



Transfer Pricing Methods

with specific reference to Domestic Transfer Pricing

Baroda Branch of ICAI

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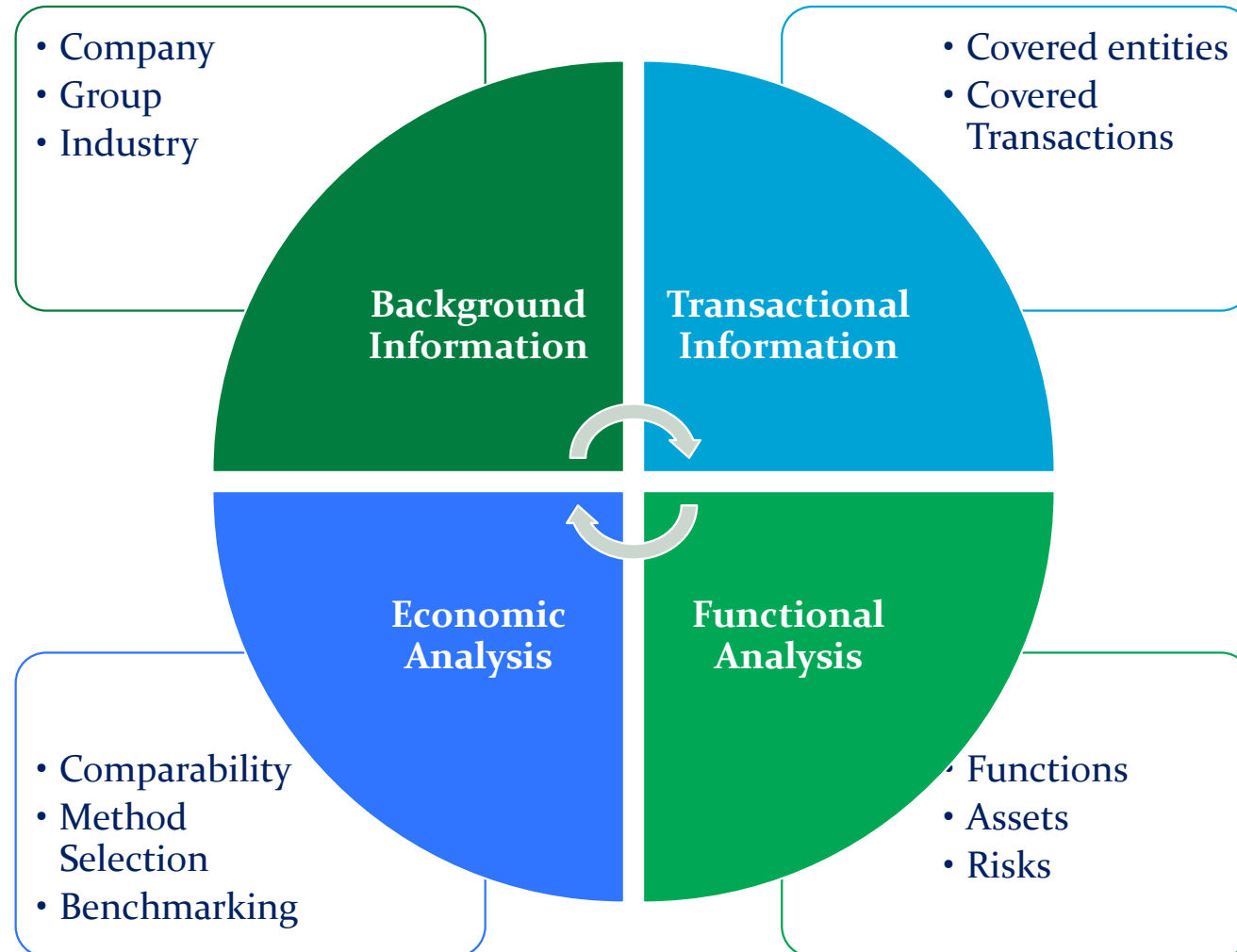
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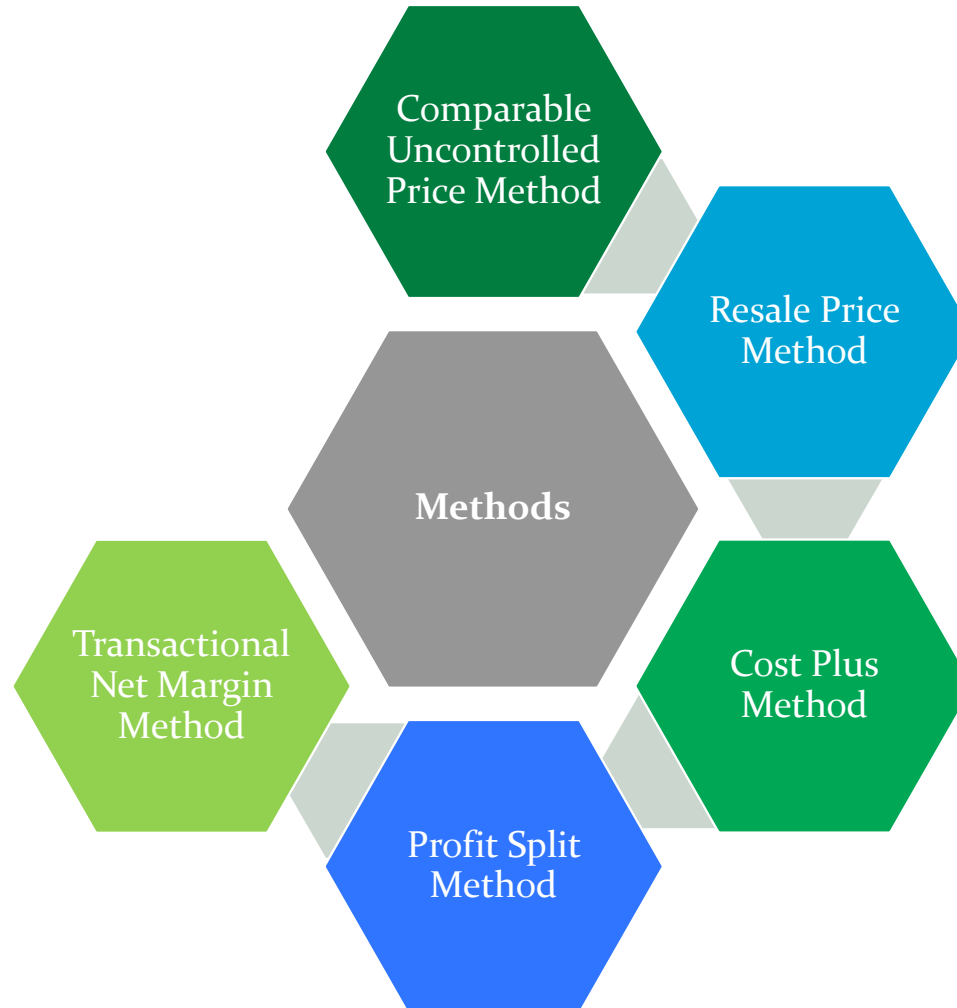
Indian TP Regulations

