

Computation of Arm's Length Price in Transfer Pricing

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Presentation Outline

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- Arms Length Price Computation – Selection of Most Appropriate Methods
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Introduction

Transfer pricing in a challenging business environment

- Transfer pricing is consistently cited by tax managers/CFOs as their number one tax issue
- The number of countries with transfer pricing rules and documentation requirements has grown
- Aggressive positions being taken by tax authorities lead to risks for MNEs, including:
 - The potential for double taxation
 - Non-deductible penalties and interest
- Currently huge adjustments are being made for share transactions, royalty transactions, marketing intangibles, financial and guarantee transactions

Introduction

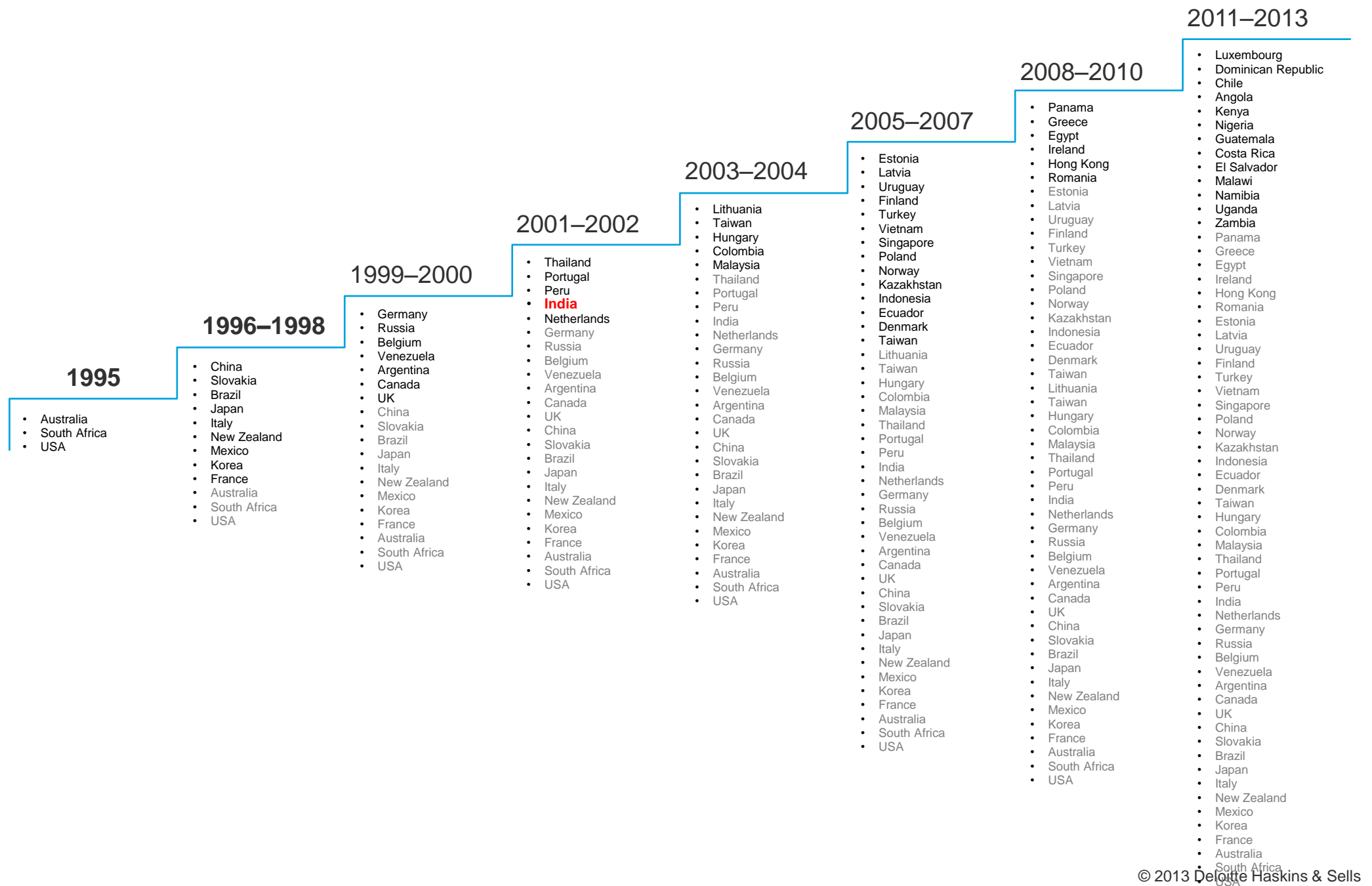
Trend of adjustments over the years

Financial Year	No. of TP Audits Completed	Number of Adjustment Cases	% of Adjustment Cases	Amount of Adjustment (Rs. in Crore)
2004-05	1,061	239	23	1,220
2005-06	1501	337	22	2,287
2006-07	1,768	471	27	3,432
2007-08	219	84	39	1,614
2008-09	1,726	670	39	6,140
2009-10	1,830	813	44	10,908
2010-11	2,301	1,138	49	23,237
2011-12	2,638	1,343	52	44,531
2012-13				80,000 plus crores

TP audit trends indicate greater scrutiny and newer issues, leading to increased adjustments and resultant litigation

Source: White Paper May 2012, Ministry Of Finance, Department Of Revenue

Escalation of Transfer Pricing Regimes and Enforcement



Transfer Pricing Regulations in India

Transfer Pricing Regulations in India

