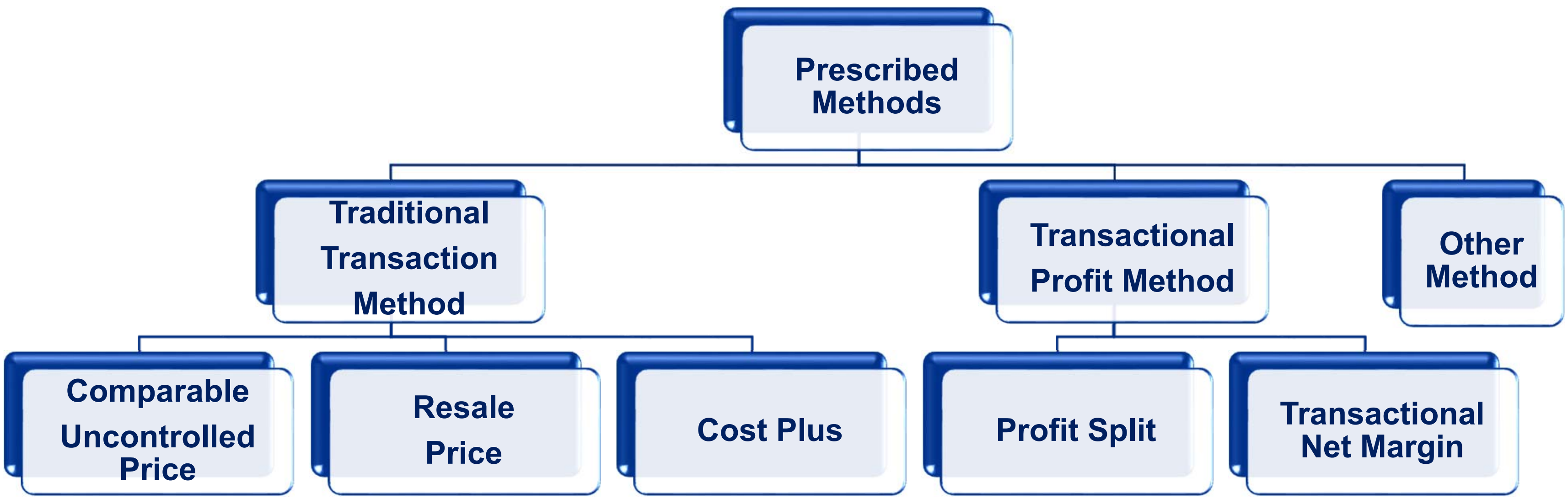
Any other transactions as may be prescribed. Till date CBDT has not prescribed any transaction

=

Aggregate value exceeds INR 5 crore in a financial year (INR 20 crore from FY 2015-16)

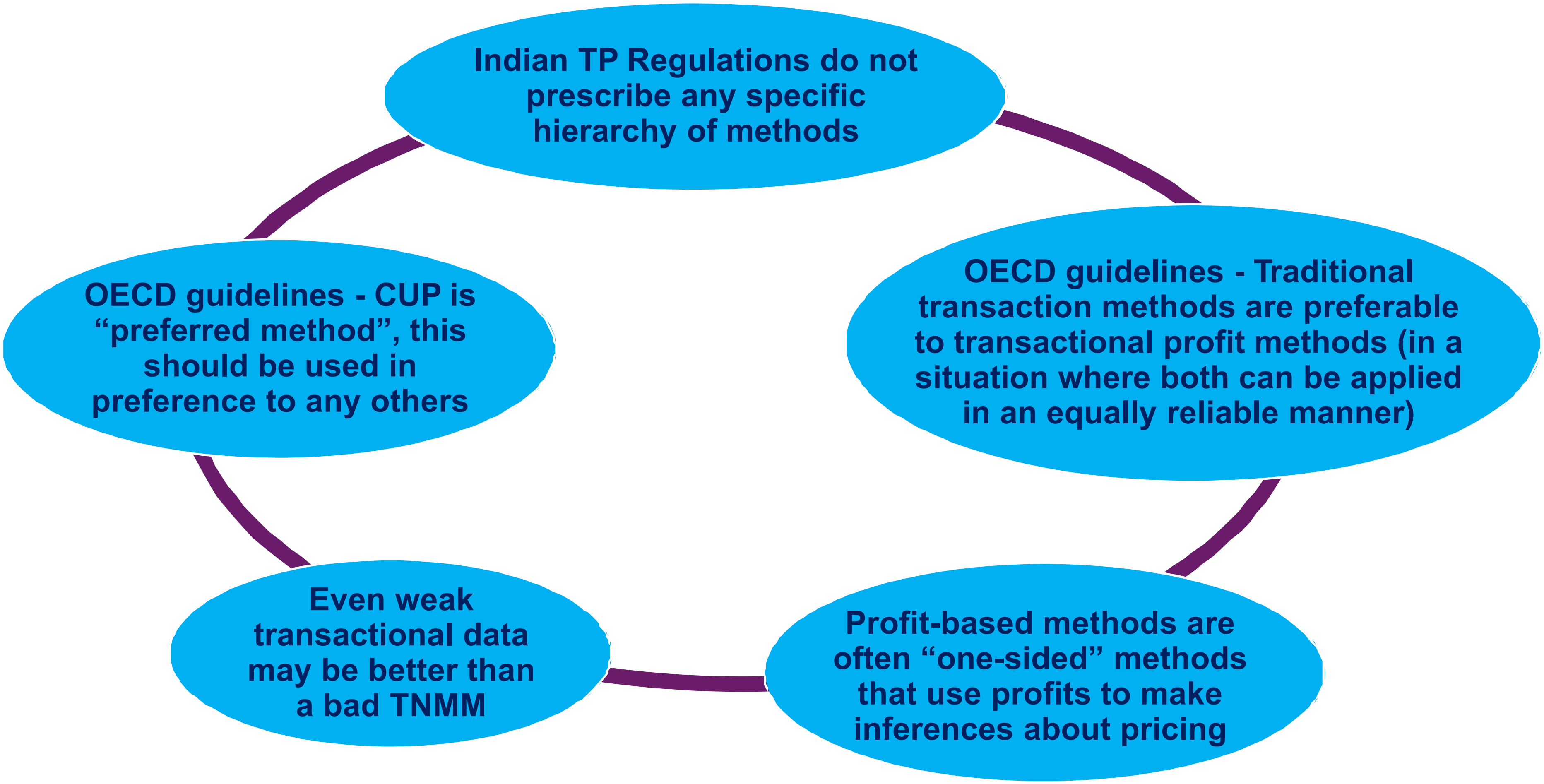
Computation of Arm's Length Price (Sec 92C)

- Determination of ALP using one of the Prescribed methods -
  - Best suited to the facts and circumstances of each particular international transaction/specified domestic transaction and
  - Provides the most reliable measure of an arm's length price in relation to the international transaction ~ termed as the "**Most Appropriate Method**"
- Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP *(w.e.f 1 April 2014, concept of range or arithmetic mean based on the rules shall apply)*



No hierarchy or preference of methods prescribed under the Act

Order of consideration of Methods



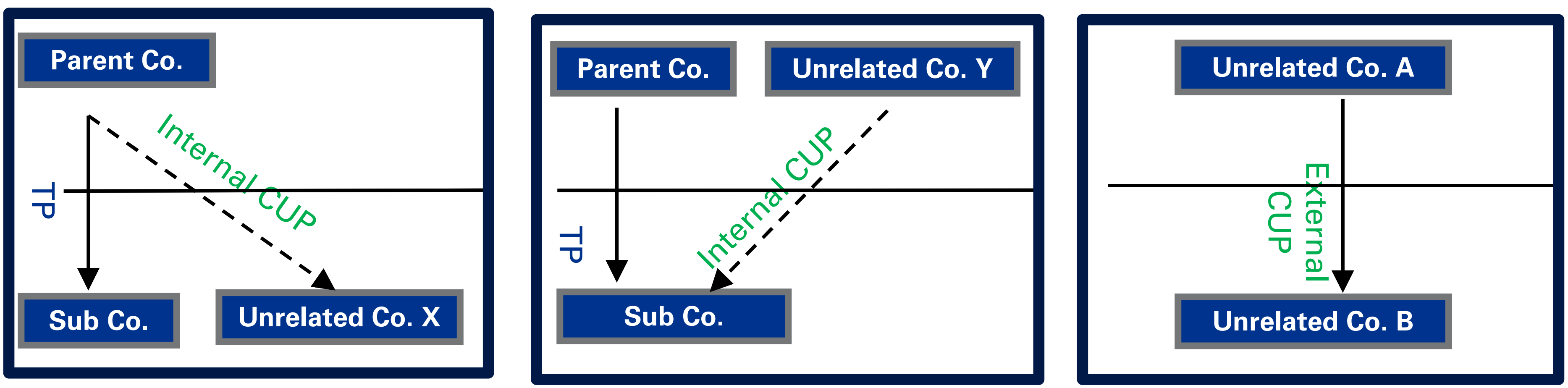
Most Appropriate Method: Rule 10C of the Rules

