Method of Computation

Transactional Net Margin Method and Profit Split Method

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Contents

Arm’s Length Price

Definition

- Price applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions

Section 92C of Indian Income-tax Act, 1961

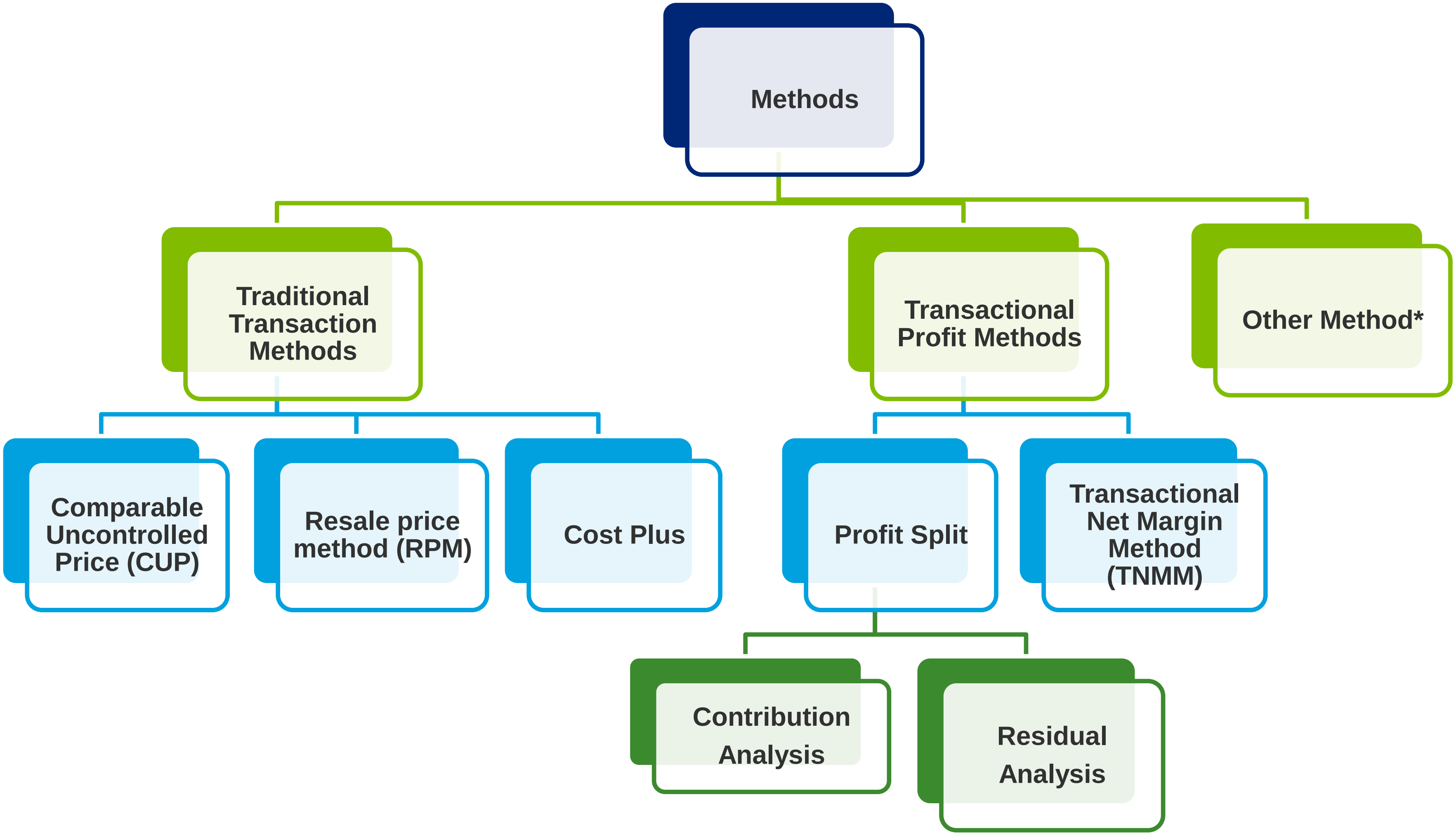
Set out Various Methods for “Arm’s Length Price”

