Transfer Pricing Methods

Comparable Uncontrolled Price (CUP) & Resale Price Method (RPM)

WIRC

21stJune 2013

Agenda

- Overview of applicability of Transfer Pricing provision and Methods
- **Comparable Uncontrolled Price (CUP) Method:**
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  - Types of CUP and examples
  - Key Aspects and Adjustments
  - Constraints in application
  - Indian Judicial Corner – important cases
- **Resale Price Method (RPM):**
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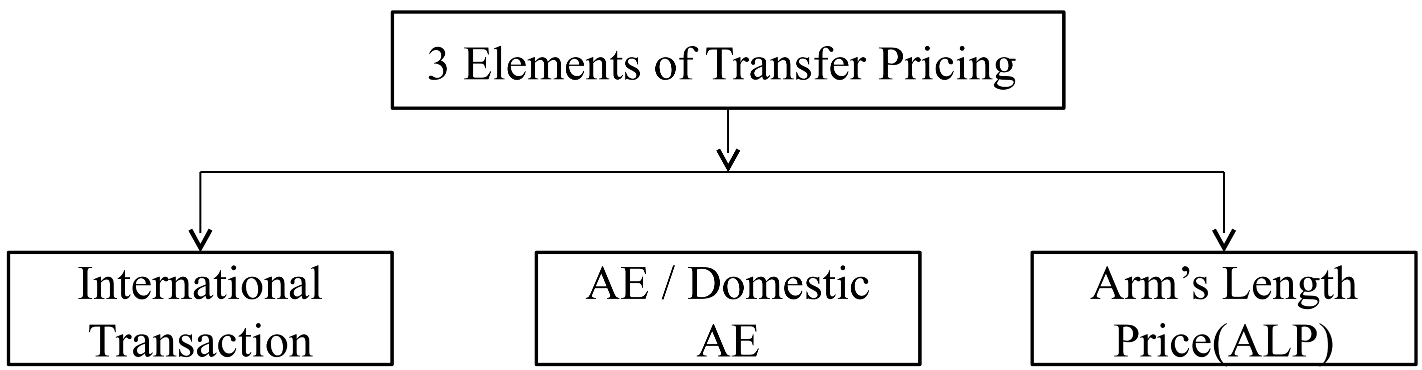
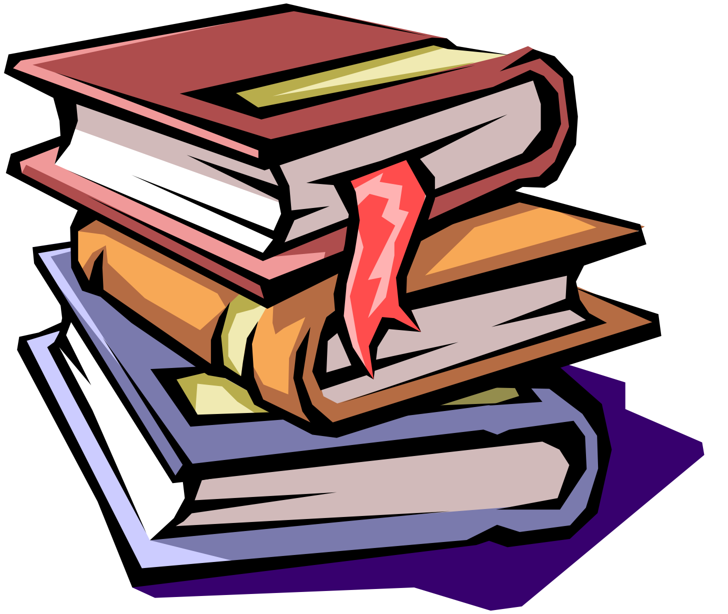
  - Types of RPM and examples
  - Key Aspects and Adjustments
  - Constraints in application
  - Indian Judicial Corner – important cases

Overview of applicability of TP Provisions

- Sec 92(1) - Any income arising from an **international transaction (IT)** between **Associated Enterprises (AE)** shall be computed having regard to the **arm's length price (ALP).**
- Sec 92(2A) - Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the **specified domestic transaction (SDT)** shall be computed having regard to the **arm's length price.**
- Sec 92F(ii) – "**Arm's length price**" means price applied or proposed to be applied in a transaction between independent parties in **uncontrolled transactions.**
- Therefore, following 3 elements are must to attract the Transfer pricing provisions:

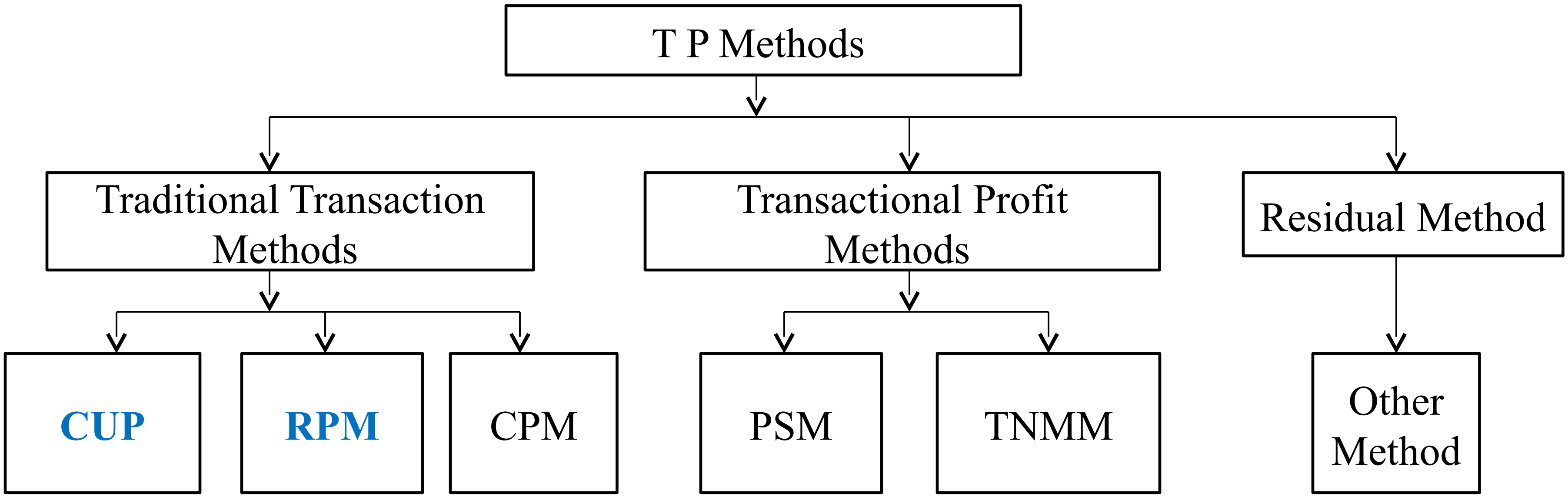


Transfer Pricing Methods



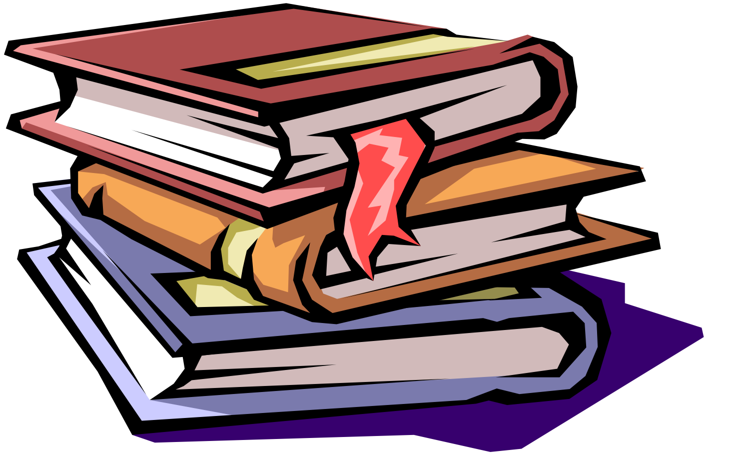
Overview of Transfer Pricing Methods

- Sec 92C(1) - Arm's Length Price (ALP) in relation to **international transactions** or **specified domestic transactions** shall be determined by the most appropriate method out of the following prescribed methods.



- Rule 10B(1) **prescribes the manner** in which each of the method that shall be applied to determine the ALP.
- Rule 10C(2) states that the **most appropriate method** shall be determined having **regard** to the **nature & class of transaction or AEs or functions performed**, etc.

Comparable Uncontrolled Price Method (CUP)



Comparable Uncontrolled Price (CUP) Method

What Rule 10B(1)(a) says:

The ALP shall be determined under CUP Method in the following manner:

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;**

v. The adjusted price arrived at under sub-clause (ii) is taken to be an ALP in respect of the property transferred or services provided in the international transaction.

CUP Method (Cond.)

Types of CUP – CUP can be either ‘Internal’ or ‘External’

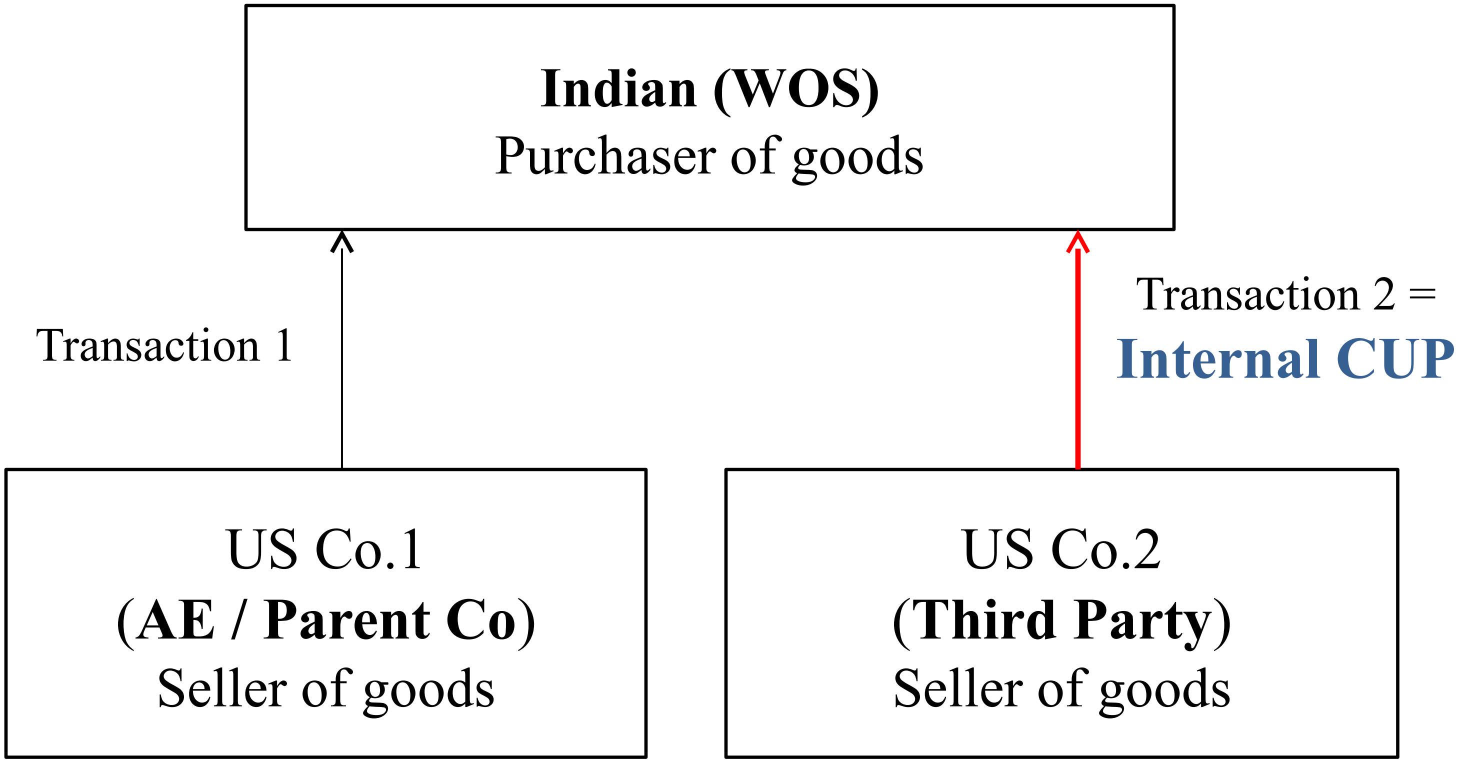
- **Internal CUP**:
  - Internal CUP is available when the tax payer enters into a similar transaction with unrelated parties, as is done with related party.