Factors considered for selection of the most appropriate method:

- Nature and class of international transaction or specified domestic transaction
- Class of associated enterprise and functions performed
- Availability, coverage and reliability of data
- Degree of comparability between the International transaction or specified domestic transaction
- Extent to which reliable and accurate adjustments can be made
- The nature, extent and reliability of assumptions for application of the method

Comparable Uncontrolled Price Method (1/4)

- Most Direct Method
- Prices are benchmarked without any reference to the profits
- Requires strict comparability in products, contractual terms, economic terms, etc.
    - Volume/ quantity of product
    - Credit terms
    - Geographic market
    - Other terms of contract
- Two types of CUPs available - Internal CUP & External CUP
- Typically Internal CUP is preferred over External CUP due to higher degree of comparability



Comparable Uncontrolled Price Method (2/4)

(a) comparable uncontrolled price method, by which,—

(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 in respect of the property transferred or services provided in the international transaction;

Comparable Uncontrolled Price Method (3/4)

Comparability Requirements	High	Approach	Prices are benchmarked	Application	Very difficult but most preferred method

CUP follows strict comparability

Neither Gross Profit nor Net Operating Profit is used

As very high degree of comparability required

Profit Level Indicator is not examined

Comparable Uncontrolled Price Method (4/4)

Issues

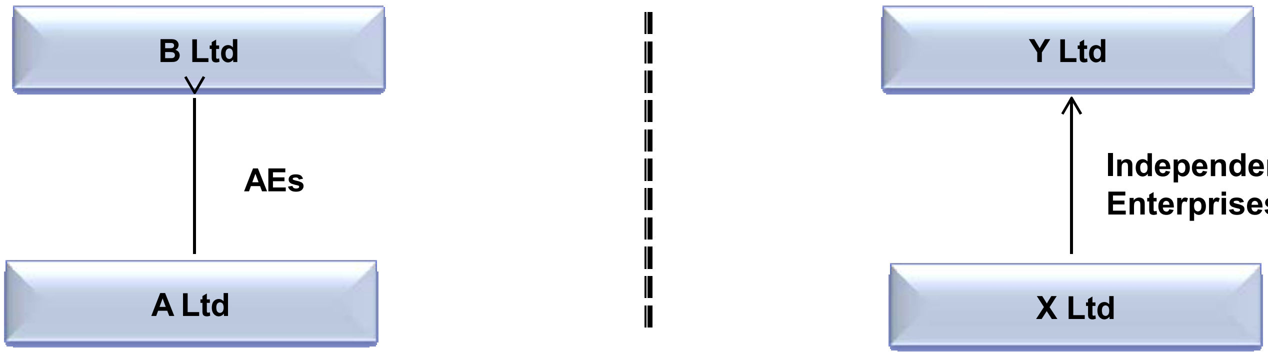
- Require strict comparability in products, contractual terms, economic terms etc.
- Internal CUP is more prevalent in India – Independent transactions of AE's with third parties generally accepted.
- Insufficient data for use of External CUP
- Can localized product be used as CUP for imports?
- Calls for adjustments to be made for differences which could materially affect the price in the open market e.g. (a) Difference in volume/quality of product (b) Difference in credit terms (c) Risks assumed (d) Geographic market
- Application of range in case single of Comparable using CUP method?

Practical Experience

- Generally prevalent use in financial services sector
- Interest on Lending and borrowing - loan transactions;
- Purchase and sale of securities;
- Commodities trading;
- Royalty

CUP - Case Study I

Both A Ltd and X Ltd sell unbranded Colombian coffee beans of a similar type, quality and quantity

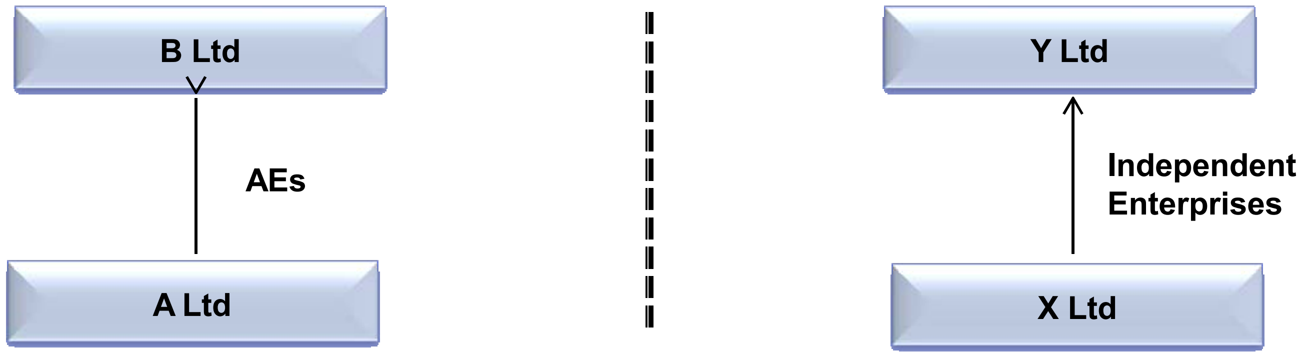


- It is assumed that controlled and un-controlled transactions occur at about the same time, at the same stage in the production/ distribution chain and under similar conditions
- If the only available uncontrolled transaction involved ***unbranded Brazilian coffee beans***, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price
- It could be asked whether the source of coffee beans commands a premium or requires a discount generally in the open market. Such information may be obtainable from commodity markets or may be deduced from dealer prices

If the differences have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to select another less direct method instead

CUP - Case Study II

Both A Ltd and X Ltd sell unbranded Colombian coffee beans of a similar type, quality and quantity



Sale price is the delivered price

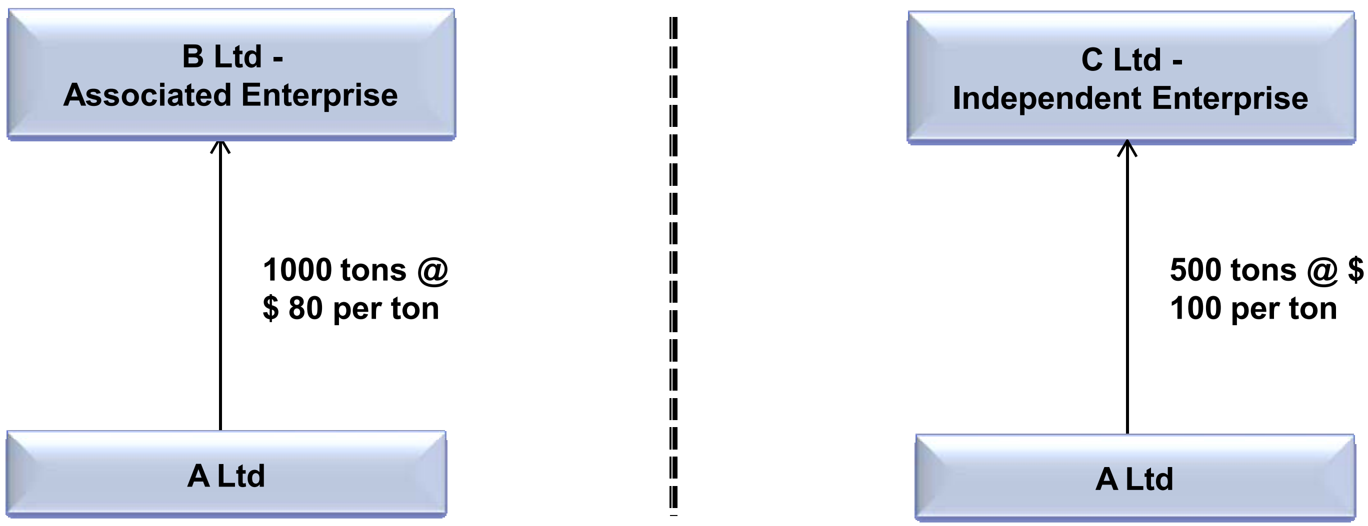
Sale price are made F.O.B. factory

The differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price.