Rule 10B of Indian Income-tax Rules, 1962

* The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations also set out various methods for establishing the <u>arm’s length price</u>

Selection of TP methods

Transfer Pricing Methods Overview



*The CBDT vide Notification No. 18/2012 has prescribed the application of the sixth method named as "Other Method" for computation of arm's length price. (Rule 10AB of the Income-tax Rules, 1962)

Transactional Net Margin Method (TNMM)

TNMM

Meaning

- Examines the net profit margin relative to an appropriate base that a taxpayer realizes from a controlled transaction
  - Costs
  - Sales
  - Assets
  - Other relevant base
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method / cost plus method / resale price method
- Broad level of product comparability and high level of functional comparability

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

TNMM
Strengths & Weaknesses (1/2)

Strengths

- Applicable for any type of transaction
- Often used to supplement analysis under other methods
- Net margins are more tolerant to some functional differences
- Classification of expenses in the gross margin frequently makes it difficult to evaluate the comparability of gross margins; use of net margins may avoid the problem
- Practical solution to otherwise insoluble transfer pricing problems

TNMM
Strengths & Weaknesses (2/2)

Weakness

- Net margin of a tax payer can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect on price or gross margins. (e.g. age of plant & equipment, self financing vs. borrowing, degree of business experience, management efficiency)
- Application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits

Potential inaccuracies to some extent can be mitigated by application of arm's length range concept

TNMM
Steps involved in application (1/3)

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 – Indian entity vs foreign entity
- Availability of appropriate data
- Does not own valuable intangibles that contribute to the generation of profits

Benchmarking exercise

- Search in local databases i.e. Prowess and Capitaline or foreign databases i.e. AMADEUS (PAN European), Compustat (North American), etc
- Select entities with similar industry classification to the tested party
- 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

TNMM
Steps involved in application (2/3)

Profit Level Indicators (‘PLI’)

PLI	Formula	Typically used for
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
Steps involved in application (3/3)

Adjustments

- Exclude non-operating income and expenses
- Working Capital Adjustment – Inventory, Receivables and Payables
- Risk adjustment, capacity utilization adjustment, etc.
- Accounting adjustment – e.g. depreciation adjustment, adjustment for customs duty
- Start-up costs / termination costs

Computation of ALP

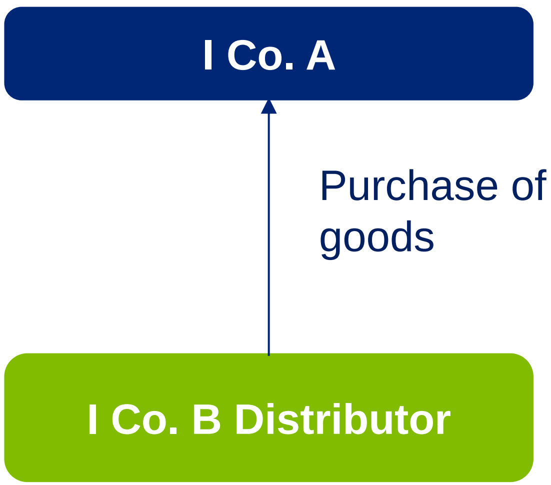
- Usage of single year data / multiple year data
- Computation of arithmetic mean
- Use of +/- range (1% in case of wholesale traders and 3% in case of others as notified by Central Government in April, 2013)

