Arm’s Length Principle

Kavita Sethia Gambhir

January 2017

Introduction

Background

- **Economic Globalization**
- **Multinational Structure**
- **Different Objectives**
  - Top Management/Key Personnel
  - Shareholders
  - Tax Authorities
- **Treaty Shopping, Tax avoidance**
- **BEPS**

Transfer Pricing issues high on Corporate & Political agenda

Transfer Pricing-An Example

Consider a world without any taxes!!!

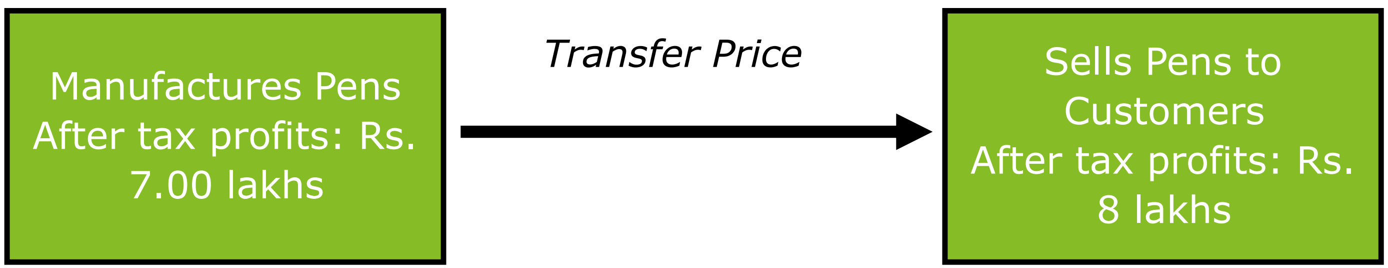
Each division makes profits of Rs. 10 lakhs

Combined profit of the firm is Rs. 20 lakhs

Assume flat tax rate of 30% in manufacturing and 20% in selling jurisdiction

Transfer Pricing-An Example

In this case, the combined after tax profits of the firm is:



The aggregate after tax profit is Rs. 15 lakhs.

Different tax rates provides incentive to structure transfer price to maximize combined tax profits

Arm’s length principle

- **Article 9 of the OECD Model Tax Convention - Associated Enterprises**

  “Where

  a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

  b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between <u>independent enterprises</u>, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

- **Article 7 of the OECD Model Tax Convention – Business Profits**

  “1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

  2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the <u>functions performed, assets used and risks assumed</u> by the enterprise through the permanent establishment and through the other parts of the enterprise.”

Functional and Comparability Analysis

Functional Analysis

- **Analysis of the controlled transaction to identify significant "comparability factors" needs to be considered:**
  - Characteristics of property or services
  - Functions performed, assets employed, risks borne
  - Contractual Terms
  - Economic Circumstances
  - Business Strategies

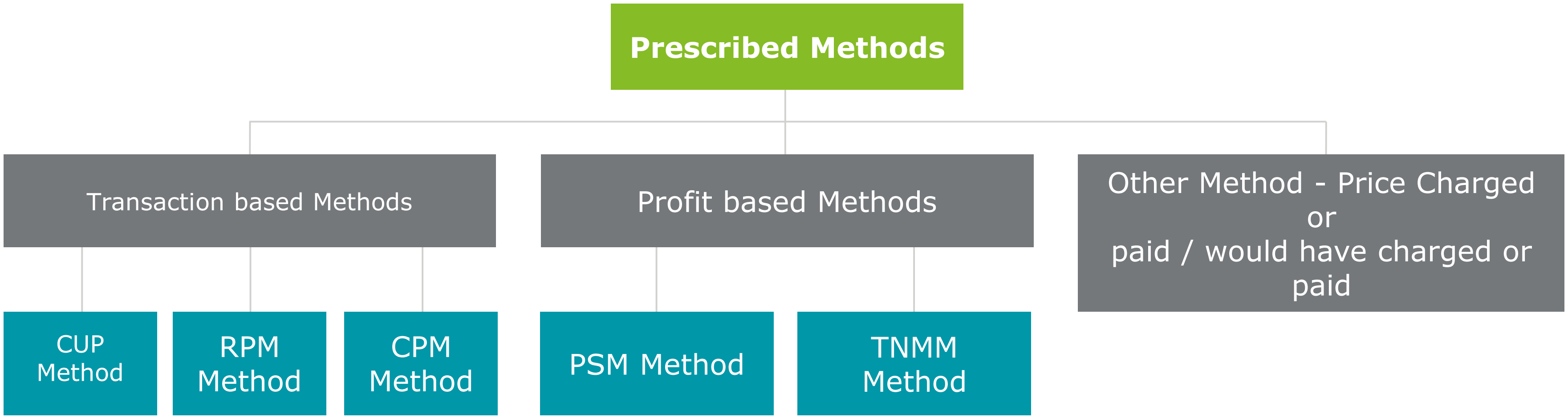
- **To select most appropriate TP method to the circumstances of the case**