- **External CUP**:
  - External CUP is available if a transaction between two independent enterprises takes place under comparable conditions involving comparable goods or services.

As per OECD TP guidelines, Internal comparable is preferred over External comparable.

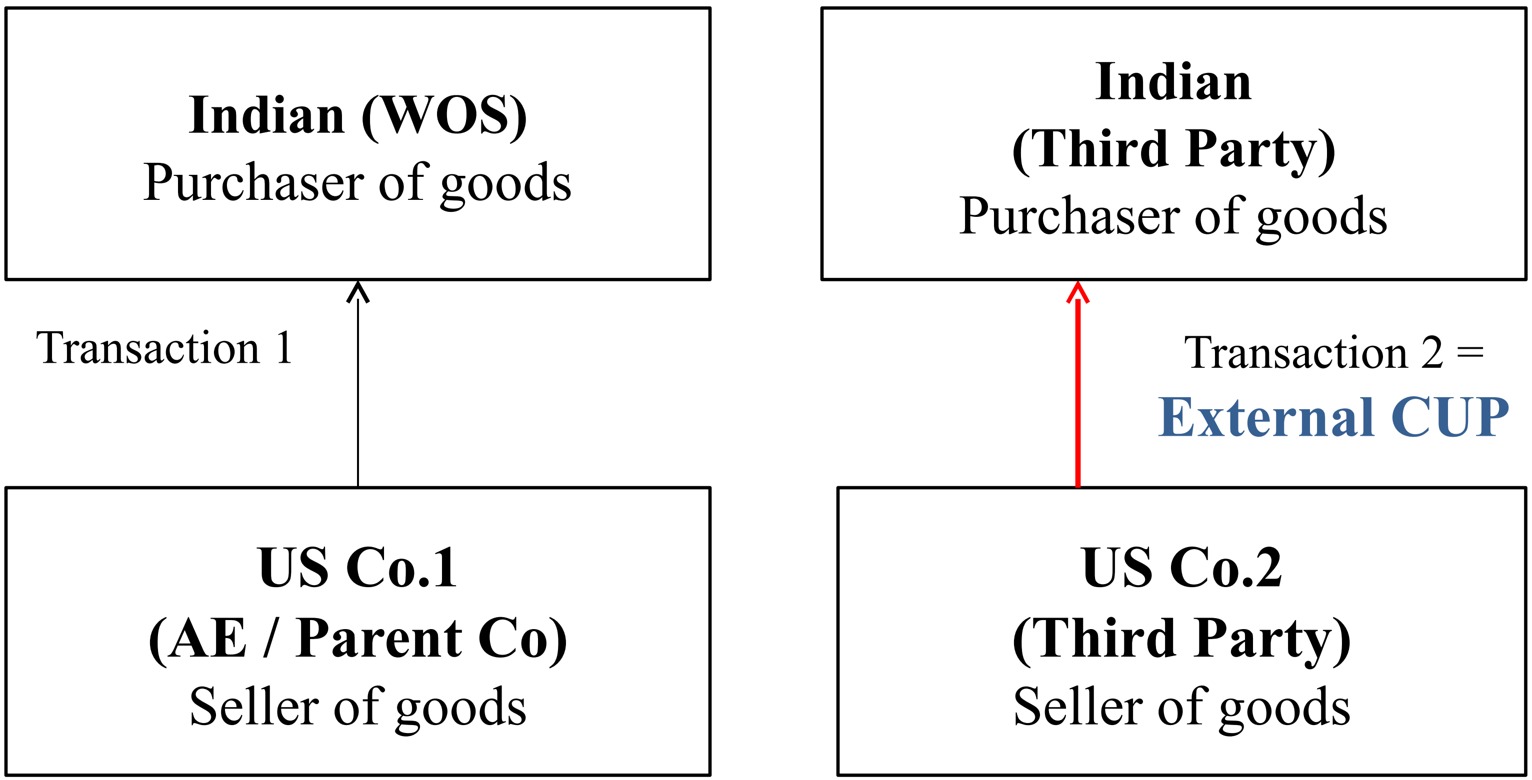
CUP Method (Cond.)