Product comparability vs functional comparability

Case Studies on application of TNMM

Case Studies

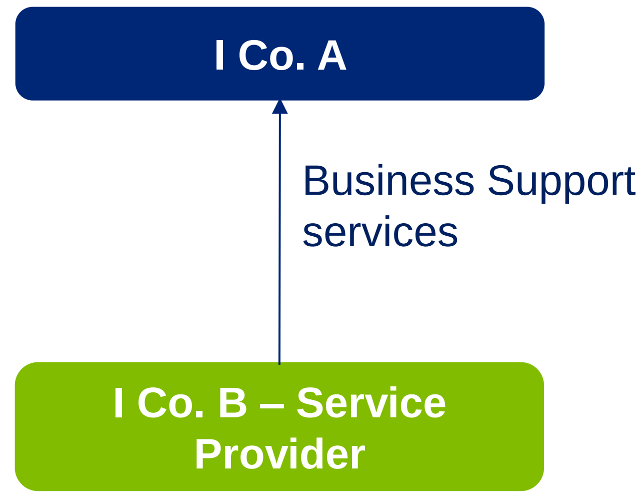
Case 1:



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%

Case 2 :



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%

Case Studies
Case 3

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

Experiences and Judicial Rulings in India

Judicial Rulings (1/3)

Issues

- TPOs prefer for CUP – first internal then external
- TNMM is the most common method followed – basically mixture of TNMM and Cost Plus Method
- Aggregation approach followed
- For trading company – RPM vs. TNMM

Ruling	Observations / Conclusions
Philips Software (Bangalore SB)	Where no infirmity exists in the TP study conducted by the taxpayer, the TPO cannot disregard the same.
MSS India (Pune Tribunal)	• Revenue cannot arbitrarily reject the method adopted by the taxpayer without providing detailed reasons for such rejection, • Factors laid down in the Rule 10C to be followed for selection of the most appropriate method.
UCB Ruling (Mumbai Tribunal)	CUP method requires a high degree of comparability with regard to quality, contractual terms, level of market, geography involved, date of transaction, intangible property, foreign currency and alternatives available with buyer and seller.
M/s Super Diamonds (Mumbai Tribunal)	In absence of sufficient details regarding comparability, quality and quantity of diamonds procured by the assessee from AE and Non-AEs, CUP method cannot be accepted.

Judicial Rulings (2/3)

Ruling	Observations / Conclusions
Kodak Polychrome Graphics (Mumbai Tribunal)	The basic tenet of the TP mechanism is to determine the most appropriate method for determination of ALP. Assessee has the initial burden of demonstrating as to which method is most appropriate for benchmarking of its transactions and of justifying that it is at ALP.
Genisys Integrating System (Bangalore Tribunal)	Internal TNMM preferred over external TNMM where similar services provided to AE and non-AE and reliable internal data available.
L'Oreal India (Mumbai Tribunal)	• Use of Resale Price Method upheld over TNMM where assessee bought products from AE and resold them without further processing, • There is no order of priority of methods to determine ALP.
Arvind Mills Ltd. (Ahmedabad Tribunal)	While applying CUP the comparability between controlled and uncontrolled transactions should not be only judged from the point of product comparability, but should also take into consideration the effect on price of other broader business functions. Comparability under this method depends on close similarities with respect to various factors. (eg. differences in contractual terms or economic conditions, geographical areas, risks assumed, functions assumed, etc.).
CISCO Systems (Bangalore Tribunal)	When the assessee cannot be held to be a trader or distributor of the spare parts, it is clear that the resale price method is not applicable for arriving at the ALP of the international transactions. TNMM applicable where no other method applicable.
J.P.Morgan India (Mumbai Tribunal)	If comparable price data is available and differences in FAR profile of taxpayer's transactions with AEs versus its transactions with third parties can be quantified, the CUP method should be preferred over the TNMM.