- **To select the "comparables"**

Application of the Arm’s Length Principle

Overview of Methods

ALP Computation - Overview of Methods

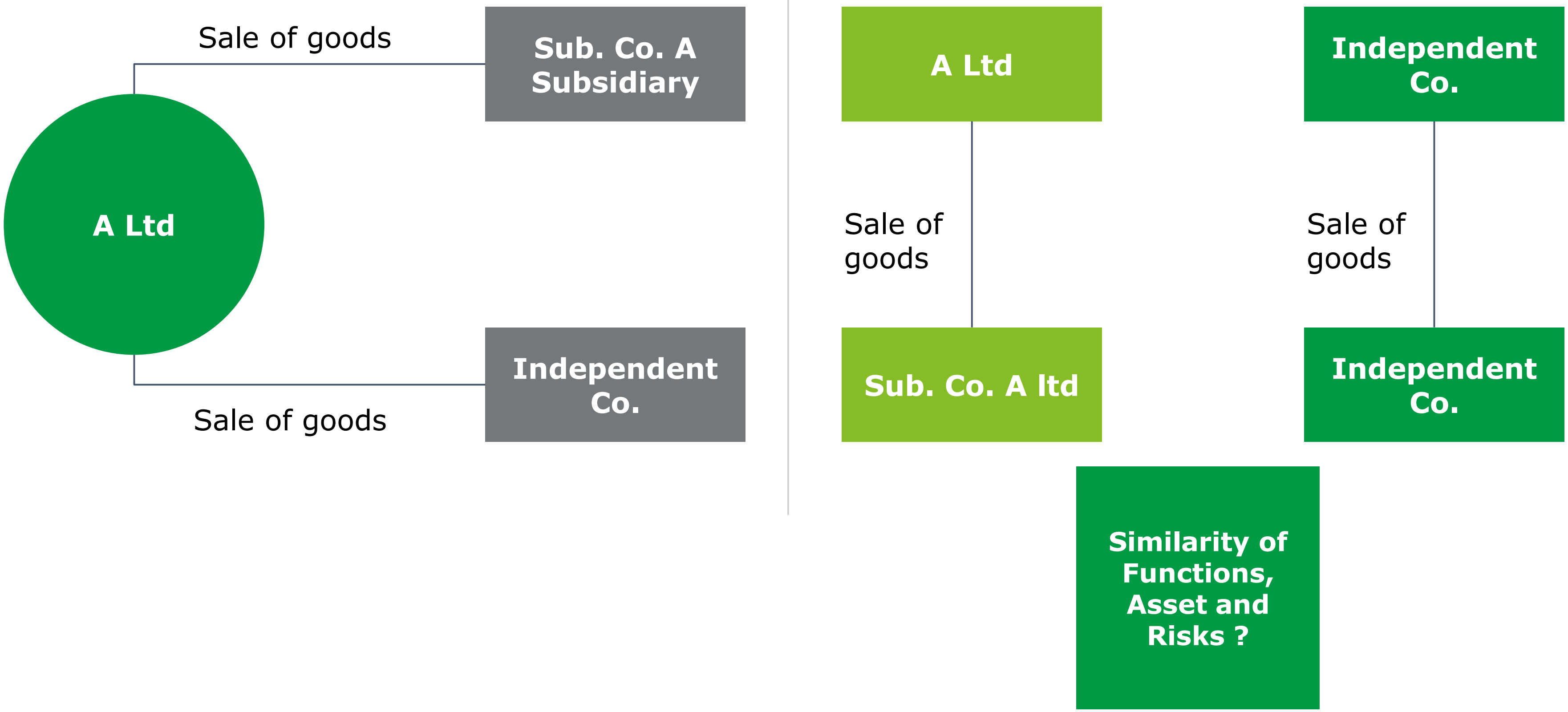


No hierarchy or preference of methods prescribed under the Act

Comparable Uncontrolled Price ('CUP') Method

- A close examination of product (or service) differences is required to assess comparability
  - High likelihood that product differences will affect the price charged
  - Product comparability is critical for CUP method

Internal CUP | **External CUP**



Internal CUP is preferable

Resale Price Method ('RPM')

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; or
- the resale price margin earned by an independent enterprise in comparable uncontrolled transactions (this information is rarely publicly available)

Features:

- Measures the value of functions performed
- Ordinarily used in cases involving the purchase and resale of tangible property
- Reseller has not added substantial value
- Packaging, labeling, or minor assembly are acceptable
- Reseller does not apply intangible assets to add substantial value
- More reliable if internal comparables are present

RPM – Example

Facts:

- A Ltd, is a leading manufacturer of laptops selling the laptops only through its related party B Ltd in India.
- There are no direct sales by A Ltd.,
- B Ltd, a wholly owned subsidiary of A Ltd, acts as a distributor of the products;
- X Ltd. a company with similar functions, assets and risks have also undertaken a similar transaction through Y Ltd, a third party. in India.

Particulars	A Ltd. P.U.	X Ltd P.U.