Example of Internal CUP:



CUP Method (Cond.)

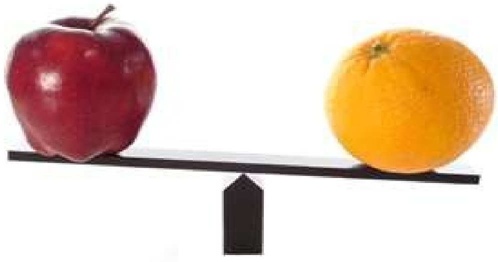
Example of External CUP:



CUP Method (Cond.)

Application of CUP Method - Key aspects & Adjustments:

- Very high degree of **product comparability** is required.



- OECD TP Guidelines (para 2.16) states:

  " In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the **effect on price** of **broader business functions** other than just product comparability". (Whole seller v/s retailer)

- Other relevant aspects:
  - Contractual terms (viz. warranties, credit terms, shipment terms, etc.)
  - Level of market (retail, wholesale, etc)
  - Volumes

CUP Method (Cond.)

Application of CUP Method - Key aspects & Adjustments:

- Other relevant aspects:
  - Geographical area (E.g.: US and Kenya market cannot be compared)
  - Timing of transactions (particularly in case of commodities which are subject to price changes on periodic basis) (E.g. perishable goods, seasonal goods etc.)
  - Intangible property associated with sale (E.g.: Price of branded products cannot be compared to the price of unbranded products)
  - Associated risks (E.g.: Market risk, credit risk, etc.)

CUP Method (Cond.)

Application of CUP Method – Key aspects & Adjustments:

- Differences between controlled and uncontrolled transaction that affects price needs to be adjusted and such **adjustment is to be made to the uncontrolled price.**

- No guidance is provided by Indian TP Regulation on such adjustments. Hence, guidance can be drawn from OECD TP Guidelines which provide an illustrative list of such adjustments.

- If it is not possible to make reasonable adjustments to the uncontrolled price, then CUP method shall be rejected and reasons for rejection shall be clearly documented in TP study report.

CUP Method (Cond.)

Application of CUP Method – Constraints:

The practical application of this method may pose various difficulties like:

- CUP method is highly sensitive to product characteristics and associated conditions which makes its application difficult;
- It is practically difficult to make reasonable accurate adjustments for differences in the comparability (differences in volumes, market, geographic, etc). Hence, very difficult to apply in actual practice;
- Further, every difference that has to be adjusted might not be backed by sufficient proof by way of documentation;
- Difficulty in obtaining prices of comparable transactions or financials of comparables from the public database.

CUP Method (Cond.)

Application of CUP Method – Some Issues:

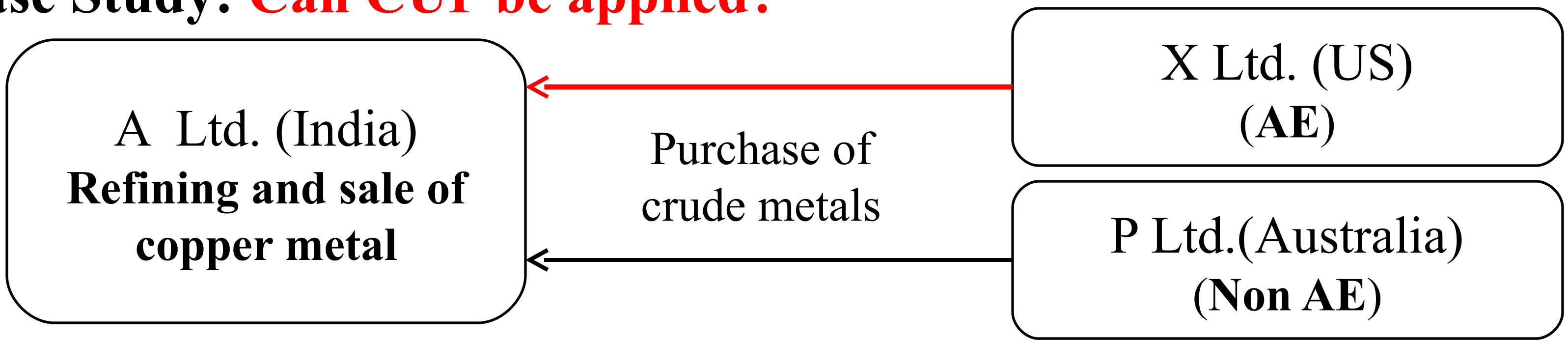
- Can local purchase transactions be used as CUP for imports from AEs?

- In case of imports from AEs, can customs data (i.e., details of imports by Third party Indian importers) be considered as appropriate CUP?

- In case of export of services to AEs, can the industry average (e.g.: use of NASSCOM man-hour rates for IT industry) be considered as appropriate CUP?
  - (Dy.CIT v. Global services Pvt.Ltd. [2011] 11taxmann.com 136)

CUP Method (Cond.)

Case Study: Can CUP be applied?



- Purchase from X Ltd. is for 10,000 MT at a price of Rs.30,000 per MT.
- Purchase from P Ltd. is for 2,500 MT at a price of Rs.40,000 per MT.
- Quantity discount of Rs.500 per MT is offered by X Ltd.
- Credit period allowed by X Ltd. is one month. Cost of the credit is 1.25% p.m.
- Transaction with X Ltd. is at FOB whereas with P Ltd. is CIF. Freight & Insurance cost is Rs.1,000.
- Alloy mix (per MT) for purchase from X Ltd. is: 0.5 kg Gold and 1 kg Silver. The alloy mix (per MT) for purchase from P Ltd. is : 1 kg Gold and 1 kg Silver. Cost of the Gold is Rs.2,000 per kg.