- Transfer Pricing introduced from AY 2002-03 for international transactions
 - Extended to Specified Domestic Transactions [SDT] from AY 2013-14
- Sections 92 to 92F amended to include reference to SDT
 - However, similar amendments to Rules 10 to 10E yet to be carried out
- Methodology to compute ALP is primarily provided in Rules
 - It is expected that appropriate amendments would be carried out in Rules to apply broadly same methods and principles to SDT as well
- Discussion in this presentation is primarily based on ALP computation mechanism applicable to ‘international transactions’ assuming that the same would be applied to SDT

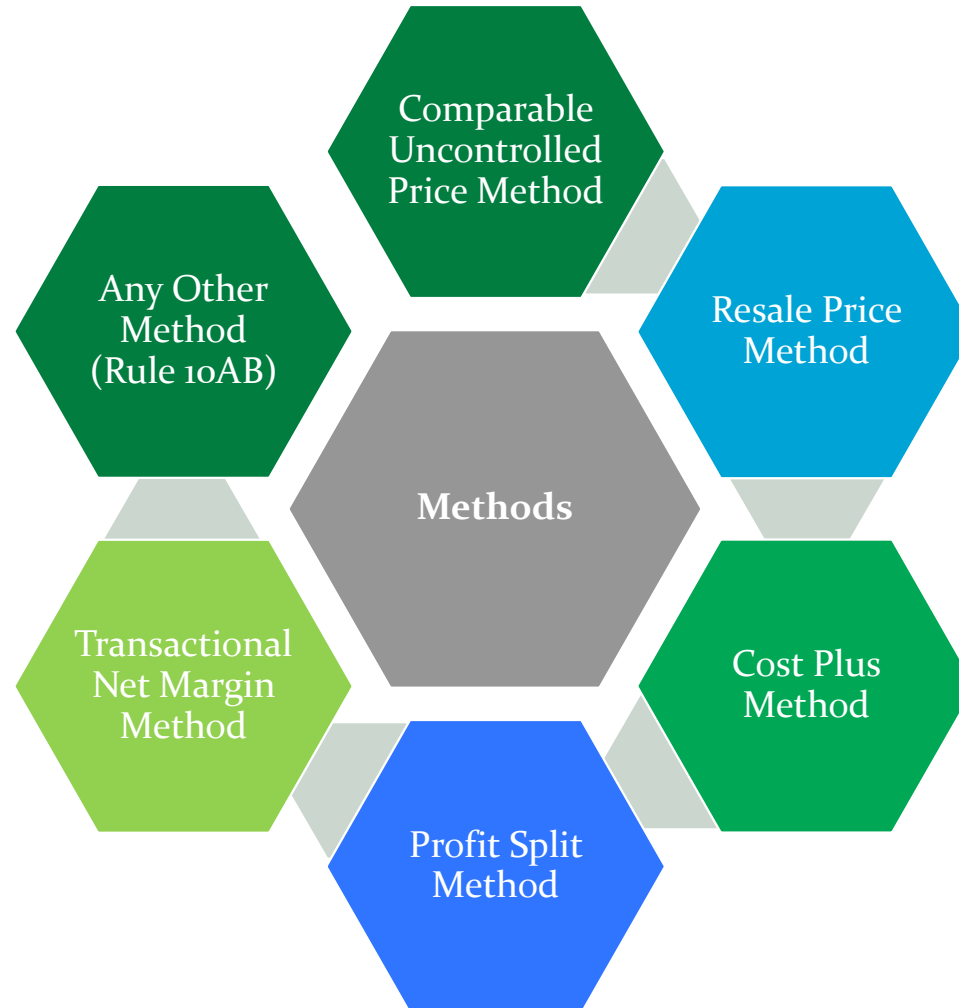
Documentation Areas



Transfer Pricing Methods



Transfer Pricing Methods





Selection of TP Method



Most Appropriate Method

- ITA does not provide any specific hierarchy of methods
- It insists on applying the ‘Most Appropriate Method’ (MAM)
- MAM means a Method
 - Which is best suited to facts and circumstances of transaction
 - Which is the most reliable measure of an arm’s length price



Selection of Most Appropriate Method

- MAM is to be determined considering –
 - Nature and class of transaction
 - Functions, assets and risks undertaken assessee and other party
 - Degree of comparability between underlying transaction and uncontrolled transactions
 - Extent to which reliable and accurate adjustments can be made to account for differences, if any
 - Availability, coverage and reliability of data necessary for application of method
 - Nature, extend and reliability of assumptions required to be made in application of method



Stages of Economic Analysis

Comparability Analysis



Selection of Tested Party



Selection of Most Appropriate Method



Selection of Profit Level Indicator



Benchmarking

Selection of Most Appropriate Method

- MAM is to be determined considering –

Selection of Tested Party

- Nature and class of transaction
- Functions, assets and risks undertaken assessee and other party

Comparability Analysis

- Degree of comparability between underlying transaction and uncontrolled transactions
- Extent to which reliable and accurate adjustments can be made to account for differences, if any

Selection of Tested Party & Comparability Analysis

- Availability, coverage and reliability of data necessary for application of method
- Nature, extend and reliability of assumptions required to be made in application of method



Comparability Analysis

- Degree of comparability and extent of reliable and accurate adjustment in case of difference is very crucial in selection as well as application of MAM
- Different methods require different degree of comparability
 - E.g. CUP would require very precise comparability whereas under TNMM, one would look for broader comparable