Adjustment should be made to the price for the difference in delivery terms to determine the uncontrolled sales price

CUP - Case Study III

A Ltd sells exactly similar product to both B Ltd and C Ltd



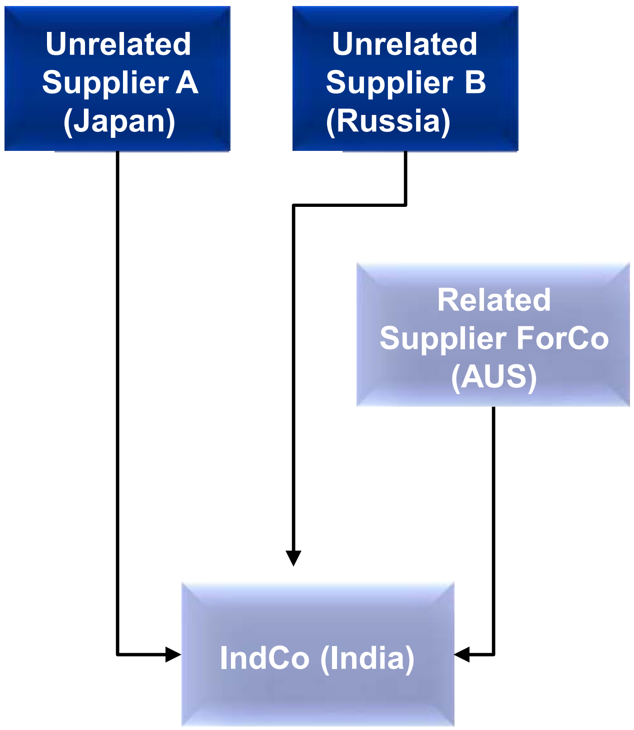
Whether the different volumes should result in an adjustment of the transfer price needs to be evaluated. The relevant market should be researched by analyzing transactions in similar products to determine typical volume discounts.

CUP - Case Study IV (1/3)

- An Indian company ('IndCo') is mainly engaged in the refining and sale of copper metal

- IndCo purchases crude metal from both related and unrelated parties, located in different countries

- Critical factors that affect the crude copper price are as follows:
  - ✓ Volume;
  - ✓ Tenure of supply contract (long term, short-term);
  - ✓ Alloy mix of product (copper crude come with or without small quantities of other metal alloys like gold and silver); and
  - ✓ Other terms of contracts (FOB vs CIF, port of shipment etc.)



CUP - Case Study IV (2/3)

Criteria	Related Party ForCo (Australia) Controlled	Unrelated Party A (Japan) Uncontrolled	Unrelated Party B (Russia) Uncontrolled
Tenure of Contract	Long Term (10 yrs)	Long Term (8 yrs)	Short Term (2 yrs)
Volume during year under consideration	2,200 MT	3,000 MT	9,000 MT
Alloy Mix	0.5% Gold, 1% silver	1% Gold, 1% silver	None
Port of shipment	Australia	Japan	Russia
Price (per MT)	INR 29,500 (applicable for entire year)	INR 32,000 (applicable for entire year)	INR 28,500 (applicable for entire year)
Other Terms	FOB basis	CIF basis	FOB basis

CUP - Case Study IV (3/3)

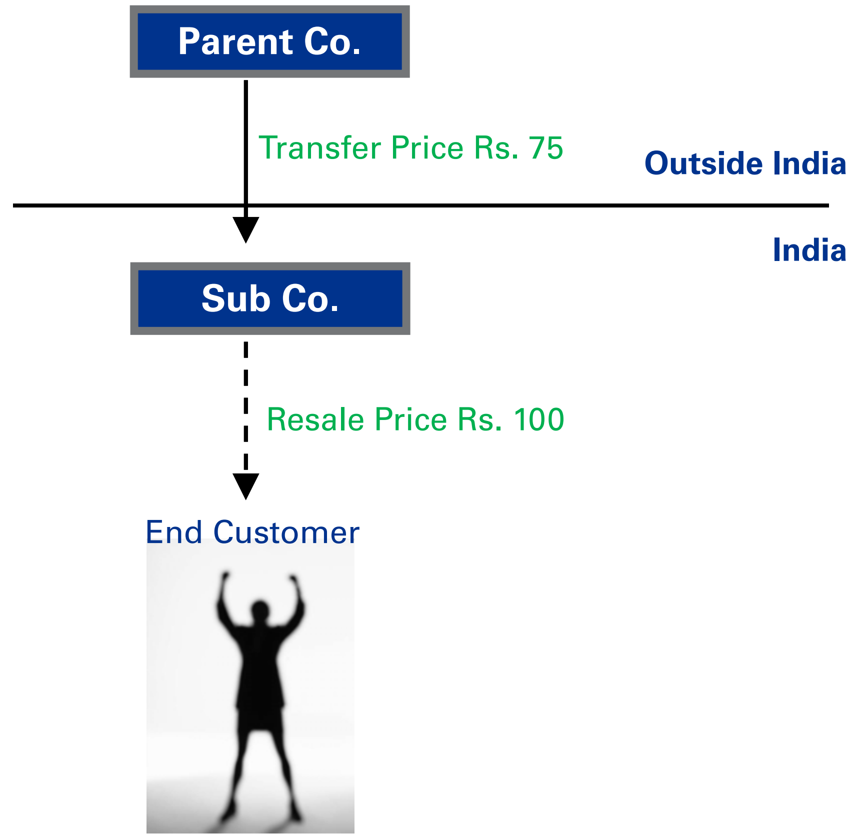
- Best Method: given the availability of required data, CUP is the most appropriate method
- Rejection of CUP related to Supplier B: the significant difference in volume render the Supplier B transactions unreliable as suitable adjustments cannot be made to account for the difference
- Acceptance of CUP related to Supplier A: the uncontrolled transaction with Supplier A is comparable with the controlled transactions with ForCo. Although, certain adjustments need to be made

Adjustments

- Difference in pricing basis (FOB vs CIF) – add freight and insurance cost to ForCo transaction
- Difference in alloy mix – adjust Supplier A's price to exclude price for higher content of gold

Resale Price Method

- Compares resale **Gross Margin**
- Preferred method for a distributor - buying purely finished goods from a group company
- Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed
- Used when reseller does not add substantial value to the goods and does not apply intangible assets to add value
- Difficult to apply where goods are further processed before resale



Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors

Resale Price Method

(b) resale price method, by which,—

(i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;

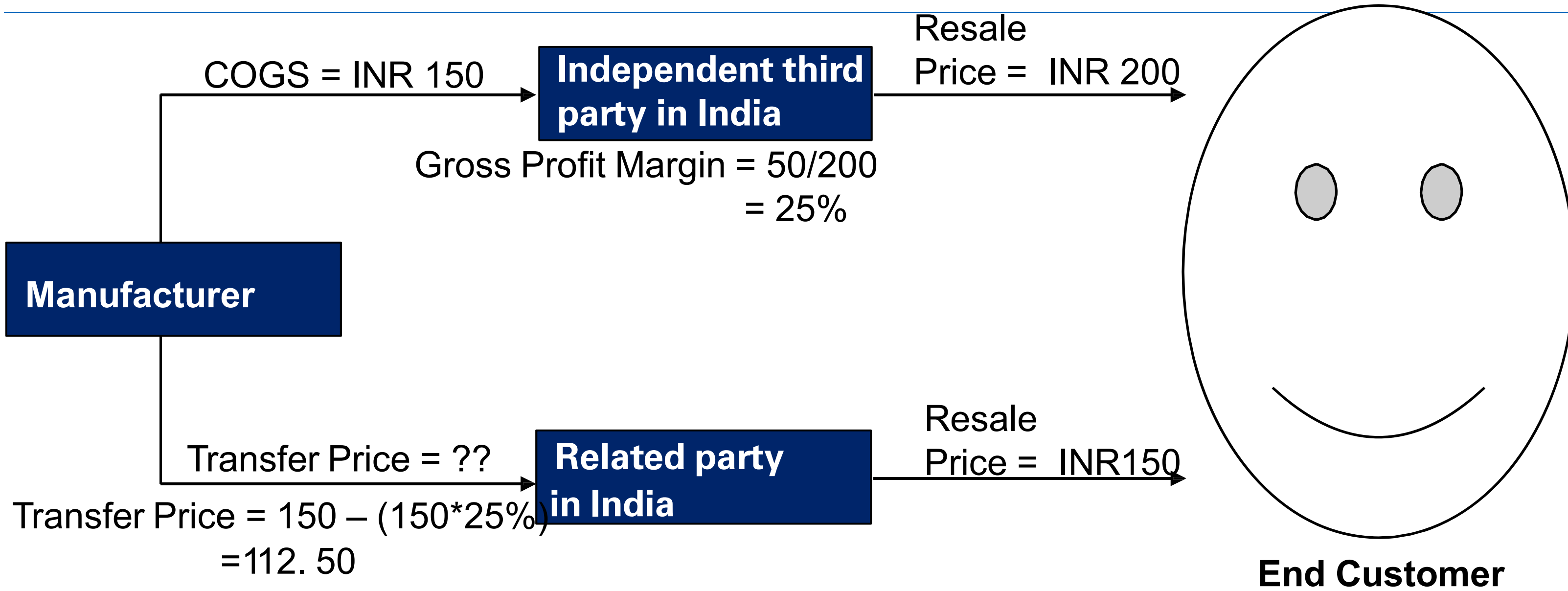
(*ii*) **such resale price is reduced by the amount of a normal gross profit margin** accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;