Section & Rules	Provisions
92	Computation of income having regard to ALP
92A	Meaning of Associated Enterprise
92B	Meaning of International transaction
92BA	Meaning of specified domestic transactions
92C (1) (Rule 10B, 10C)	Methods of computation of ALP *Rule 10AB – Any other method for determination of ALP
92CA	Reference to Transfer Pricing Officer (TPO)
92CB	Safe harbour rules
92CC	Advance Pricing agreement
92CD	Effect of advance pricing agreement
92D (Rule 10D)	Maintenance of information and documents by persons entering into an international transaction or specified domestic transaction
92E (Rule 10E, Form 3CEB)	Accountant's Report entering into an international transaction or specified domestic transaction
92F (Rule 10A)	Definitions: Accountant, ALP, Enterprise, PE, Specified date, Transaction *

* **Sec 92F – Definitions does not define terms relevant for domestic TP transactions**

Transfer Pricing Regulations in India

- Transfer pricing regulations are based on the OECD* model with some significant differences, i.e., arm's length range, multiple year analysis
- Adherence to Arm's Length Principle ("ALP")
 - Section 92(1) of the Income Tax Act says "Any income(or expense) arising from an international transaction shall be computed having regard to the arm's length price"
 - **"arm's length price"** means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions
 - Section 92C(1) of the Income Tax Act (read with Rule 10B and 10C)
 - "The arm's length price in relation to an international transaction [or specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method"
 - Indian Transfer Pricing Methods are in sync with OECD's five prescribed methods

