Transfer Pricing Methods of determination of Arm's Length Price

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My special thanks to ICAI – I have based major part of my preparation on the Guidance Note on Transfer Pricing Report U/s 92E - 2013 edition

1) Method as per 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.

2) Method as per Rule 10B

1. Comparable Uncontrolled Price Method
2. Cost Plus Method
3. Resale Price Method
4. Profit Split Method
5. Transactional Net Marginal Method
6. Any Other Method Prescribed by CBDT

	Typical Transactions	When is it reliable?
CUP Method	Transfer of goods, provision of services, Intangibles, Interest on loans	Where an independent enterprise sells the same product as is sold between two associated enterprises.
Resale Price Method	Distribution of goods involving little or no value addition	Where it is realized within a short time of the reseller's purchase of the goods.
Cost Plus Method	Provision of services, joint facility arrangements, transfer of semi-finished goods, long term buying and selling arrangements	Contract Manufacturer or Service Provider

Profit Split Method	-Integrated services provided by more than one enterprise (e.g. in case of financial service sector, where the activities performed by Indian co. and foreign AEs in relation of a merger and acquisition transaction are so interrelated that it may not be possible to segregate them. -Transfer of Unique intangibles, (e.g. two associated enterprise contribute their respective intangibles to develop a new product or process and earn income from such product or process.	

Transactional Net Margin Method	Provision of services , Distribution of finished products where resale price method cannot be applied, transfer of semi finished goods where cost plus method cannot be applied, transaction involving intangibles where profit split method cannot be applied.	
Other Method	Rule 10AB	

Method – Applicability –Basis for ALP Determination

Method	Applicability	Basis of ALP Determination
CUP	CUP method can be applied where reliable data of similar uncontrolled transaction between two unrelated parties or between party is available.	Price
RPM	Where an enterprise purchases goods or services from a related party and sells them to unrelated parties without adding any substantial values to the product	Gross Profit Margins
CPM	Where there is transfer of semi finished goods between related parties or in case of services	Gross Profit /Direct& indirect cost of Production
PSM	In case of transfer of unique intangibles or in multiple inter related transaction which can not be evaluated separately for determining the arms length price	Operating Profit Margin
TNMM	when all other methods for determining alp fails and reliable comparable data with broad functional similarity is available	Operating Profit Margin – to OR/OC/Assets employed Variant cash profit to … Berry's
Methods as per rule 10AB	Where the price which would be charged for similar transaction between parties is available .	Such "would be Price"

Transactional Net Margin Method

- the net profit margin realised by the enterprise from an international 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;

- 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;

- 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 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;

Transactional Net Margin Method

- 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);

- 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.

Selection of Profit Level Indicator

- TNMM essentially compares Enterprise level profitability from operations
- There are few variant
  - Operating Profits to Operating Revenue
  - Operating Profits to Operating Cost
  - Cash Profits to Operating Revenue
  - Cash Profits to Operating Cost
  - Profit to operating Expenses- Berry Ratio

Selection of Profit Level Indicator-2

- The denominator should also be focused on relevant indicator(s) as demonstrated by functional analysis
- The denominator should be reasonably independent of the controlled transaction
- Denominator should be one that is capable of being measured in a reasonably reliable and consistent manner at the level of the taxpayer's controlled transaction

When Major Revenue comes from AE – OP/OC or CP/OC
When Major Purchases come from AE – OP/OR or CP/OR

Tested Party

- Tested party concept is not in Indian IT Law but is found in US law and also recognized in OECD- well accepted or used in Indian TP evaluations
- TESTED PARTY is the one out of the 2 AE which
  - is least complex (functionally)
  - should have reliable data which requires fewest and more reliable adjustments
  - should own none or fewer intangibles
- Following decision are against Foreign AE to be taken as tested party- however , the decisions should be read in the light of FACTS of the case.
  - Onward Technologies Ltd. 7985/Mum/2010
  - Aurinopro Solutions 7872/Mum/2010
  - Global Vantedge 37 SOT 1 (Delhi)

Methods Vs Tested Parties

Methods	Tested parties
Cost plus method	The tested party is a seller (often a manufacturer or service Provider) and the tested financial indicator is the markup on the costs of seller.
Resale price method	The tested party is the buyer(often a distributer) and the tested financial indicator is the resale margin (i.e. gross margin)
Transactional Net Margin method	The tested party can be either the seller or the buyer. In the former case, the tested financial indicator is generally the net profit on costs or the net profit on assets. In the latter case, the tested financial indicator is generally the net profit on sales.
Transactional Profit Split method	Both parties to the transaction are tested. For this reason, the transactional profit split method is often referred to as a “two-sided method”, while the cost plus, resale price and TNMM are referred to as “one-sided methods”. What is being tested in a transactional profit split is the division of profits between the parties

Data bases available in public domain

- India
  - Prowess
  - Capitaline Plus
  - Ace TP
  - Also Naascom Data can be used for Software Sector
- Widely used foreign Data Base in India.
  - Onesource (North American Region)
  - Edger Stat

After identifying the comparable companies- it is advisable to download Annual Reports.