Judicial Rulings (3/3)

Issue	Ruling	Observations / Conclusions
Working capital adjustment	**Avineon India P. Ltd. (TS-165-ITAT-2014(HYD)-TP)**	ITAT held that working capital adjustment necessary for adequate comparability
	Ariston Thermo India Limited (TS-221-ITAT-2013(PUN)-TP)	ITAT allowed capacity adjustment while working out tested party margin
Risk Adjustment	**D.E. Shaw India Software (P) Ltd. (TS-315-ITAT-2014(HYD)-TP)**	ITAT relied on assessee's own case for AY 2007-08 [TS-348-ITAT-2013(HYD)-TP] and observed that CIT(A) had analysed the issue in detail and ITAT confirmed CIT(A) order granting risk adjustment at 1%. Thus, the ITAT in the current year, upheld the risk adjustment.
Aggregation of transactions	**Essar Steel Ltd. (TS-278-ITAT-2014(Mum)-TP)**	ITAT upheld aggregation of sales transactions to AE, deletes TP addition
	Star India P. Ltd (TS-18-ITAT-2008(Mum)	ITAT held that ALP not to be determined by clubbing different international transactions

Some experiences involving application of TNMM

- Use of foreign tested party not accepted
- High mark-ups for captive service providers (ITES/BPO industry)
- Business reasons for losses not easily accepted
- Regulations do not prohibit foreign comparables
- However local comparables are preferred
- Multiple year data vs. tax year data
- Regulations permit 2 additional years, provided they have influence on determination of transfer prices
- Lesser emphasis on economic factors/business strategies
- start up phase, market penetration, excess capacity etc.
- Business strategies require strong documentation
- Entrepreneurial risk, start up phase, market penetration, excess capacity, etc
- Use of secret comparable
- Transfer Pricing adjustment on whole entity including to unrelated portion
- Mark-up on pass through costs

Profit Split Method (PSM)

PSM
Indian Transfer Pricing Rules (1/ 2)

Rule 10 (d):

Profit split method, which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which-

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

(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;

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

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

PSM
Indian Transfer Pricing Rules (2/2)

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 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;

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

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

PSM
Strengths

- Both parties to the transaction are tested
- Two sided approach – Used to achieve division of profits from economies of scale or other joint venture efficiencies
- Allocation based on division of functions
- Flexibility taking into account specific facts and circumstances that are not present in independent enterprises
- Less probability of extreme profit split since both parties to the transaction are evaluated
- May be appropriate in cases where application of method is agreed both by the taxpayer and the tax administration

PSM
Weakness (1/2)