Purchase price by B, Y	1000	750
Sale price by B,Y in India	1150	950

RPM – Case Study

Particulars		3rd party transaction	Related party transaction
Sale price of Desktops	(A)	950	1150
Purchase Price from 3rd party	(B)	750	
Margin earned	(C=B-A)	200	
Resale Margin	(C/A)	21%	21%
ALP	(A - A*21.05%)		909
Purchase price from related party			1000

Is the Transaction at Arms Length?

Cost Plus Method ('CPM')

The cost plus mark up of the supplier in the controlled transaction be established by reference to:

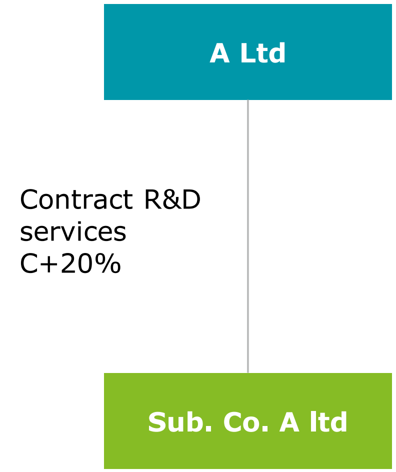
- the cost plus mark up that the same supplier earns in comparable uncontrolled transactions; or
- the cost plus mark up that would have been earned in comparable transactions by an independent enterprise (such information is rarely publicly available)

Features:

- Ordinarily appropriate in cases involving manufacturing or assembly of tangible goods sold to a related party or where services are provided to a related party.
- Similarity of products/services transferred – not a prerequisite
- Similarity of functions is a prerequisite for applying CPM
- Gross margins are more sensitive to difference in functions and risks
- Most useful method where, interalia, related parties undertake transaction in respect of:
  - Sale of semi-finished goods
  - Joint facility agreements
  - Long term buy and supply arrangements
  - Provisions of services on contract basis
- Profit mark-up here provides compensation for the performance of the manufacturing, assembly or service functions as well as a return on the capital invested and risks assumed by the manufacturer/ service provider.