Normal Filters applied

- Activities (Business)
- Turnover
- Export/Import
- RPT (Related Party Transactions)
- R & D Activities/ Expenditure
- Loss making
- Extreme High/ Low Profitability

Normal Adjustment Made in PLI

- Capacity Utilization
- Working Capital
  - Inventory
  - Book Debts
- Abnormal Exchange Rate Fluctuations (Honda Trading Corp- ITA No. 5297/Del/2011)
- FAR based

There are quite few decision in favour and against- facts of cases play very important role in the decision.

Illustration: TNMM

AE1 Ltd., is an Indian company.

AE1 Ltd., manufactures compact disc (CD) writers and sells the same to AE2
Ltd., which is an associated enterprise of AE1 Ltd.

As AE1 Ltd., does not have similar transaction with a non AE, no internal CUT is available. As AE1 Ltd., does not have information and data to identify a comparable company, it has used the databases in public domain for carrying out the search, and selected company : Z Ltd.

The comparison between AE1 Ltd., and Z Ltd., is carried out as follows:

Financials	AE1 Ltd (Rs in Crores)	Z Ltd. (Rs. In Crores)
Sales	130	200
Other income	5	10
Total Income	135	210
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Loss on sale of undertaking	5	0
Expenses relating to non operating income	1	3
Total expenditure	106	142
Net profits	24	58

Operating Margin	AE1 Ltd (Rs in Crores)	Z Ltd. (Rs. In Crores)
Sales	130	200
Gross revenue	130	200
Operating expenses	85	120
Interest	5	7
Depreciation	10	12
Total operating cost	100	139
Operating profit	30.00	61.00
Operating margin (before intt. and depreciation)	52.94	66.67
Operating margin (after depreciation but before interest)	36.84	51.52

In this example following enterprise level differences could be visualized:

Working Capital	There may be differences in stock holding, debtors & creditors. Appropriate adjustment to eliminate the impact of above difference may be made by taking the prevailing interest rate. However, in this example, it is assumed that the difference in WC is not significant requiring any adjustment.
Cost of Capital	There may be difference in the manner of funding such as equity, preference, debenture, inter corporate loans etc. In order that such difference does not impact the net profit, the operating margin on operating cost before interest is taken as profit level indicator

Assets Employed	There may be difference in assets employed and the method of providing depreciation. In order that such difference does not impact the net profit, the operating margin on operating cost before depreciation is taken as profit level indicator
Cost of Capital	There may be a difference in the customer/ revenue model of the assessee vis-à-vis the comparables. For example, the comparables identified may be entrepreneurs bearing the market risks of business volume, customer continuity, etc and the assessee's international transaction is in the nature of captive service provider or contract manufacturer with assured volumes and/or assured compensation and/or assured business period, etc. Such differences may be eliminated by making appropriate adjustment for low-risk or risk free business.

Computation of arm’s length price under the transactional net margin method

	%
Net profit margin of Z Ltd. - i.e. operating margin on cost before interest and after depreciation.	51.52
Adjustments for transaction level differences.	0.00
Arm's length net profit margin.	51.52

	Rs.
Operating costs before interest and after depreciation	95.00
Arm's length sale revenue	143.94
Actual sales	130.00
Income increases by	13.94

Method as per 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.

The introduction of the Other Method as the sixth method allows the use of “any method” which would take into account:

(i) the price which has been charged or paid or

(ii) would have been charged or paid for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all relevant facts.

Rule

Does not describe any ETHODOLOGY

Only provides an ENABLING PROVISION to use any method.

The various data which may possibly be used for comparability purpose could be:

(a) Third party quotations;

(b) Valuation reports;

(c) Tender/Bid documents;

(d) Documents relating to the negotiations;

(e) Standard rate cards;

(f) Commercial & economic business models; etc.

(g) Comparable events within or outside the entity

Why "Other Method" may be needed?