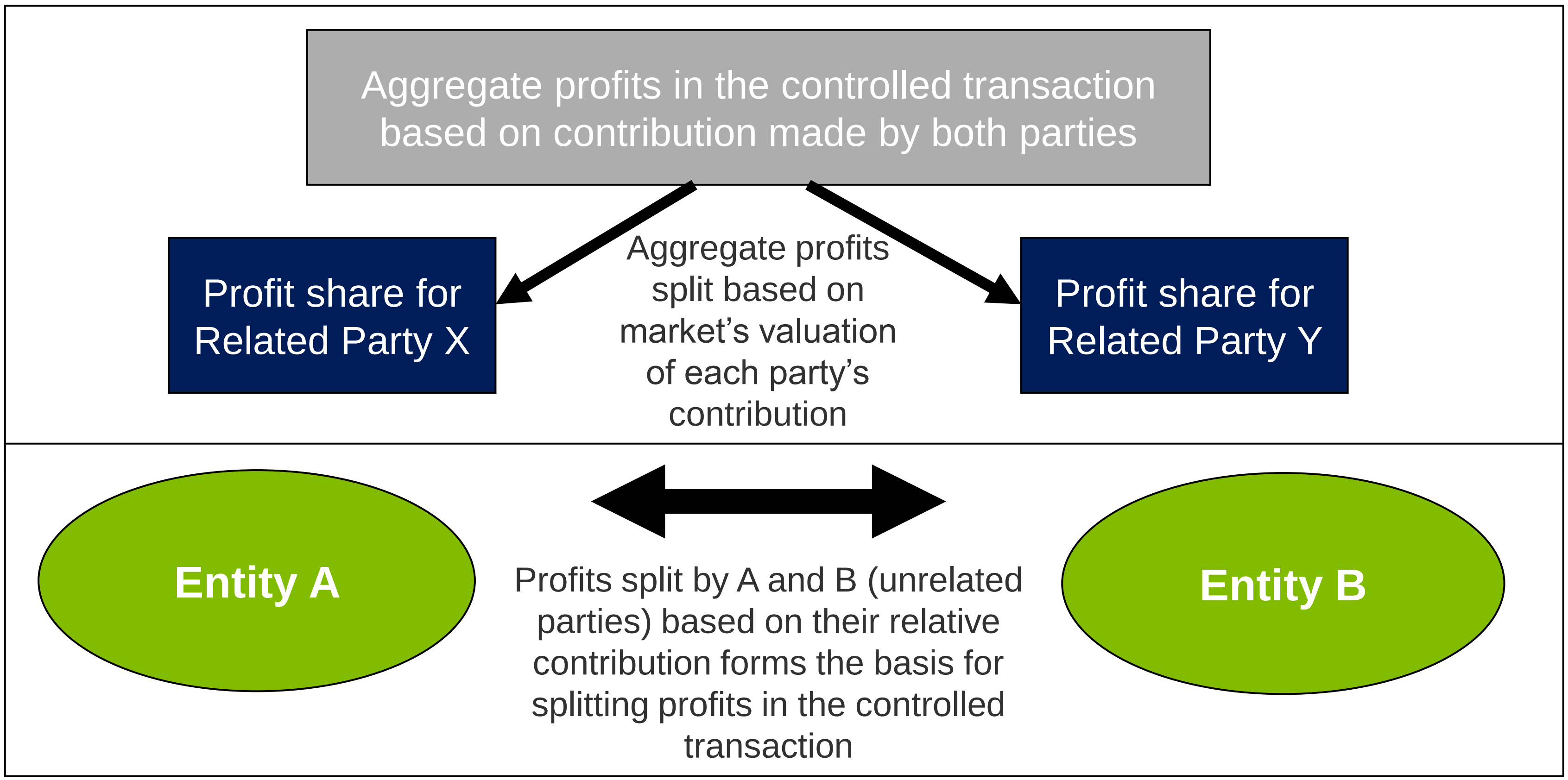
- External data considered to value contribution of enterprises may be less closely connected to those transaction than in case of other methods
- Difficult to identify profit and contribution of each party (require comparables)
- High level of analysis and benchmarking required (very complex)
- Difficult to access information from foreign affiliates
- Difficult to measure combined revenue and costs for all the associated enterprises since this would require stating books and records on a common basis and currencies
- If applied to operating profit, it is difficult to identify appropriate operating expenses associated with transaction and allocate costs

PSM
Weakness (2/2)

- External data considered to value contribution of enterprises may be less closely connected to those transaction than in case of other methods
- At present the transfer pricing guidelines do not provide much guidance on determining the combined profit to be split
- There are issues relating to accounting standards and issues on whether to select net, operating or gross profits
- The accounts of the parties must be brought onto a common basis in relation to accounting practice and to currency and then combined
- How to measure the profits depends on the facts of the case and the comparability and functional analysis of the controlled transactions. The choice may also be dependent on the availability of comparable external data