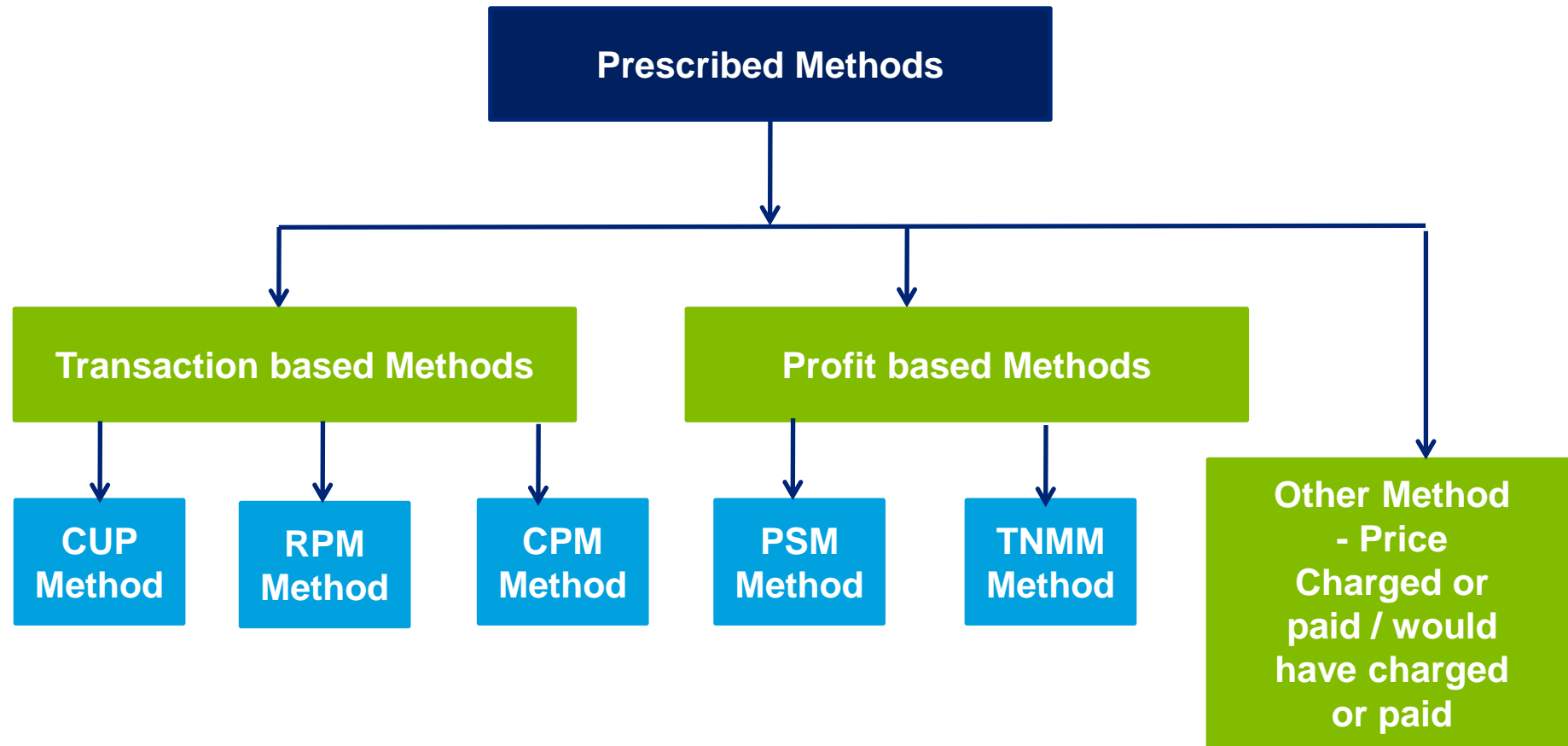
* Organisation of Economic Co-operation and Development

Transfer Pricing Penalty provisions

Sr. No.	Type of penalty	Section	Penalty quantified
1	a) Failure to maintain prescribed information/ documents (b) Failure to report any such transaction or (c) Furnish incorrect information	271AA	2% of transaction value
2	Failure to furnish information/ documents during assessment u/s 92D	271G	2% of transaction value
3	Transfer pricing adjustment–Concealment of income or furnishing inaccurate particulars of income	271(1)(c)	100-300% of amount of tax sought to be evaded on concealment of particulars of income or furnishing inaccurate particulars of such income
4	Failure to furnish accountant's report u/s 92E	271BA	INR 100,000

ALP computation - Overview of Methods

ALP Computation - Overview of Methods



No hierarchy or preference of methods prescribed under the Act

The methods applicable for determining ALP for SDT transactions are same as those for international transactions