The application of five methods may not be possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as :

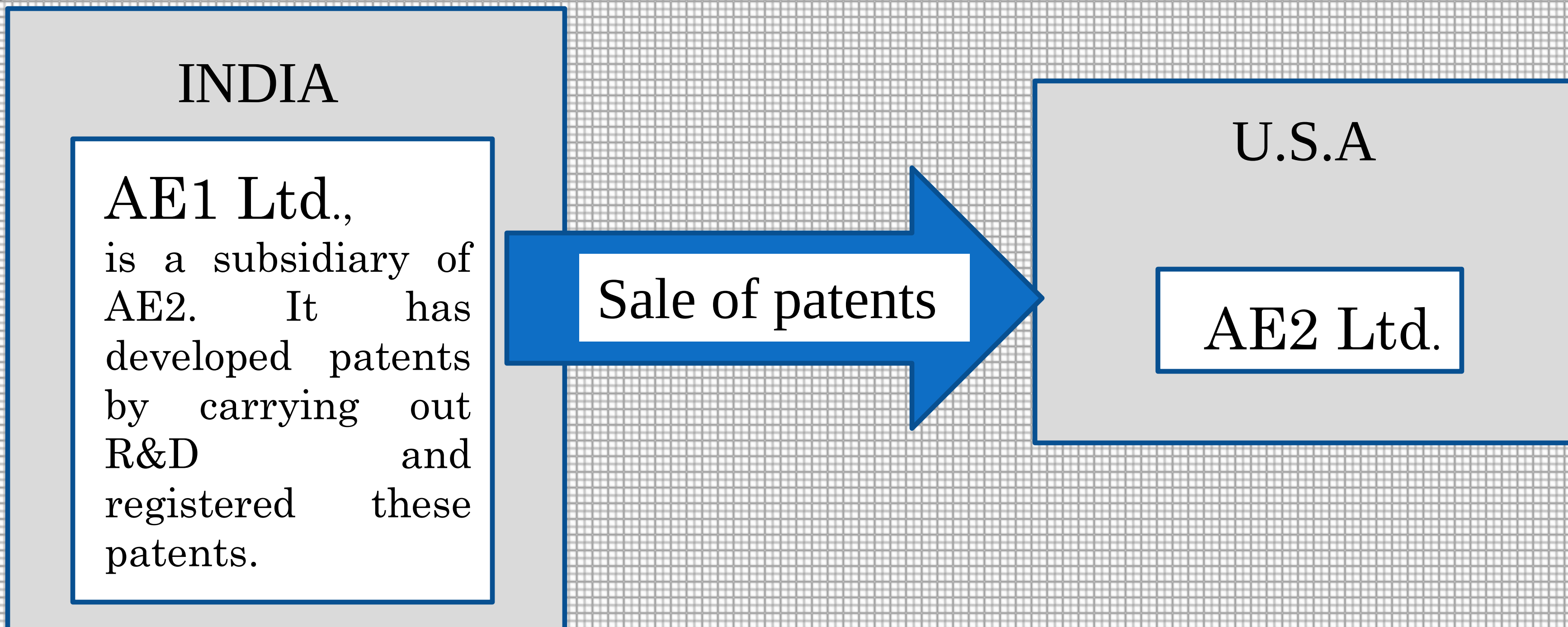
- Intangibles or business transfers
- Transfer of unlisted shares
- Sale of fixed assets
- Revenue allocating/splitting
- Guarantees provided and received etc.

But before opting for "other method"…

•It would be necessary to justify and document reasons for rejection of all other five methods while selecting the 'Other Method' as the most appropriate method.

•The OECD Guidelines also permit the use of any other method and state that the taxpayer retain the freedom to apply methods not described in OECD Guidelines to establish prices, provided those prices satisfy the arm's length principle.

Illustration A



- AE1 Ltd., has sold its registered patents to AE2 Ltd., for Rs. 50 Crores. The price has been determined based on valuation report obtained from an independent valuer.
- The sale of patents is a UNIQUE TRANSACTION and AE1 or AE2 has not entered into similar transaction with third parties and hence no internal or external CUP is available.
- AE1 Ltd., may select the Other Method as the most appropriate method and use the independent valuation report for comparability purposes.

Illustration B

•An Indian Company (I Co) buys back its equity shares issued to its foreign associated enterprise (AE Co).

•I Co obtains a valuation report from an external firm identifying the fair market value of these shares. I Co purchases the shares at the value determined in the valuation report.

•This value denotes a price that would have been charged if a third party would have bought the same shares.

•Hence, I Co could use Rule 10AB and rely upon the valuation report to demonstrate this transaction to be arm's length

Illustration C

•Another example where this method could be used is in cases of cost allocation arrangements where a taxpayer benefits from certain services provided by a central entity of the group and has to pay a portion of the total cost incurred by the service provider.

•These costs are generally allocated on the basis of allocation keys like headcount, time spent, revenues etc. and a third party outside the group may not have the capability to provide identical services.

•Hence, in the absence of comparable prices or transactions, Rule 10AB may be applied and the cost allocation arrangement could be justified appropriately.

Illustration D

- Managing Director is given an increase in Remuneration
- History of assessment states that his remuneration has been considered to be reasonable
- Data relating to % increase in the remuneration of senior level employees of the company shows that the average rise is 15%
- The increase in the remuneration to MD is also 15%
- In absence of any other reliable data, the data of increment to other employees can be justified as `any other method' under Rule 10AB

Thank You