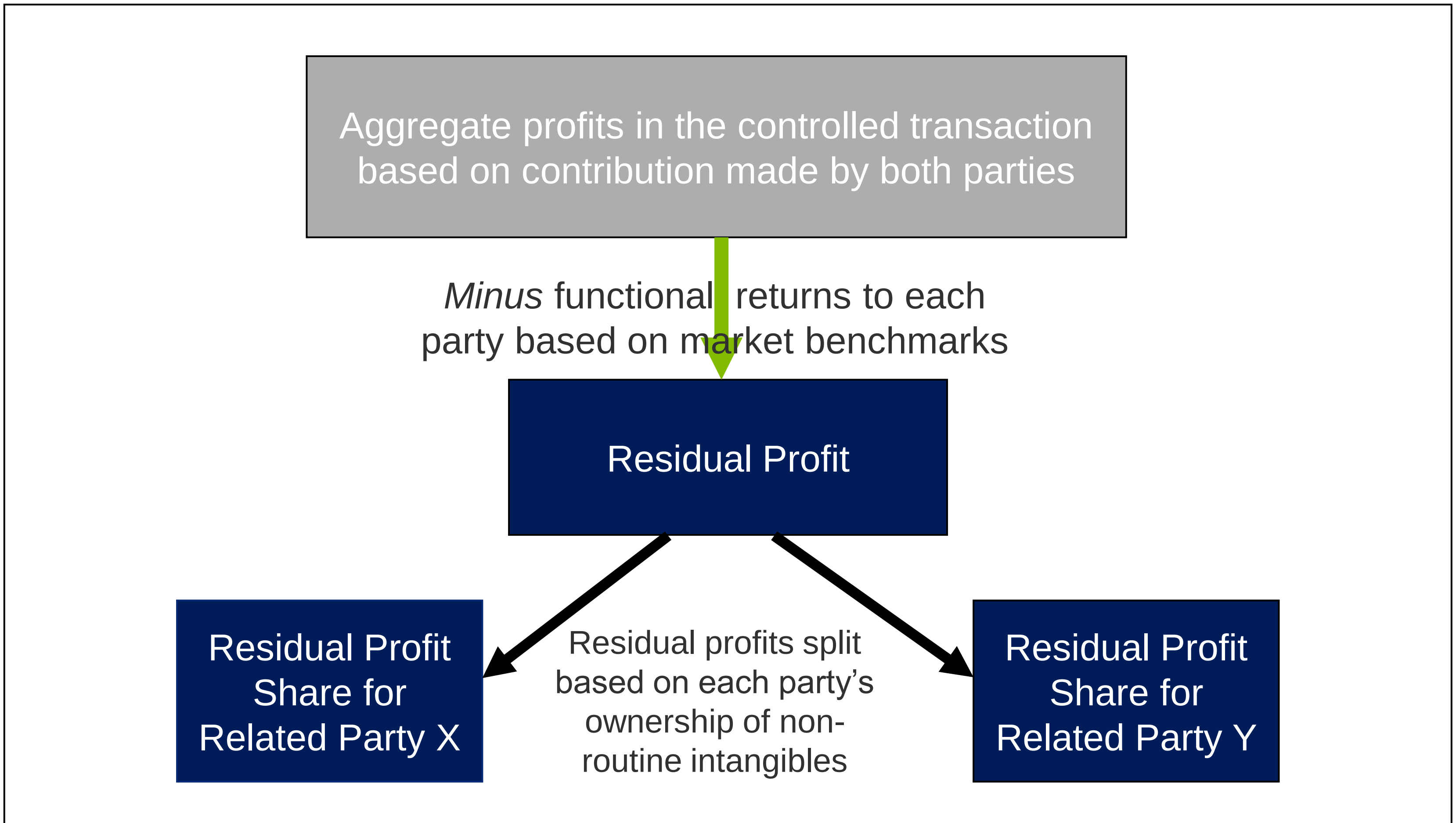
PSM
Application

Forms of the PSM: Comparable Profit Split Method (or the "Contribution" method)



PSM
Application

Forms of the PSM: Residual Profit Split Method ('RPSM')



PSM
Application

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

Case Studies on application of PSM

PSM
Case 1 :

Consider a pharmaceutical company with operations in two countries, A and B, with the functions spread across the two countries as follows:

COUNTRY A

- Develops innovative compounds and post sales clinical trials using feedback from Country B sub.
- Performs primary manufacturing.
- Renders HQ services.