Scope of work

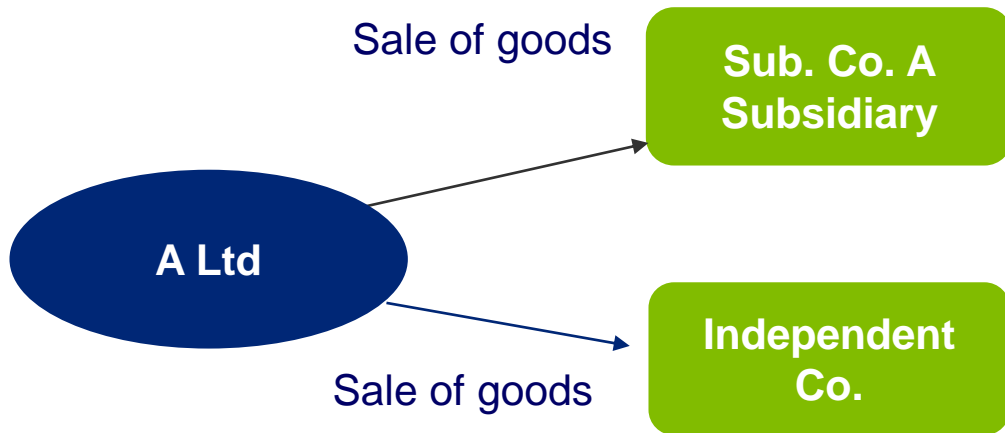
- Comparison of controlled transaction with the uncontrolled transaction(s)
- High degree of comparability of products or services
- Direct and reliable

Comparability Factors

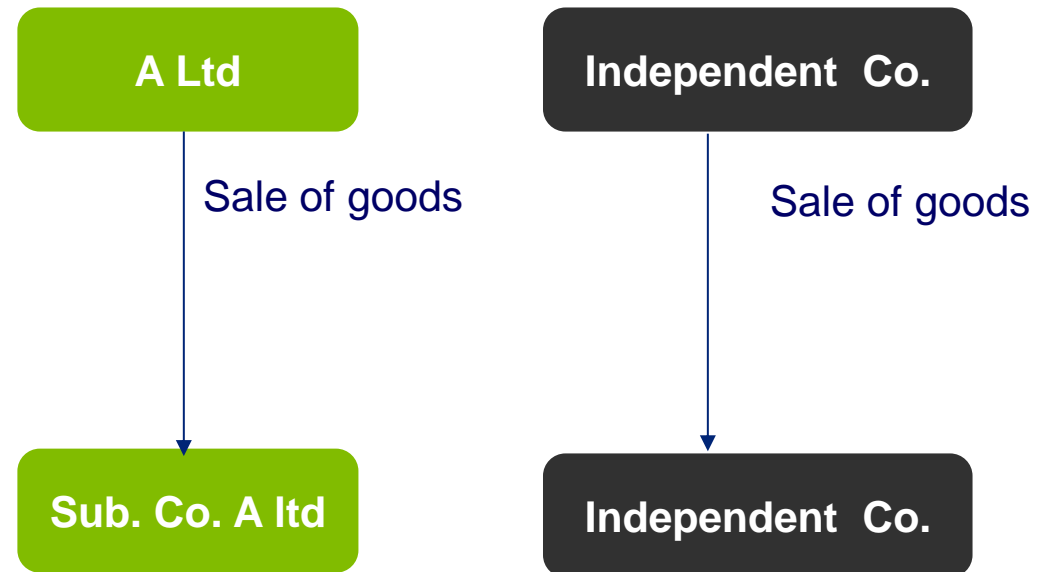
- Similarity of products and services
- Geography of markets
- Functions performed, Assets deployed and Risks borne
- Contractual terms
- Economic Circumstances
- Business strategies

CUP Method - Examples

Internal CUP



External CUP



Similarity of Functions, Asset and Risks ?

Internal CUP is preferable

CUP Method – Practical Perspective

- Due to the increased market volatility and increased complexity in related party transactions it is often difficult to obtain identical transactions under similar facts and circumstances
- Indirect evidences of CUP – Can Industry average data / commodity exchanges / quotations be used ?



Resale Price Method ('RPM')

- 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 – How to arrive at ALP?