CUP Method (Cond.)

Analysis of Terms of the transactions:

Terms	International transaction (with X Ltd. AE.)	Comparable uncontrolled transaction (with P Ltd. Non AE)	Particulars
Volume (MT)	10,000	2,500	
Price (Per MT)	30,000	40,000	
Quantity Discount	Yes	No	Quantity discount Rs.500 per MT
Credit Period	One month	No	Cost of credit 1.25% per month
Alloy Mix (per MT)	0.5 kg Gold & 1 kg Silver	1 kg Gold & 1 kg Silver	Cost of gold- Rs.2,000 per kg
Delivery terms	FOB basis	CIF basis	Freight and insurance Rs.1,000

CUP Method (Cond.)

Factors to be considered:

- The terms of the transactions are different and hence, it has affected the prices of the crude copper. Therefore, adjustments are required.
- Adjustments required for differences in;
  - **Quantity discount**: If similar discount offered by P Ltd., the price charged by P Ltd. would have been lesser by Rs.500 per MT.
  - **Alloy mix content:** Gold content is high in purchases from P Ltd. and hence, the price charged shall be reduced to exclude cost of higher gold content.
  - **Freight & Insurance (FOB Vs CIF)**: If purchase from P Ltd. is also on FOB basis, then the price charged by P Ltd. would have been lower. Hence, cost of freight & insurance shall be reduced from the purchase price.
  - **Credit period**: If similar credit is offered by P Ltd., then the price charged by them would have been higher after factoring this cost. Hence, value of credit (i.e., 1.25% p.m) shall be added to purchase price.

CUP Method (Cond.)

Computation of ALP:

Particulars	Price per MT (Comparable uncontrolled transaction with P Co.)
Price (Per MT)	40,000
Adjustments: Less: Quantity discount	(500)
Less: Alloy Mix - Gold content (0.5*2,000)	(1,000)
Less: Freight & insurance cost	(1,000)
Add: Interest for the differential credit period (40,000*1.25%)	500
Arm's Length Price (Per MT)	**38,000**

CUP Method (Cond.)

Indian Judicial Corner – Some Important Case Laws:

- **Internal v/s External CUP:**
  - **VVF Ltd.** v. Dy(ITA No.673-Mum.-08)-Internal CUP preferred over external CUP
  - **Gharda Chemicals Ltd.** v. Dy. CIT[2010]35 SOT 406/130 TTJ 556(Mum.)-External CUP preferred over Internal

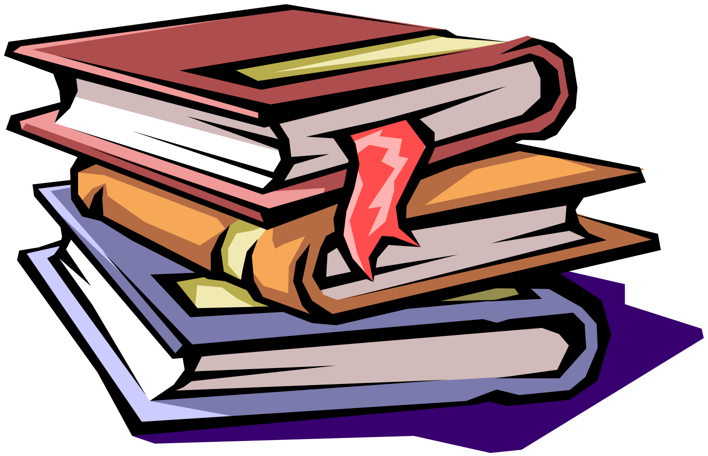
- **Market Conditions:**
  - **M/s. Clear Plus India** Pvt. Ltd. v/s. Dy. CIT-The relevant market condition for testing a transaction is the market where goods are sold and not the place of origin
  - **M/s. Intervet India** Pvt. Ltd. v/s. ACIT- Sale to AE in Thailand and Non AE in Vietnam cannot be considered under CUP Method. Mere geographical contiguity in two countries need not mean similarity in economic and market conditions when retail price was different.

CUP Method (Cond.)

Indian Judicial Corner – Some Important Case Laws:

- **Geographic Market:**
  - **Genesys International Corp.** Ltd. [2012] 26 taxmann.com 102 (Mum.)-Geographic market relevant for comparability
  - **Agility Logistics(P.) Ltd.** [2012]19 taxmann.com 159 (Mum.)-Geographic market not material for logistics industry
- **Customs Data:**
  - **Coastal Energy Pvt. Ltd.** Vs ACIT (Chennai ITAT)- Use of comparable prices obtained from Customs authorities are appropriate in computing ALP of import transactions.
  - **Serdia Pharmaceuticals** (India) Pvt Ltd Vs ACIT (Mumbai ITAT) & **Panasonic India Private Limited** Vs ITO (Delhi ITAT)- Prices obtained from Customs authorities were not considered as appropriate CUP.

Resale Price Method (RPM)



Resale Price Method (RPM)

What Rule 10B(1)(b) says:

The ALP shall be determined under RP Method in the following manner:

i. The **price** at which **property purchased** or services obtained **from an AE** is **resold** or provided **to an unrelated enterprise**, is **identified**;

ii. **Such resale price is reduced** by the amount of a normal **gross profit margin** in a **comparable uncontrolled transaction**;

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

iv. The price so arrived at is **further adjusted** to take into account the **functional**

RPM (Cond.)

Applicability of RPM

- RPM is applicable only when goods are purchased from an AE and resold to an Unrelated party. Put differently, this method is applicable in case of Distributors and not Manufacturer.