COUNTRY B

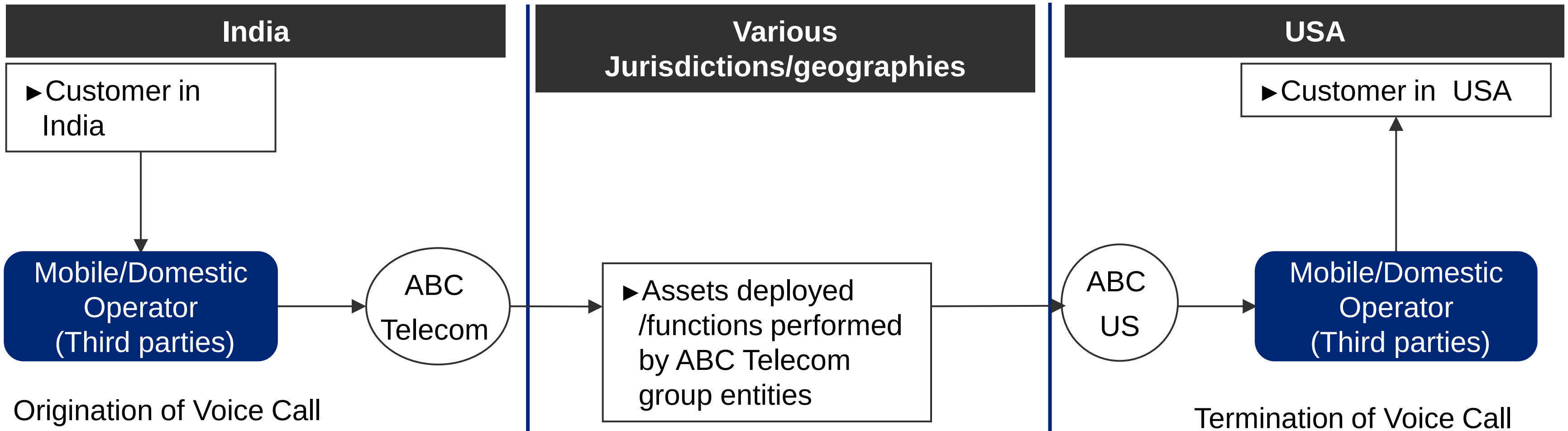
- Develops worldwide marketing strategy
- Performs secondary manufacturing
- Packages the products Sells and Distributes
- Collects post sales reports and sends to R&D team for continuing research

PSM
Case 1 :

- How do you set up appropriate transfer prices?
- Note that both the entities are legitimately entitled to profits due to their respective intangible creating activities
  - Entity in A does creative R&D (but gets input from entity in B)
  - Entity in B creates valuable marketing intangibles and provides secondary input to ongoing R&D
- One approach may be to assign each firm a suitable return for their “routine” functions and then split the remaining aggregate profits based upon each entity’s contribution (i.e. ownership) to the “non-routine” intangibles

PSM

Case 2 : International voice transmission



ABC Telecom will receive the call from MNO/Domestic Carrier on its network to carry the same and terminate it to a person in US

ABC US receives the call and terminates it on the network of MNO/Domestic Carrier which will carry the call to Customer in US.

India	Various Jurisdictions/geographies	USA
F Selling & Marketing efforts, Contracting with Mobile co in India.	F Network & Operations, General & Administrative	F Selling & Marketing efforts; Contracting with Mobile co in US
A Landing station, switches and cables within territorial jurisdiction of India	A Landing station, switches and cables within territorial jurisdictions of Group entities	A Landing station, switches and cables within territorial jurisdiction of US
R Investment risk, market risk, Exchange Risk	R Investment risk, market risk	R Investment risk, market risk, Exchange Risk