Steps

1 Determine the gross profit margin earned in comparable uncontrolled transactions



2 Subtract the appropriate gross margin and expenses from the applicable resale price



3 The remainder will be the arm's length price with the controlled entity

RPM – Example

Facts:

- A Ltd, is a leading manufacturer of laptops selling the laptops only through its related party Sub Co A in India.
- There are no direct sales by A Ltd.,
- Sub Co A , a wholly owned subsidiary of A Ltd, acts as a distributor of the products;
- A Ltd., would supply the warranty replacements free of costs to Sub Co A.
- Sub Co A, also trades in Desktops manufactured by X Ltd., an uncontrolled entity;
- X Ltd also supply the warranty replacements free of costs to Sub Co A.

Particulars	A Ltd. P.U.	X Ltd P.U.
Purchase price by Sub Co A	1000	750
Sale price by Sub Co A in India	1150	950

RPM – Case Study

Particulars		3 rd party transaction	Related party transaction
Sale price of Desktops	(A)	950	1150
Purchase Price from 3 rd 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?

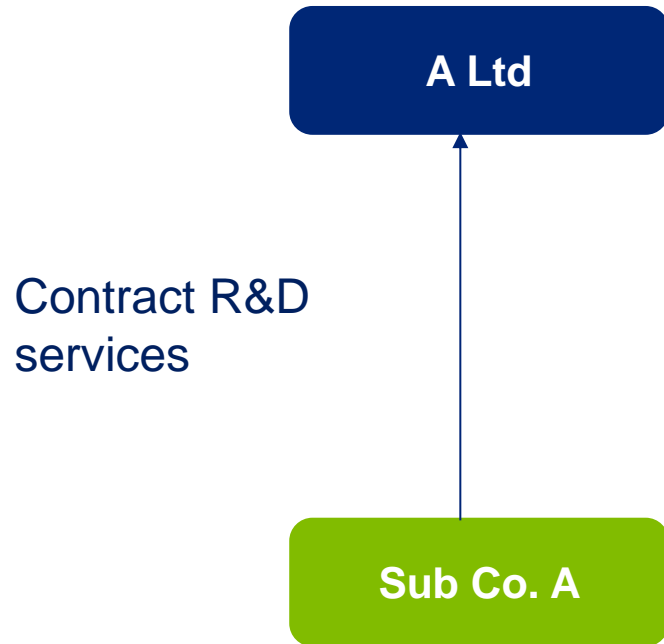
RPM – Practical Perspective

- How to determine Gross Profit margin when no internal comparables are available?
- Tolerant to minor product difference. However, high degree of functional comparability required
- Impact of intangibles to be duly considered

Cost Plus Method ('CPM')

- 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, inter alia, 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

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

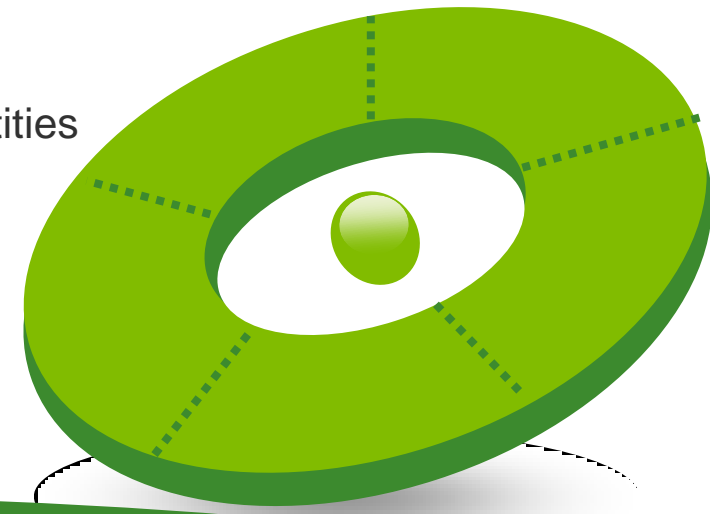
All costs for Research is compensated alongwith mark up

CPM – Practical Perspective

- Inadequate data to compute gross margins accurately. As under Indian GAAP, companies reporting financial statements are not required to compute gross margin separately
- Using total cost plus as PLI under TNMM may be a better approach
- Better applied for comparison with “internal comparable”, due to lack of reliable data