(iii) the price so arrived at is further reduced by the expenses incurred by the **enterprise in connection with the purchase** of property or obtaining of services;

(iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, 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 gross profit margin in the open market;

(v) the adjusted price arrived at under sub-clause (*iv*) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;

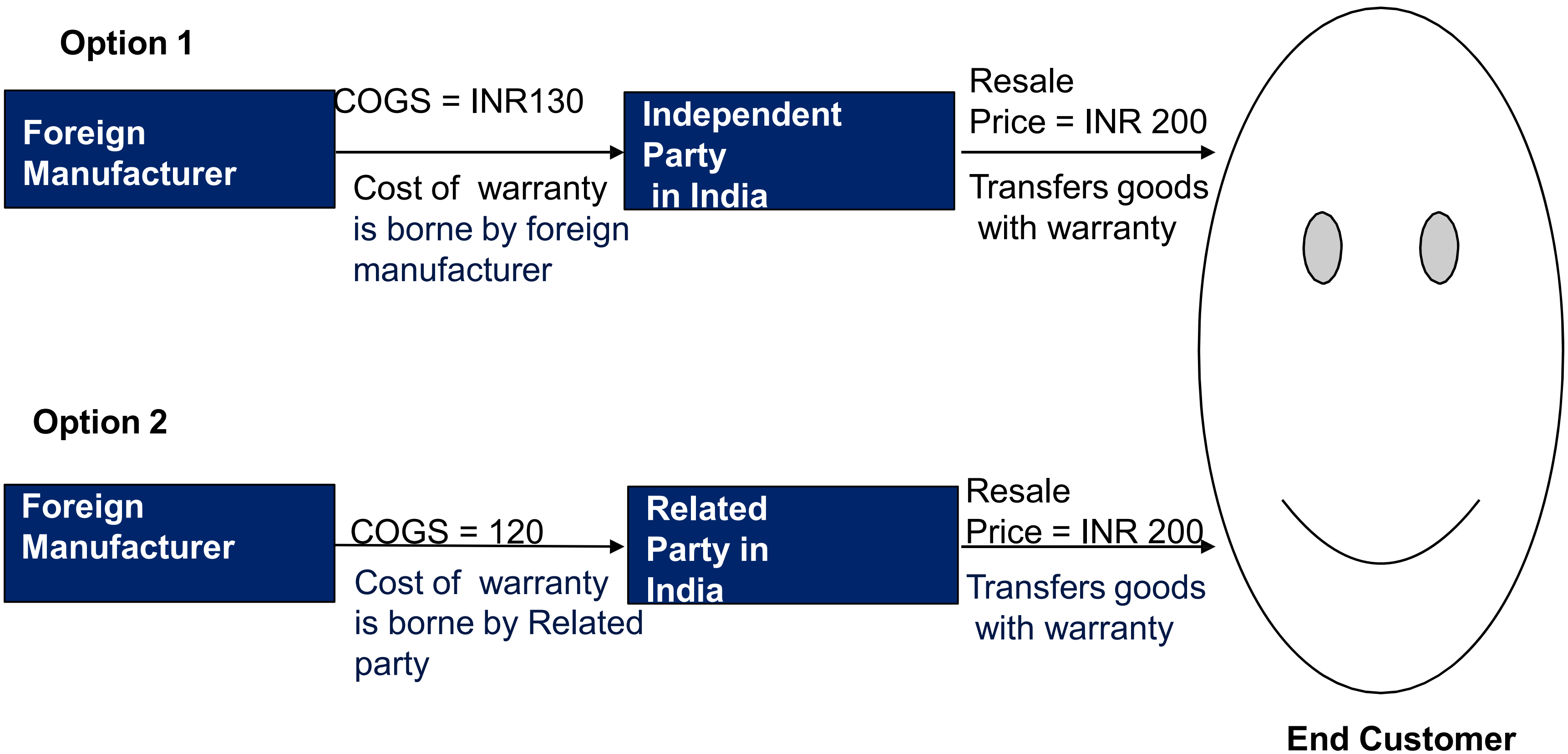
RPM - Case Study I



- Sale to independent third party at INR 150 and sale to end customer by third party at INR 200
- Sale to end customer by related party at INR 150

Particulars	Amount
Gross Profit	50 i.e. (200-150)
Gross Margin	25% i.e. (50/200)
Arm's Length Purchase Cost	112.50 i.e. [150 – (25% 0f 150)]

RPM - Case Study II (1/2)



RPM - Case Study II (2/2)

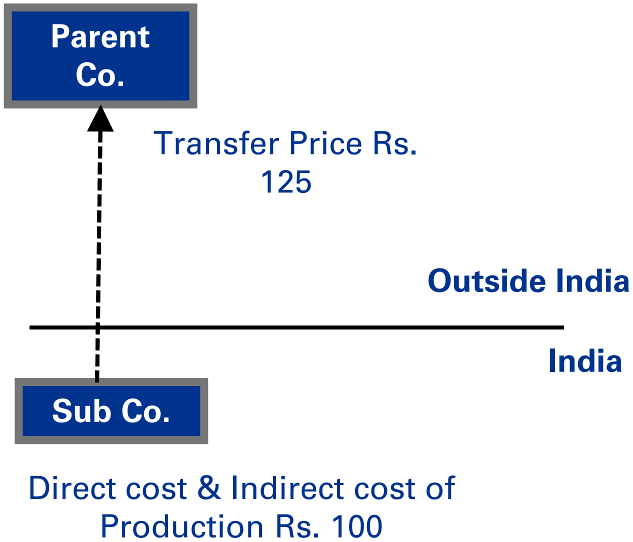
- Under option 1, foreign manufacturer bears the warranty cost
- Under option 2, Related party bears the warranty cost;
- Cost of warranty under both options is INR 20;

Particulars	Amount
Gross Profit	70 i.e. (200-130)
Gross Margin	35% i.e. (70/200)
Arm's Length Purchase Cost	110 i.e. [200 – (35% of 200)- (20)]]

- Actual purchase cost i.e. INR 120 > Arm's length purchase cost i.e. INR 110;
- Not at arm's length from Indian TP perspective

Cost Plus Method

- Compares and identifies mark-up earned on direct and indirect costs of production incurred with that of comparable independent companies
- Preferred method in case-
  - Semi-finished goods sold between related parties
  - Contract manufacturing agreement
  - Provision of services
- To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/ provided to AEs
- Comparability under this method is relatively not as much dependent on close physical similarity between the products.
- Larger emphasis on functional comparability



Price charged by Sub Co. to AE is at arm's length if the 25% mark-up on cost is more than that of similar Indian assemblers

Cost Plus Method

(c) cost plus method, by which,—

(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;

Cost Plus Method

- **Steps Involved**
  - ✓ Determine the direct and indirect cost of production in respect of property transferred or service provided to an associated enterprise
  - ✓ Identify one or more comparable uncontrolled transactions for same or similar property or service
  - ✓ Determine normal gross profit mark-up on costs in the comparable uncontrolled transaction
  - ✓ Adjust the gross profit mark-up to account for functional and other differences between the international transaction and the comparable uncontrolled transaction.
  - ✓ The direct and indirect cost of production in the international transaction is increased by such adjusted gross profit markup
  - ✓ The resultant figure is the arm’s length price

Cost Plus Method - Finding the right cost base

The cost plus method presents some difficulties in proper application, particularly in the determination of costs to be included in the cost base for applying a mark-up thereon. The relevant points to be kept in determination of an appropriate cost base are as below:

- Look at all costs associated with providing the service
- Consider the direct and indirect costs
- If fixtures and fittings are used then include depreciation
- Must be the same as the comparable data
- Comparable mark-up must be applied to a comparable cost base

Cost Plus Method - Impact of differences in Accounting Policies

The OECD Guidelines, 2010 classifies the costs of an enterprise under three broad categories:

Direct Costs of Production

- **Differences could arise on account of:**
- Accounting policies followed for inventory valuation
- Varied method of recognising labour costs and different wage accounting principles

Indirect Cost of Production

- **Differences could arise on account of:**
- Basis of absorbtion of indirect cost, i.e. whether on direct costs or revenue, etc.
- Policy and method followed for charging depreciation and amortisation

Operating Expenses

- **Differences could arise on account of:**
- Classification of expenses, the same could be classified as indirect costs.
- Accounting policy followed for recognising provisions, treatment and classification of assets, i.e. leased assets vis-à-vis owned assets.