Example:

A Ltd. (Foreign Co. / AE) — Sells Rs.100 → B Ltd. (Indian Co. / Tested Party) — Sells Rs.120 → C Ltd. (Indian Co. / Non AE)

RPM applicable?

YES

RPM is applicable in case of Distributors and not Manufacturer !!!

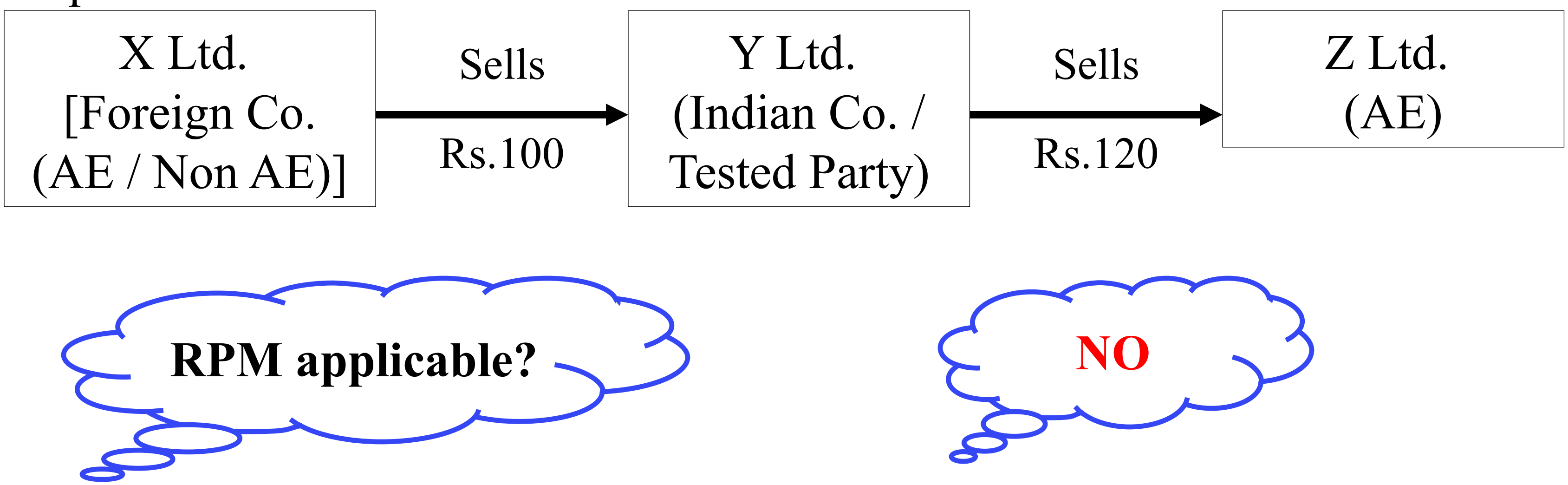
RPM (Cond.)

Applicability of RPM

- When goods are purchased from AE or Unrelated party and same are sold to AE, this method cannot be applied, since it can be applied only in a situation where goods are purchased are from AE and same are sold to Unrelated party.

  (**based on strict interpretation of Rule 10B(1)(b)**)

Example:



RPM (Cond.)

Steps in computing ALP:

Resale price charged to unrelated enterprise in resale of property purchased/service obtained from an AE	XXX
Less: Normal gross profit margin in a comparable uncontrolled transaction whether internal or external	XXX
Less: Expenses (custom duty, etc) in connection with purchase of property/service from AEs	XXX
Add/Less: Functional/other differences (including differences in accounting practices, adjustments for opening & closing inventories) between the transactions / enterprises, which affect gross margin	XXX
Arm's Length Price	XXX

RPM (Cond.)

Types of RPM – RPM can be applied either by using 'Internal data' or 'External' data.

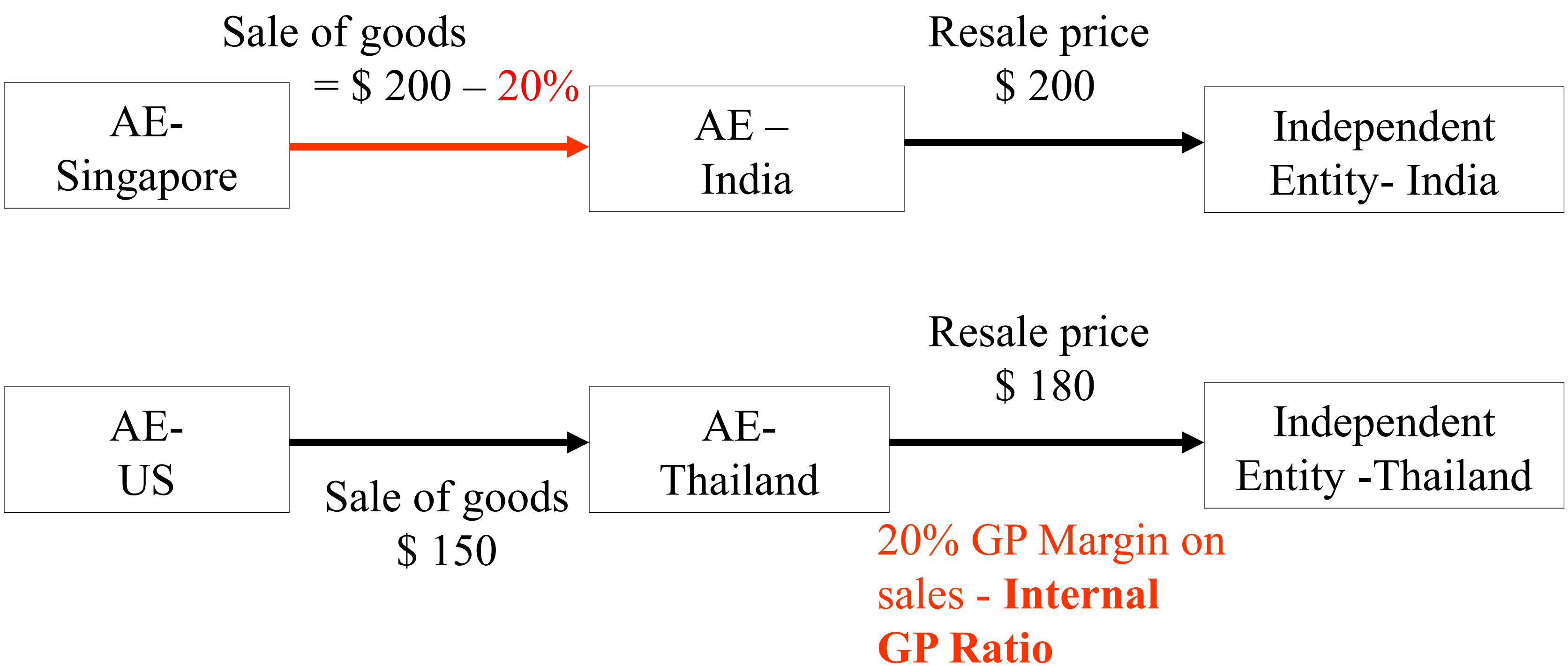
- **Internal Data**:
  - The gross profit margin of the reseller in the controlled transaction is compared with the gross profit margin that the same reseller earns on items purchased or sold in the comparable uncontrolled transactions.