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



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

PSM – Practical Perspective

Typical example of Industries, where PSM can be applied:

- Telecommunications
- Pharmaceuticals
- Courier/logistic

Implementation Issues:

- External market data
- Identification of value drivers
- Measurement of value drivers contributed by each entities in the group
- Assignment of weight to value drivers



Transactional Net Margin Method ('TNMM')

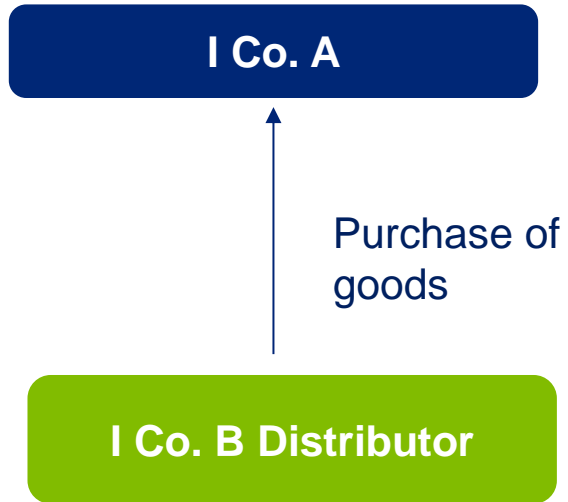
- Most practical and widely used method
- Broad level of similarity of Functions, Assets and Risks
- TNMM can be applied as internal TNMM as well as external TNMM
- Comparison is at net operating margin with the application of appropriate Profit Level Indicators (PLIs)

Profit Level Indicators

Method	PLI	Formula	Typically used for
TNMM	Return on Total Costs	Operating profit / Total Costs	Contract Manufacturer / Toll Manufacturer / Service Provider
	Return on Sales	Operating Profit / Sales	Manufacturer / Distributor
	Return on Assets	Operating Profit / Operating assets	Manufacturer / Asset Intensive business
	Return on Capital Employed	Operating Profit / Capital Employed	Financial Transactions
	Return on Value Added Expenses	Operating Profit / Value Added Expenses	Agents

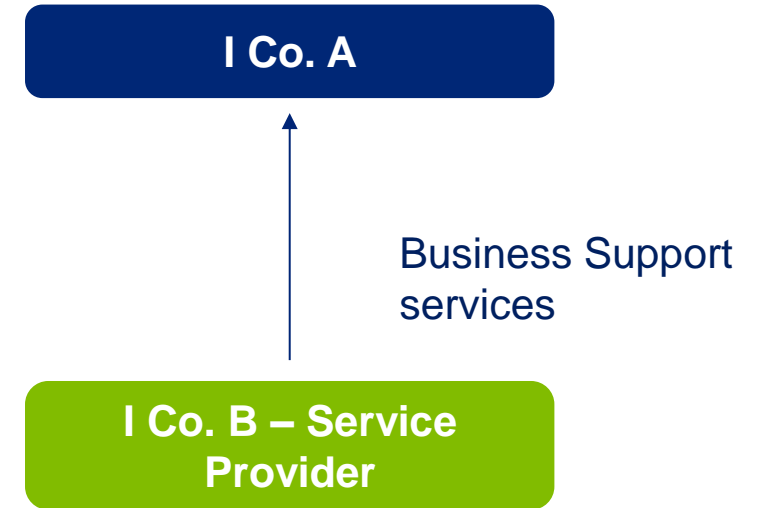
TNMM - Example

PLI of OP / Sales



Particulars		Rs.
Purchase from I Co. A	(A)	800
Sales to 3rd party	(B)	1000
Profit	(C = B - A)	200
OP / Sales		20%

PLI of OP / Cost



Particulars		Rs.
Services provided to I Co. A	(A)	1100
Operating Exps.	(B)	1000
Profit	(C = B - A)	100
OP / TC		10%