Cost Plus Method - Issues

- Difficulty in application – lack of publicly available data as regard gross margins
- No requirement to report gross margins in audited accounts
- No guidance for treatment of different costs for computation of gross margins
- Costs are unstable
- Heavy capital expenditure - may be a sign that cost plus is not appropriate
- Activities are inherently complex or risky - would not be commercial to expect one party simply to pay another’s costs
- Bad management - generally you would not expect the costs of being inefficient to be recharged
- Allocation of costs may be distorted by intra-group arrangements
- Transaction flows from a high cost jurisdiction to a low cost jurisdiction (eg. services provided from UK to India)
- Method is not always suitable as assumes perpetual profit
- Always consider the other side of the transaction

Cost Plus Method - Case Study I

- Indian Co Limited provides IT support services to its fellow group members. Its costs are as follows:

Particulars	Amount (in Rs)
Salaries	3,84,275
Office Costs	59,212
Depreciation	20,112
Interest	2,005
Bank Charges	186
Total	4,65,790

- Indian Co Limited's arm's length reward is ascertained as cost plus 17%

What is Indian Co Limited's turnover?

Cost Plus Method - Case Study I

- The turnover of Indian Co Limited is calculated as below:

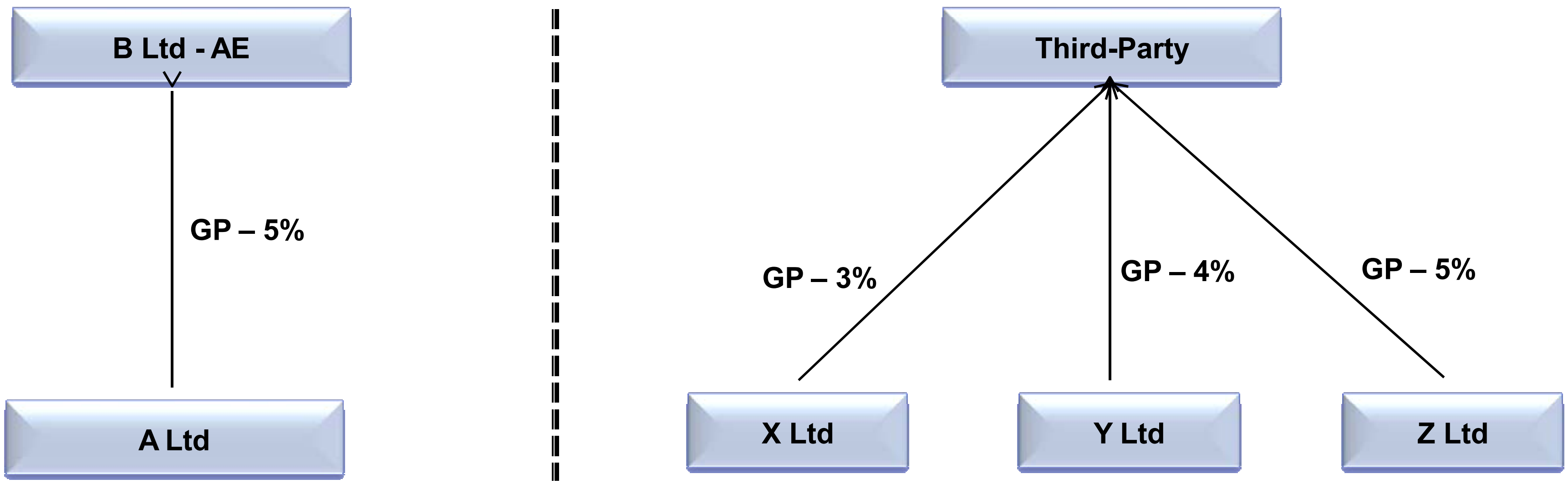
$$\text{Turnover} = \text{Rs } 4{,}65{,}790 \quad X \quad \frac{117}{100} = \text{Rs } 5{,}44{,}974$$

$$\text{Net Profit} = \text{Rs } 5{,}44{,}974 - \text{Rs } 4{,}65{,}790 = \text{Rs } 79{,}184$$

Summary		
Particulars		Amount (in Rs)
Turnover	(A)	5,44,974
Total Costs	(B)	4,65,790
Net Profit	(C) = A – B	79,184
Operating Margin	(D) = C/A * 100	14.5%

Cost Plus Method - Case Study II

A Ltd, X Ltd, Y Ltd and Z Ltd are manufacturers of timing mechanisms for mass market clocks

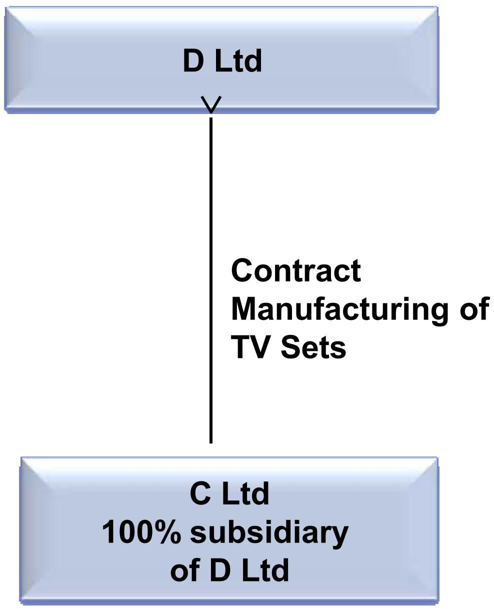


A Ltd accounts for supervisory, general, and administrative ('SG&A') costs as operating expenses. These costs are not reflected in cost of goods sold ('COGS')

The gross profit mark ups of X Ltd, Y Ltd and Z Ltd, however, reflect SG&A costs as part of COGS

The gross profit mark ups of X Ltd, Y Ltd, and Z Ltd must be adjusted to provide accounting consistency

Cost Plus Method - Case Study III



- D Ltd bears all expenses and risks in relation to assembly of TV sets
- All the necessary components, know-how, etc. are provided by D Ltd
- The purchase of the assembled product is guaranteed by D Ltd in case the television sets fail to meet a certain quality standard
- After the quality check the television sets are brought – at the expense and risk of D Ltd – to distribution centres it has in several countries
- The risks C Ltd could bear are eventual differences in the agreed quality and quantity

The basis for applying the cost plus method will be formed by all the costs connected to the assembling activities.

Cost Plus Method - Case Study IV

A Ltd. (AE)

100 man-hours @ INR 2,000 per man-hour
Total Costs incurred
(INR 175,000)

C Ltd
(Third Party)

@ INR 3,000 per man-hour
GP margin earned on costs 40 %

B Ltd

B Ltd. – Software Development + onsite and offsite consultancy services

DIFFERENCES

B Ltd. derives technology support from

A Ltd.

(20 percent of normal GP)

Marketing Risks associated with services rendered to customers other than A Ltd
(10 percent of normal GP)

B Ltd. offered one month's credit to A Ltd.
(1.5 percent GP)

Arm's Length Price for transaction between B Ltd and A Ltd?