CPM – Example

- A Ltd Provides directions for the manner in which research has to be carried out
- A Ltd assumes all risks associated with Research
- A Ltd also owns all intangibles developed through Research
- Sub Co. A agrees to carry-out Contract Research



All costs for Research is compensated along with mark up

Transactional Net Margin Method (‘TNMM’)

- Most practical and widely used method
- Broad level of similarity of Functions, Assets and Risks
- TNMM can be applied as internal TNMM as well as external TNMM
- Comparison is at net operating margin with the application of appropriate Profit Level Indicators (PLIs)
- TNMM can be reliably applied even if some differences exist between the products (or services) exchanged and the functions performed
  - Differences in products and functions are less likely to affect net margins than prices or gross margins
  - Much easier to use external comparable data when applying the TNMM than when applying other methods

Steps involved in application of TNMM

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
- Availability of appropriate data

Selection of Profit Level Indicator

- Operating Margin – manufacturers / distributors
- Costs plus Mark-up – service providers / contract manufacturers
- Return on assets – capital intensive activities like manufacturing
- Berry Ratio – GP to operating expenses - intermediate activities e.g. commission agent

Benchmarking exercise

- Entity with similar industry classification to the tested party
- Search in Prowess and Capitaline databases
- Screen entities by applying appropriate quantitative filters, such as
- Manufacturing sales >75% ; R&D exp >5% ; Advertisement exp >5%.; RPT = 0
- Review financial and textual information available
- Exact FAR of comparables difficult to derive
- Use of foreign databases: PAN European: AMADEUS, North American: Compustat, etc.

Steps involved in application of TNMM (continued….)

Adjustments

- Exclude non-operating income and expenses
- Working Capital Adjustment – Inventory, Receivables and Payables
- Risk adjustment, capacity utilization adjustment, etc
- Start-up costs / termination costs

Computation of ALP

- In case of 6 or more comparables
  - Usage of range concept and multiple year data (3 years including the year under consideration)
  - Arm's length range → 35th percentile to 65th percentile
  - No benefit of +/- % range

- In case of less than 6 comparables
  - Usage of single year / multiple year data
  - Computation of arithmetic mean
  - Use of +/- % range (1% in case of wholesale traders and 3% in case of others as notified by Central Government)

TNMM - Case Study

Facts

- Indian Auto Manufacturer
  - Full fledged manufacturer
  - R&D and IP with overseas parent

- Limited international transaction - Import of clutch assembly

- Financial Data of Indian entity:
  - Revenues from end customers = INR 100
  - Other operating costs = INR 13

TNMM - Case Study (continued….)