- **External Data**:
  - The gross profit margin of the reseller in the controlled transaction is compared with the gross profit margin earned by an independent third party in a comparable uncontrolled transactions.

As per OECD TP guidelines, Internal comparable is preferred over External comparable.

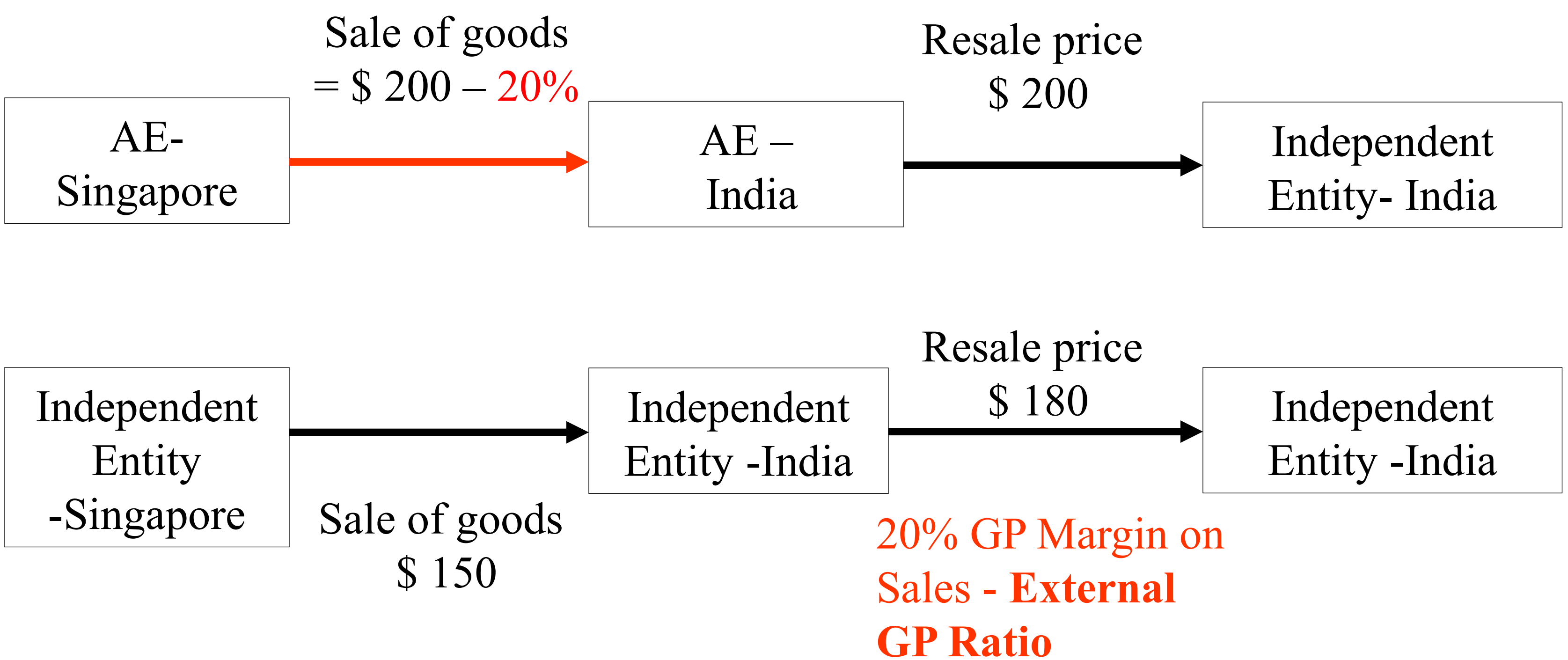
RPM (Cond.)

Example for RPM using Internal Data:



RPM (Cond.)

Example for RPM using External Data:



RPM (Cond.)