Cost Plus Method - Case Study IV

Particulars		**Amount (in Rs)**
Direct and Indirect Costs		175,000
G.P mark-up in comparable uncontrolled transaction	(A)	40 %
Less:		
Adjustment for Technology Support from A Ltd. (20% of 40%)		(8%)
Risk adjustment – no market risk as regard trades with A Ltd. (10% of 40%)		(4%)
	Sub-total (B)	12%
Add:		
Cost of credit to A Ltd.		1.5%
	Sub-total (C)	1.5%
Arm's length GP mark-up = (A) – (B) + (C)		**29.50%**
Arm's length Income (INR)		**226,625**
Increased Income INR (226,625 – 200,000)		**26,625**

Profit Spilt Method

- PSM is applied in cases:
    - involving transfer of unique intangibles or
    - multiple international transactions that cannot be evaluated separately
- PSM can be (a) Total Profit Split or (b) Residual Profit Split.
- PSM requires selection and application of appropriate allocation keys for splitting profits amongst the members of the MNE group contributing to generation of combined profits.
- Strengths and weakness of PSM

Strengths	Weakness
• 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	• Difficulty in application • Necessitating application of similar accounting policies and standards • Selection of allocation keys • Reluctance of tax authorities to accept

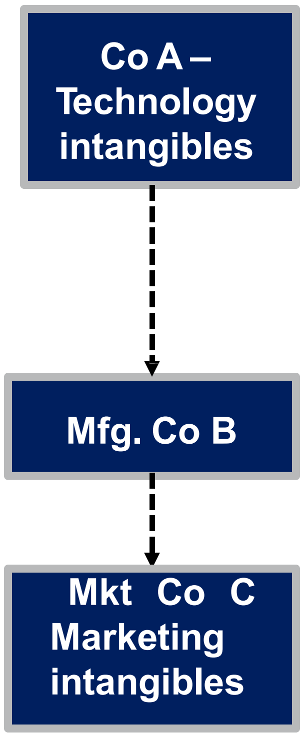
Profit Spilt Method

(d) Profit split method, by which, -

- the combined net profit of the associated enterprises arising from the international transaction or the specified domestic transaction in which they are engaged, is determined;
- 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;
- the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);
- 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 or the specified domestic transaction:
- Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the [type of international transaction or specified domestic transaction] in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from [the international transaction or the specified domestic transaction]

Profit Spilt Method

- To be applied in cases involving transfer of unique intangibles or in multiple transactions that cannot be evaluated separately
- Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit
- Evaluates allocation of combined profit/loss in controlled integrated transactions
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data
- The two methods discussed by OECD Guidelines:
  - Contribution PSM Analysis
  - Residual PSM Analysis



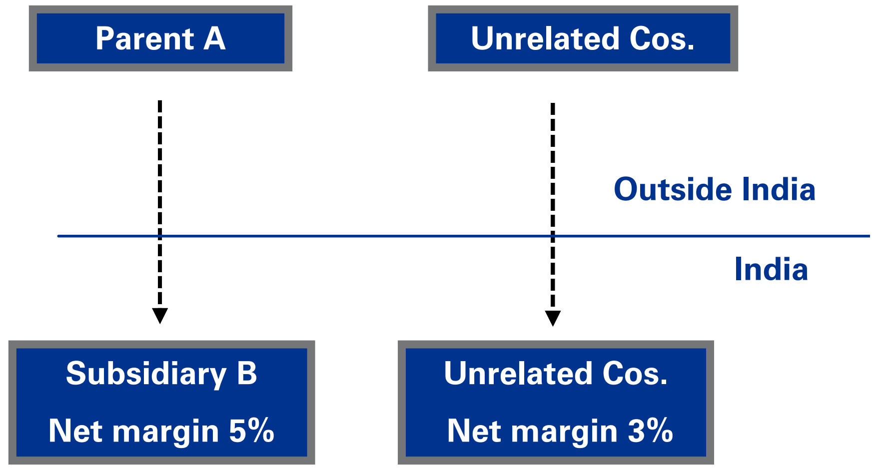
Transactional Net Margin Method...

(d) Transactional net margin method, by which,—

- (i) the net profit margin realised by the enterprise from an international transaction or a specified domestic 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 realised 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 or the specified domestic 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 realised 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 or the specified domestic transaction.

Transactional Net Margin Method…

- Most frequently used method, due to lack of availability of data for application of other methods
- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc)
- Both internal TNMM and external TNMM are possible
- Broad level of product comparability and high level of functional comparability
- Applicable for most categories of transaction and often used to supplement analysis under other methods



… Transactional Net Margin Method

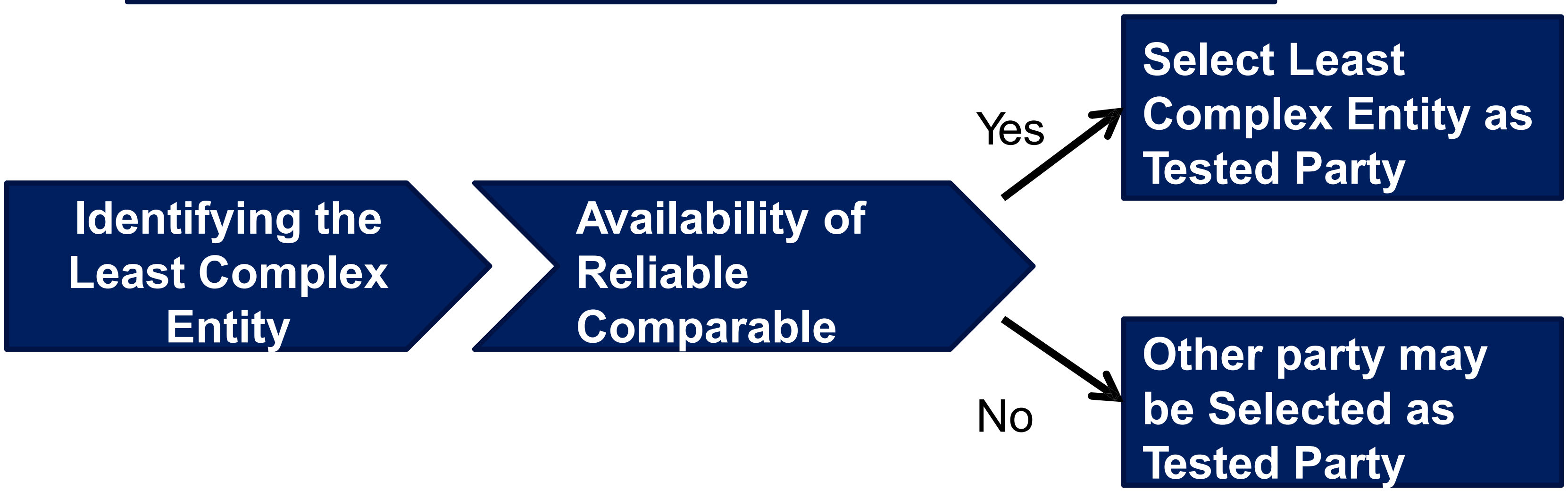
- Grouping of transaction - Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- **Selection of tested party - Least complex entity**
- Selection of Profit Level Indicator such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by transfer price
- Benchmarking exercise (**on Databases**)
  - Entity with similar industry classification to the tested party – through search in Prowess and Capitaline plus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales <75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
  - Computation of ALP

Usually regarded as an indirect and one-sided method, but is most widely adopted

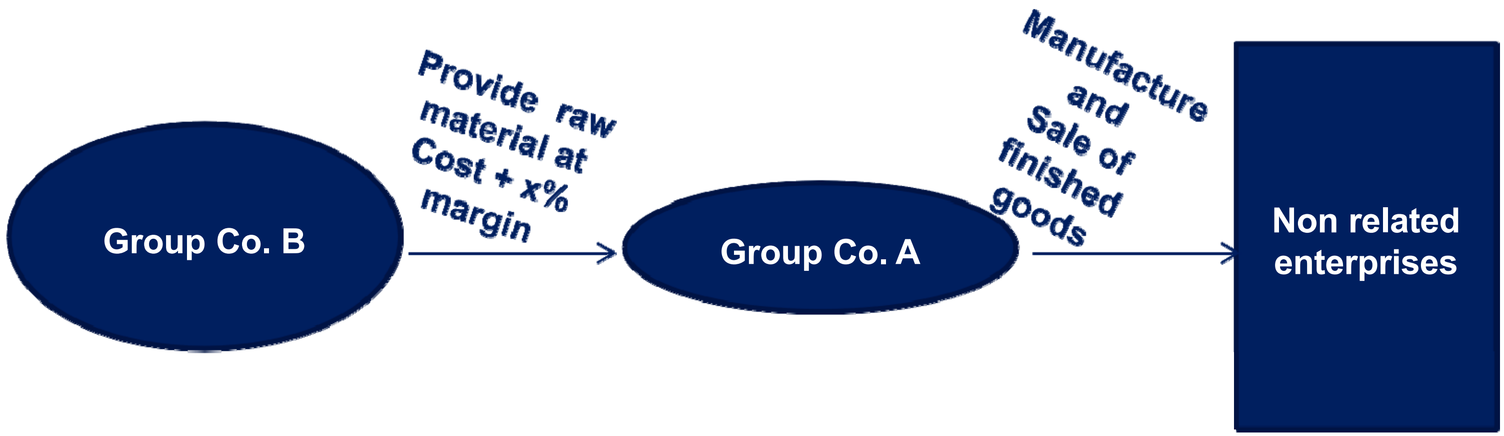
Selection of Tested Party

- Generally understood to mean the party to the international transaction with reference to which the comparability is undertaken
- No guidance on factors to be considered for selection of the tested party provided under the Indian law
- OECD guidelines provide useful guidance