Analysis

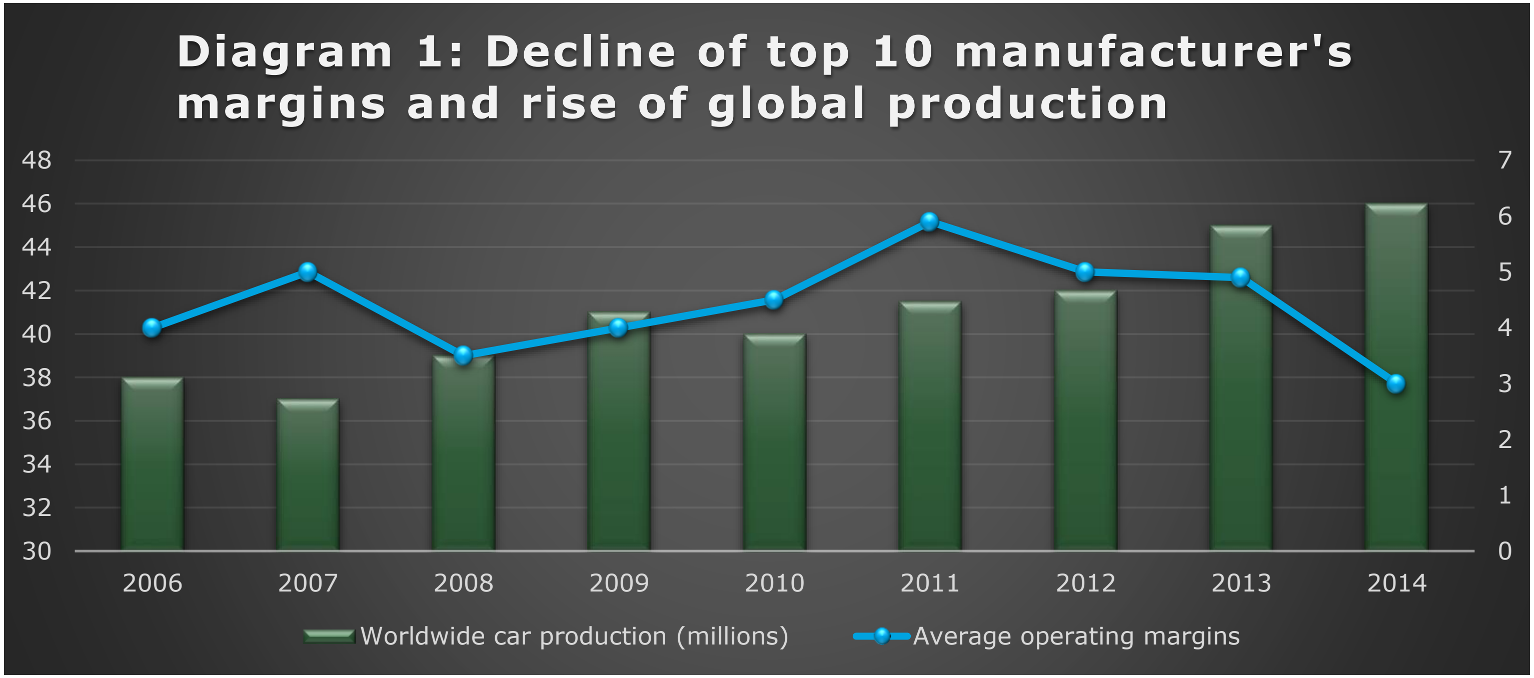
- Most Appropriate Method: given the availability of required data, the TNMM is the best method
- While applying the TNMM method, due consideration must be given to the following -
  - Industry characteristics
  - FAR analysis
  - Differences if any for which adjustments need to be made

Industry Characteristics

- Overcapacity
- Capital Intensive - Plant & Machinery, R&D
- Pressure on Innovation / Product Launches
- Global scale v/s local requirements
- Extreme Volume and Price risks
- Complex supply chains

TNMM – Case Study (continued….)

- **Industry Analysis**



TNMM - Case Study (continued….)

Conclusion

- Indian entity being the simpler entity is the tested party
- Profit level indicator
  - Cost based PLI can't be used as the cost is affected by transfer prices
  - Asset based PLI can't be used as sufficient information of comparable companies' asset base is not available
  - Net Profit Margin (Net operating profits/sales) seems to be the most appropriate
- Internal TNMM not possible because of given facts and circumstances
- External benchmarking suggest that the Indian entity should earn **net profit margin in the range of 4% to 6%**
- Transfer Price = Final sales price – arm's length net profit margin – operating expenses of tested party.
- Therefore, transfer price could be in the range of

  Lower range = INR 100 – INR 4 - INR13 = INR 83

  Upper range = INR 100 – INR 6 - INR13 = INR 81

Profit Split Method ('PSM') - Applicability

- The PSM is typically applied in complex situations when other available methods (such as the CUP or the TNMM) are not sufficient to price the functions performed
- Profit split methods are usually appropriate when:
  - Transactions are very interrelated it might be that they cannot be evaluated on a separate basis.
  - Valuable, non-routine intangibles exist in transactions and profit arising to the group cannot be assigned to one of the entities of the group
  - Significant differences between controlled and uncontrolled transactions are attributable to economies of horizontal/vertical integration
  - Adequate comparables are unavailable to set margins for all the entities.