Application of RPM – Key Aspects:

- **Reseller adds relatively little or no value to the goods through physical modification or by using intangible property.**
  - **Limited enhancements** such as packaging, repacking, labeling or minor assembly which generally does not add significant value **to the goods is acceptable.**
  - **Significant value addition** through physical modification such as converting rough diamonds into cut and polished diamonds adds significant value to the goods and hence, **RPM cannot be applied** for such value added activity.
  - Again, where goods are imported from AE and sold in local market by adding brand name of Indian company, then RPM cannot be applied since there is significant addition in value of goods due to the use of brand name of Indian

RPM (Cond.)

Application of RPM – Key Aspects:

- **High degree of functional comparability rather than product comparability**. This is because, in RPM, the comparability is at Gross margin level and hence, differences in the functions would affect the gross margins.
- **Minor differences in the products are acceptable** if they are **less likely** to have **effect on the gross profit margin** earned from sale of such products.
  - E.g. Gross profit margin earned from trading of Microwave ovens in controlled transactions can be compared with gross profit margin earned by unrelated parties from trading of toasters. This is because, both are consumer durables and fall in within the same industry.
- **Shorter the time gap** between purchase and resale, **more accurate is the correct calculation of gross margin.**
  - If sugar is purchased at the time of low demand and sold after 6 months when high demand, the gross margin is highly affected due to sales price. Hence, RPM can not be applied unless with adjustments.

RPM (Cond.)

Application of RPM – Adjustments:

The material differences such as the following which affect the gross profit margin shall be adjusted for:

- Inventory Levels
- Contractual Terms
- Accounting practices
- Sales & marketing and additional functions

RPM (Cond.)

Application of RPM – Constraints:

The practical application of this method may pose

various difficulties like:

- Differential accounting policies followed by the enterprises make application of RPM very difficult.
  - E.g.: Some companies include exchange loss or gain in purchase / sale whereas some companies show it as part of administrative and other expenses.
  - E.g.: Some companies include excise duty on purchase in Purchase A/c whereas some companies show it as part of rent, rates and taxes.

RPM (Cond.)

Application of RPM – Constraints:

- Non availability of gross margin data of comparable companies from the public database.
  - Companies Act, 1956 does not require disclosure of Gross Profit margin in the financial statements.
  - Tax Audit Reports which contain Gross Profit margin calculation, however, are not available in public database.

- RPM is unlikely to give accurate result, if there is difference in level of market, functions performed, or product sold.
  - E.g.: Gross Profit margin of a shoe distributor cannot be compared with Gross Profit margin of a detergent distributor even though both products are falls under FMCG category. This is because, there are huge differences in the products which affect the Gross Profit margin.

RPM (Cond.)
Case Study:

Product A- Rs.60,
Freight expense - Rs.20

B Co.(India) WOS & Distributor

Resale Price Rs.100

Indian Third Party

A Co.(USA)- Manufacturer & Parent Co.

Product A – Rs.79

C Co.(India) Third Party- Distributor

Resale Price Rs.100

GP Margin 21%

Indian Third Party

Opening Stock of B Co is Rs.10 and Closing stock is Rs.20.

RPM (Cond.)

Case Study:

Terms of Contract:

Terms	Sale by B Co. (Subsidiary)	Sale by C Co. (Independent Co.)
Quantity Discount	Yes - 1% of GP	No
Free gifts	No	One product with purchase of every product. Sale price unchanged
Warranty	No	Yes - 6 months (No change in sale price). Warranty cost is Rs.200 per unit

Note : Assuming CUP method cannot be applied.

RPM (Cond.)

Case Study:

Analysis of terms of Contract:

Terms	Sale by B Co. (Subsidiary)	Sale by C Co. (Independent Co.)	Analysis/Effect on GP margin of C Co.
Quantity Discount	Yes-the cost of the same is estimated at 1% of GP	No	***1% on GP margin***
Free gifts	No	One product with purchase of every product (No change in sale price)	As such cost is not debited to Trading Account, hence ***no impact on GP margin***
Warranty	No	Yes, 6 months (No change in sale price)-warranty cost-Rs.200 per unit	As such cost is not debited to Trading Account, hence ***no impact on GP margin***

Therefore, adjusted Gross Profit Margin of C Co. is 20% (21% less 1%)

RPM (Cond.)

Case Study:

Computation of ALP using RPM

Particulars	Amount (Rs.)
Resale Price charged by B Co. to Third Party (i)	100
Less: Adjusted gross profit margin of C Co. (100*20%) (ii)	(20)
Cost of Sales A= (i-ii)	**80**
Add: B Co. (Tested party's) stock adj...[20(Cl. Stock)-10(Op. Stock)] (iii)	10
Less: Freight exp. incurred by B Co. for purchase from A Co. (iv)	(20)
Arm's Length Price B= (A +iii-iv)	**70**

Conclusion: **The actual purchase price (i.e., Rs.60) is lower than the ALP (i.e., Rs.70) determined above and hence, international transaction of purchase from A Co. is meeting with arm's length requirements.**

RPM (Cond.)

Indian Judicial Corner – Some Important Case Laws:

- **CISCO Systems (India) (P.) Ltd.** v. Dy. CIT [2012] 49 SOT 108 (Bang.)-Where assessee was only a custodian o goods imported till they were delivered to customers of parent company on its direction, assessee could not be he be trader or distributor of goods and RPM cannot be adopted and TNMM to be used to determine ALP.

- **Gharda Chemicals** Ltd.v.Dy. CIT[2010] 35 SOT 406/130 TTJ 556 (Mum.)-RPM could be applied only in cases where Indian entity had ***"purchased"*** goods or services from its foreign enterprise. Since assessee was selling goods to its AE, RPM cannot be applied in the instant case.

Thank You & Queries??

Sudhir Nayak