TNMM – Example

Segmental – AE and Non AE business

Particulars	AE	Non – AE	Total
Sales	110	100	210
Purchases	85	80	165
Other Administrative Expenses	12	10	22
Operating Profit	13	10	23
OP/Sales	11.81%	10%	10.95%

Comparability when:

- Internal comparability exists - Internal TNMM
- No internal comparability exists - External TNMM

TNMM – Practical Experience

- Net profit margins may be influenced by some factors that have less or no effect on the price or gross margins
- Net profit margins may be affected by varying cost structures, business experience, management efficiency, etc.
- Net margins are less affected by the transactional differences e.g. difference in contractual terms, credit period, etc.
- In absence of applicability of CUP, RPM, CPM and PSM, TNMM is applied



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

- Revenue split
- Valuation of intangible property
- Valuation of shares
- Cost allocation
- Reimbursements

**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	<ul style="list-style-type: none"> • Similar products • Similar conditions 	<ul style="list-style-type: none"> • Product quality • Contractual terms • Level of market • Intangible property • Transaction date • Foreign Exchange
RPM	Gross Income	<ul style="list-style-type: none"> • Similar functions • Risk • Contractual terms • Similar product group 	<ul style="list-style-type: none"> • Inventory levels • Turnover rates • Operating expenses • Foreign currency risks • Accounting differences
CPM	Gross Income	<ul style="list-style-type: none"> • Similar functions • Risk • Contractual terms • Similar product group 	<ul style="list-style-type: none"> • Operating Complexity • Operating expenses • Foreign currency risks • Accounting differences

Transfer Pricing Method – A comparative statement

Method	Measurement Focus	Comparability Requirements	Indicative difference requiring adjustments
TNMM	Operating Income	<ul style="list-style-type: none"> • Functions • Asset • Risks 	<ul style="list-style-type: none"> • Asset intensity adjustment • Economic risk adjustment • Accounting differences • Foreign currency risk
PSM	Profit	<ul style="list-style-type: none"> • Functions performed <ul style="list-style-type: none"> - Routine & non-routine • Value drivers • Industry value indicators • Multiple transactions 	

ALP Computation- Selection of Most Appropriate Method

Selecting the Most Appropriate Method

Rule 10C(1)

- Method which best suits to the facts and circumstances
- Provides the most reliable measures of an ALP
- Transaction wise

Rule 10C(2)

- Due regard to
 - Nature and class of transaction
 - Class or classes of AEs entering into transaction and their FAR analysis
 - Availability, coverage and reliability of data
 - Degree of comparability between controlled and uncontrolled transactions
 - Extent and reliability / accuracy of adjustments
 - Nature, extent and reliability of the assumptions required

Most Appropriate Method – General applicability

Method	Transaction Type
CUP	<ul style="list-style-type: none">• Sale and Purchase of goods and services• Guarantee fees• Loans• Royalties• Commission
RPM	Distributor
CPM	Sale of finished / semi-finished goods or services
PSM	Transactions which are interrelated and involve more than one enterprise or involves valuable intangibles <ul style="list-style-type: none">• Joint Research and Development• Development of joint Intellectual Property Rights• Certain Financial Transactions
TNMM	<ul style="list-style-type: none">• Manufacture / distribution of finished goods• Provision of services

Benefit of +/- 3%

Old Provision (Applicable prior to amendment by Finance Act 2009)

“Provision that where more than one price is determined by the Most appropriate method, the ALP shall be taken to be the arithmetical mean of such prices, or at the option of the assessee, a price which may vary from arithmetical mean by an amount not exceeding five percent of such arithmetical mean.”

Amendment made by Finance Act 2011

(w.e.f. 1-4-2012)

“Provided further that if the variation between the ALP so determined and the price at which the international transaction has actually been undertaken does not exceed **such percentage** of the latter, as may be notified by the Central Government in the official gazette in this behalf, the price at which the international transaction has actually been undertaken shall be deemed to be the ALP”

Amendment made by Finance Act 2012

(w.e.f. 1-4-2013)

The percentage notified for the said purpose is three percent



Microsoft Excel
Worksheet

Any Questions?