Steps Involved	
Routine Return	Assign basic return to each entity based on third party comparable
Residual profit	Residual profit after assigning routine return to be allocated based on allocation keys determined

PSM is contribution analysis, rather than comparability analysis

How to apply Residual Profit Split Method?

Particulars	Rs.	Rs.
Combined Group Profits		100
Assign basic return to each entity		
• Entity A	30	
• Entity B	20	
• Entity C	10	60
Residual profit		40
Contribution analysis (based on relative contribution of the entities)		
• Entity A		30
• Entity B		10

Contribution Analysis – Element of subjectivity

Other Method

- Rule 10AB

  "For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction shall be 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."

- Other Method can be used for following transactions
  - Valuation of intangible property
  - Valuation of shares
  - Cost allocation

Notification No. 18 of 2012 dated 23rd May 2012 effective AY 2012-13

Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
CUP	Price	• Similar products • Similar conditions	• Product quality • Contractual terms • Level of market • Intangible property • Transaction date • Foreign Exchange
RPM	Gross Income	• Similar functions • Risk • Contractual terms • Similar product group	• Inventory levels • Turnover rates • Operating expenses • Foreign currency risks • Accounting differences
CPM	Gross Income	• Similar functions • Risk • Contractual terms • Similar product group	• Operating Complexity • Operating expenses • Foreign currency risks • Accounting differences
PSM	Profit	• Functions performed – Routine & non-routine • Value drivers • Industry value indicators • Multiple transactions	

Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
TNMM	Operating Income	• Functions • Asset • Risks	• Asset intensity adjustment • Economic risk adjustment • Accounting differences • Foreign currency risk

Country by Country Reporting (CbCr)

Compliance Documentation 3-tiered approach

Tier 1	**Country-by-country report** • Aggregate tax jurisdiction-wide information • 2 main tables + 1 for additional information • Available to each relevant tax administration / Filing Process to be agreed • To be finalized maximum 1 year following the last day of FY of the Ultimate Parent	Information on the global allocation of income, the taxes paid and certain indicators of the location of economic activity among tax jurisdictions in which the Group operates List of entities per tax jurisdiction
Tier 2	**Master File** • "Blueprint" of the Group as a whole • 5 main categories • Available to each relevant tax administration / Filing Process to be agreed • To be reviewed / updated by the Ultimate Parent tax return due date	Provide an high level overview on Group business, including: • Nature of global business operations; • Overall TP policies
Tier 3	**Local File** • Focus on specific intercompany transactions • 3 main categories • To be delivered directly to local tax administrations • To be finalized no later than the due date for the filing of the local tax return	Provide more detailed information relating to specific intercompany transactions Ensure that the taxpayer has complied with the arm's length principle

Action 13 – Re-examine TP Documentation

Tier 1

(CbC) Template

1. Revenue (3rd party and intercompany)
2. Earnings before taxes
3. Cash tax paid
4. Current tax accrual
5. Capital
6. Retained earnings
7. Tangible assets
8. Number of full time equivalent employees
9. A list of entities and permanent establishments, and activity codes for each entity and permanent establishment

Tier 2

Master file

- Prescribed global level management and transfer pricing management items (transactions, agreements, policies, rulings, unilateral Advance Pricing Agreement (APA)) covering the following areas
  - Major business lines
  - Intangibles
  - Intercompany financing
  - Finance and tax positions
- The Master file may be prepared on a global or product / business line basis

Tier 3

Local file

- Information that has traditionally been contained in entity specific documentation reports
  - Reporting line information
  - Disclosure of transactional amounts
  - Disclosure of financial results
  - Disclosure of unilateral or bilateral APAs potentially relevant to the transaction
  - Reconciliation of transactional amounts to financial results

Thank You