Steps involved in selection of tested party



Selection of Tested Party - Case Study



1. Test which entity perform least complex function

2. Co. B provides raw materials to Co. A after manufacturing the same (based on the instructions received from of Co. A)

3. Co. A performs manufacturing function, employed all necessary assets relevant for manufacturing finished goods and bear all the related risks

4. Based on the above, Co. B can be selected as the tested party

Selection of Profit Level Indicator

- Rule 10B(1)(e) (i) "the net profit margin realised by the 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"***
- Thus, the net profit margin is computed with reference to an appropriate base or denominator being: Costs incurred; Sales effected; Assets employed; Any other relevant base – e.g. return on value added expenses
- Factors relevant for the selection of the PLI
  - ✓ Selection of denominator / base depends on the activity of the tested party
  - ✓ The denominator should be independent of the controlled transaction
- Illustrative scenarios for selection of PLI

Transaction	PLI to be selected
Purchase from AE and distribution in Indian market	Return on Sales
Provision of services	Return on Cost
Capital / Asset intensive activities	Return on assets

"Other Method" - Sixth method notified by CBDT

- CBDT had notified the "Other method" vide Notification No. 18/2012 dated 23.05.2012
- Applicable from FY 2011-12

Rule 10AB - "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."

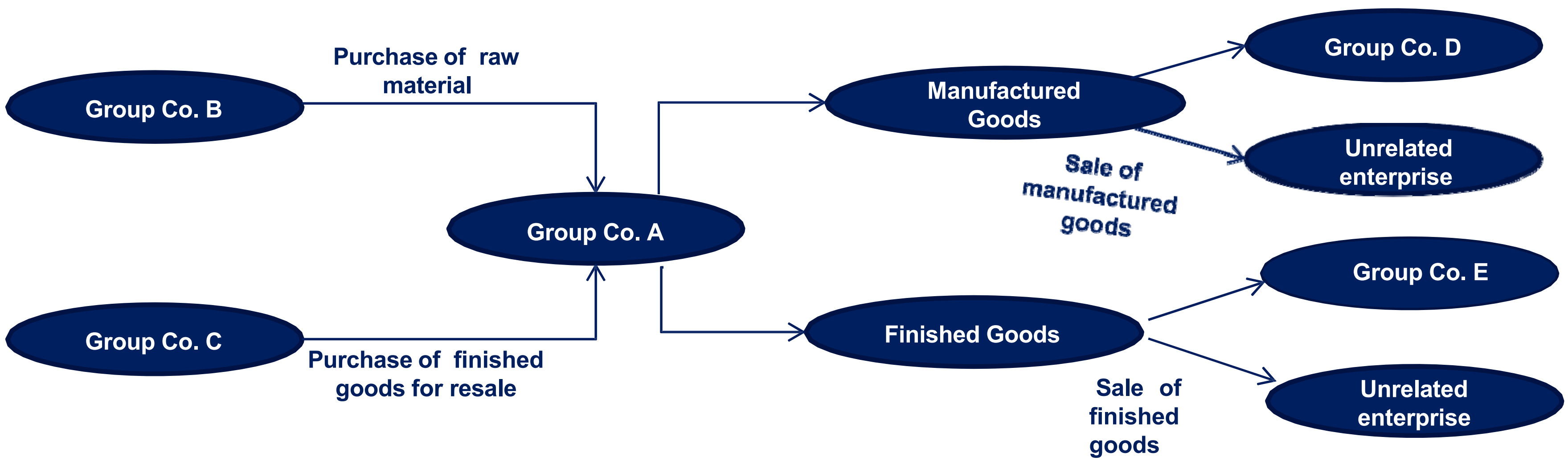
- Effectively this implies that "quotations" rather than "actual prices" charged or paid can also be used
- Could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 – Expansion of definition of "international transaction" and introduction of domestic transfer pricing
- To maintain proper documentation specifying the rejection reasons for non-application of other five methods and appropriateness of the "other method"

Transfer Pricing Method and Comparability

Methods	Comparability Requirements	Approach	Practical Applicability
CUP	Very High	Prices are benchmarked	Low
RPM	High	Gross margins are benchmarked	Low
CPM	High	Gross margins are benchmarked	Low
PSM	Medium	Operating margins are benchmarked	Medium
TNMM	**Medium**	**Operating margins are benchmarked**	**High**

Case Study I

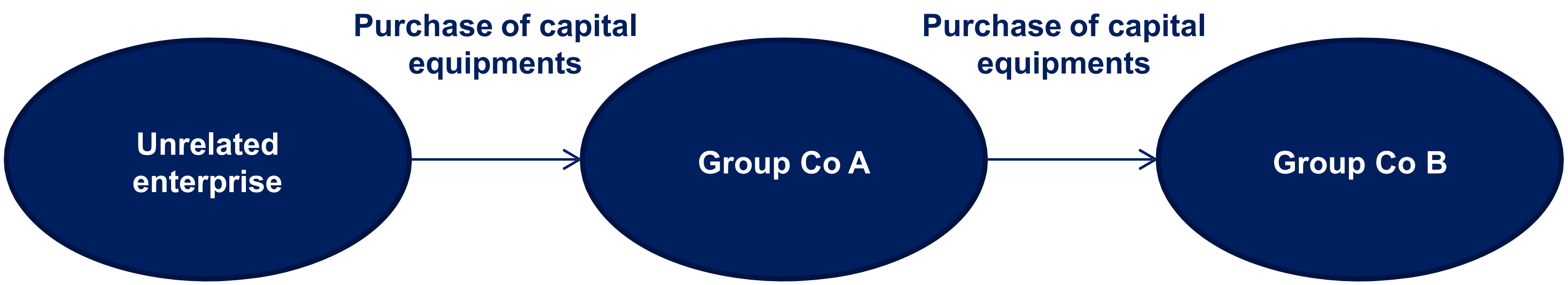
Transaction by transaction analysis



1. Emphasis on function analysis;
2. Characterization of Group entities critical
3. Every transaction is a separate class of transactions and separate economic analysis would be required for separate class of transactions
4. Require to maintain segmental accounts, if more than one class of transaction has been entered
5. Manufacturing activity: Depend upon the complexities of entities, either Co. A 's or Co. B's gross profit/ net profit needs to be benchmarked
6. Trading activity: A's gross profit/ net profit for trading function need to be benchmarked

Case Study II

Applicability of CUP Method – Back to back arrangement



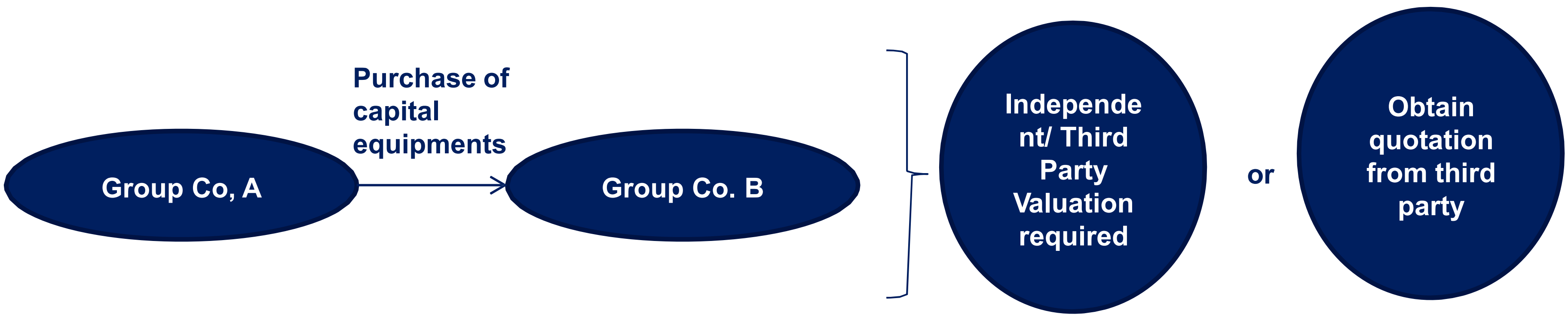
1. In present case capital equipments are purchased by Group Co. A from unrelated enterprises and sold to Group Co. B and therefore back to back arrangement