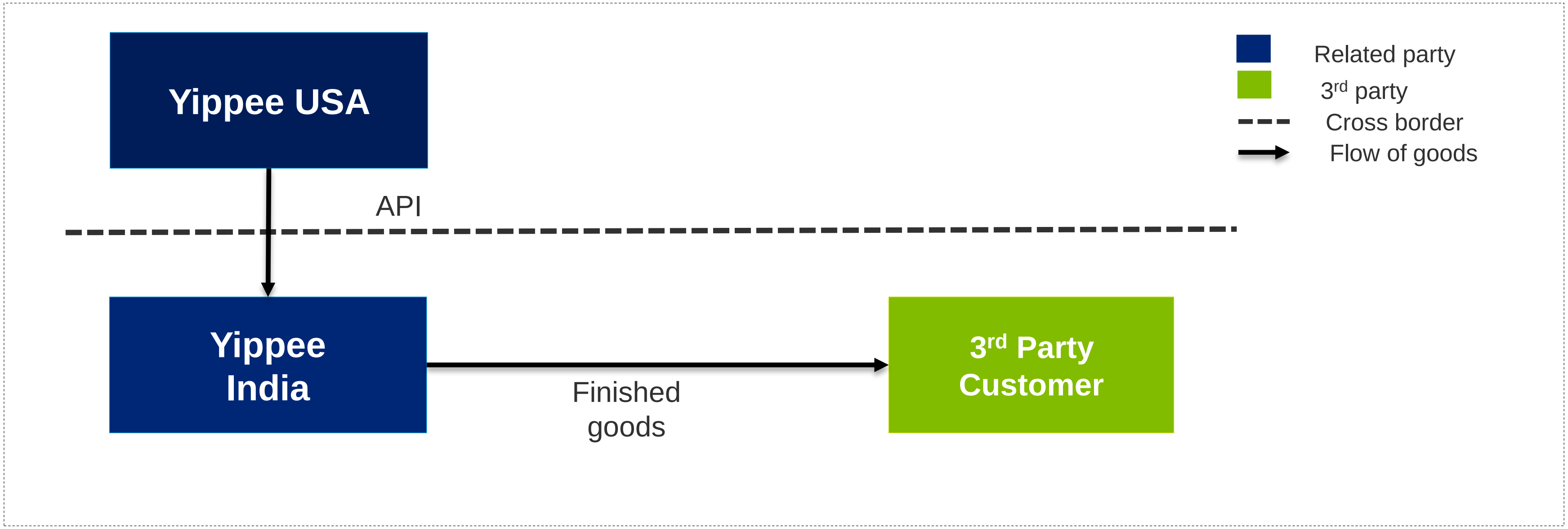
F: Functions, A: Assets, R: Risks

PSM

Case 3 :

- Yippee is US based pharmaceutical company that specializes in developing anti depressants.
- Yippee USA has a wholly owned subsidiary located in India.
- Yippee USA is in the business of core R&D and manufacturing of pharmaceutical ingredients (“API”) for anti depressants.
- Yippee India performs R&D activity for secondary manufacturing process of these API and sells finished products to 3rd party customers in India.

Covered Transaction



Judicial Rulings

Ruling	Observations / Conclusions
Global One India P. Ltd.	ITAT : Upholds PSM over TNMM; Adopts residual profit benchmarking considering each entity's contribution
Net Freight (India) Pvt. Ltd.	ITAT : Explains 'Contribution & Residual PSM' application, rejects TNMM
DHL Danzas Lemuir P. Ltd.	ITAT : Sharing of 50:50 revenues justified for logistics provider whose FAR similar to AEs

Any Questions?

Reference materials

- **Income Tax Act, 1961**

  http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx

- **Income Tax Rules, 1962**

  http://law.incometaxindia.gov.in/DIT/income-tax-rules.aspx

- **ICAI Guidance notes**

  http://www.icai.org/new_post.html?post_id=501&c_id=222

- **OECD Guidelines**
- **Transfer Pricing Law and Practice in India – By Deloitte and CCH**
- **Judicial Rulings**

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