2. Documentation needs to be maintained to substantiate that capital equipments are purchased on cost to cost basis by Co. B from Co. A

3. Also need to substantiate that Co. A is not rendering any service to Co. B. Co. A is purchasing capital equipments from unrelated enterprises for administrative convenience only

Case Study III

Sale of Capital equipments after usage



1. In present case capital equipments are sold by Group Co. A to Group Co. B

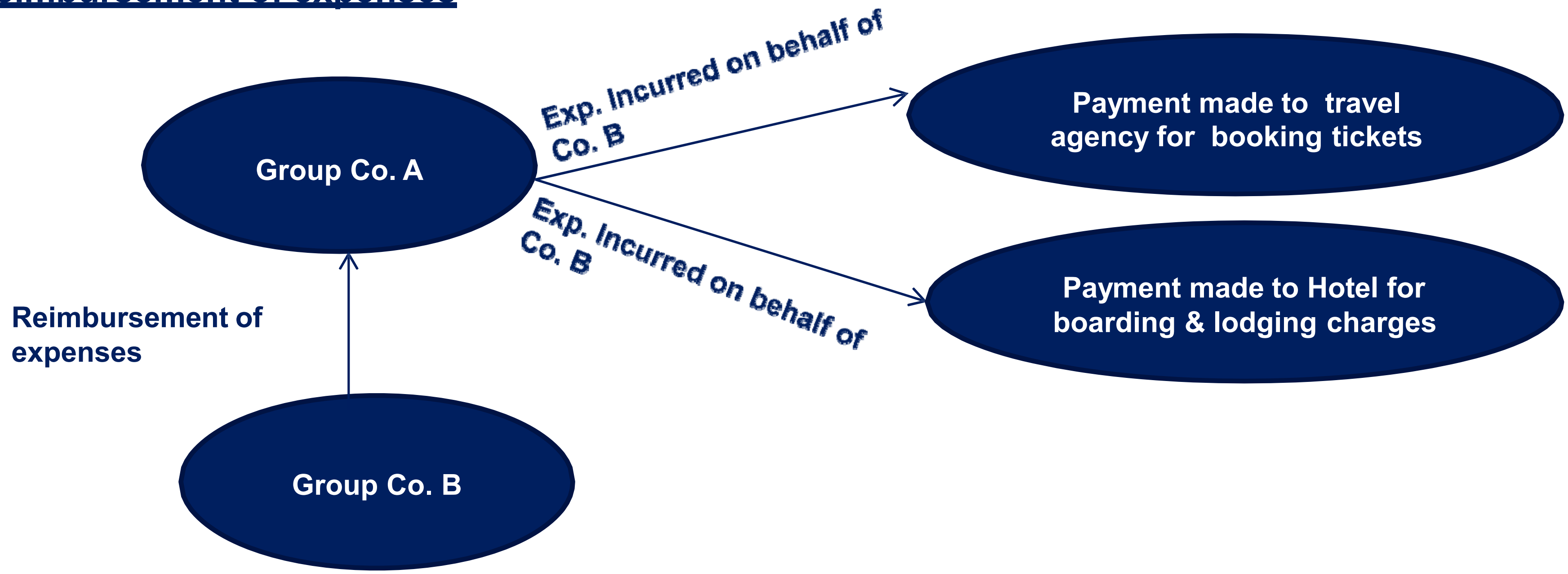
2. Two ways of benchmarking:

   - Obtain third party valuation certificate

   - Obtain quotations from third party [applicability of sixth method]

Case Study IV

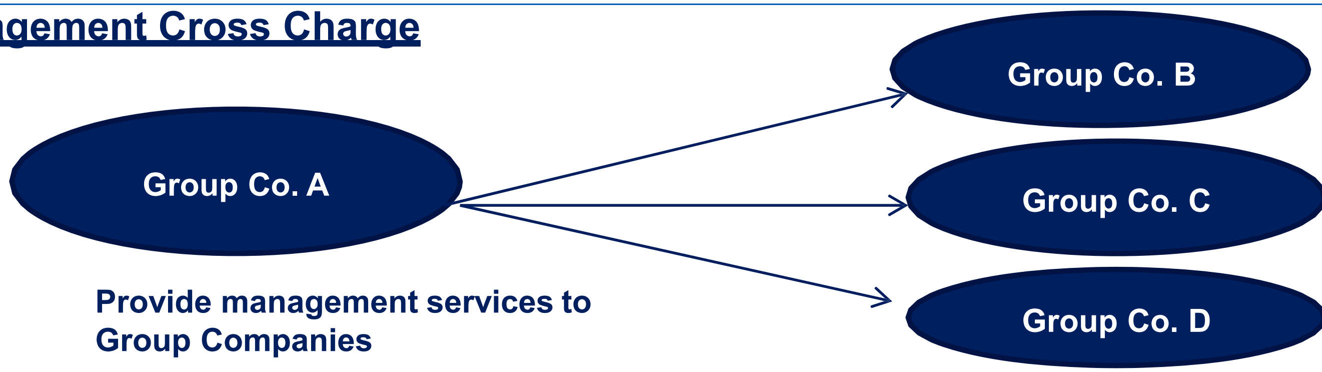
Reimbursement of expenses



1. Substantiate there is no element of service
2. Substantiate benefit arising to other group companies are purely incidental
3. Supporting documents to substantiate that transactions has entered into on a cost-to-cost basis

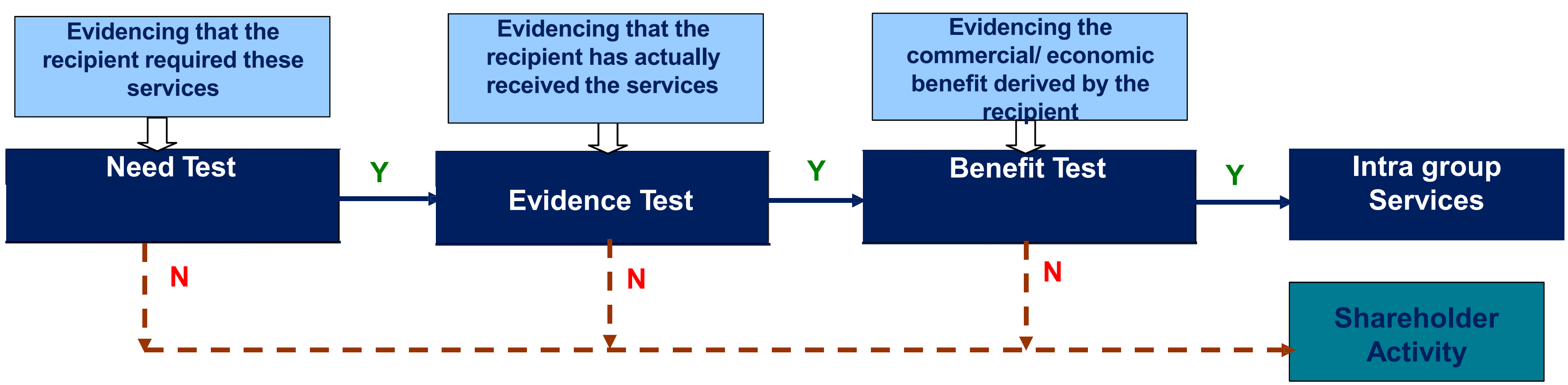
Case Study V

Management Cross Charge



1. Maintenance of adequate documentation to justify the “services” character, evidence receipt of services, and demonstrate benefit derived
2. Costs allocation to be audited by an independent accountant (if feasible)

Benefit Burden Test



Questions and answers

Questions

&

Answers

Thank you