Comparability Analysis

- Comparability is to be established in terms of -
 - Specific characteristics of the property transferred or services provided
 - Functions performed, assets employed or risks assumed by both parties
 - Contractual terms (whether in writing or not)
 - Which may relate to timing, delivery, payment, warranty, currency, etc.
 - Conditions in the markets in which both parties operate
 - Geographical location and size of market
 - Laws and Government orders in force
 - Costs of labour and capital in the markets
 - Overall economic development
 - Level of competition
 - Wholesale v. retail



Comparability Analysis

- Attempt should be to identify comparable transactions
 - Firstly internal transactions, if not, then external transactions
 - Transactions with few differences can still be considered for comparison
 - If accurate and reliable adjustments can be made for the differences
- If no comparable transaction is available, one may look for companies comparable activities
 - Functional comparability is given more importance
 - Product comparability standard may be relaxed but cannot be ignored
 - Understand the price-setting mechanism and identify the factors that goes through the mind (and its impact) while determining price
 - These will provide you the best comparability standards (search filters) to identify the companies that may be compared



Selection of Tested Party

- Tested party is generally the participant in the transaction
 - whose transfer price / profitability attributable to the controlled transactions can be verified using the most reliable data; and
 - requiring the fewest and most reliable adjustments; and
 - for which reliable data regarding uncontrolled comparable companies can be located
- In most cases –
 - Tested party will be the least complex of the transacting parties and does not own valuable intangible property or unique assets



Application of TP Methods



Classification of Methods

Price based Methods

- Comparable Uncontrolled Price Method (CUP)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)

Profit based Methods

- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)

Other

- Any other method which takes into account price charged or paid between uncontrolled parties considering all relevant facts



Comparable Uncontrolled Price



Comparable Uncontrolled Price (CUP)

- Compare the prices charged for property or services
- Price under ‘controlled transaction’ is compared with ‘uncontrolled transaction’
- It requires close similarity in products, property or services that are involved
- Where the prices of the product fluctuate regularly, timing of the transaction also relevant
 - Where the prices remain constant over period, such transactions can be aggregated and be benchmarked together

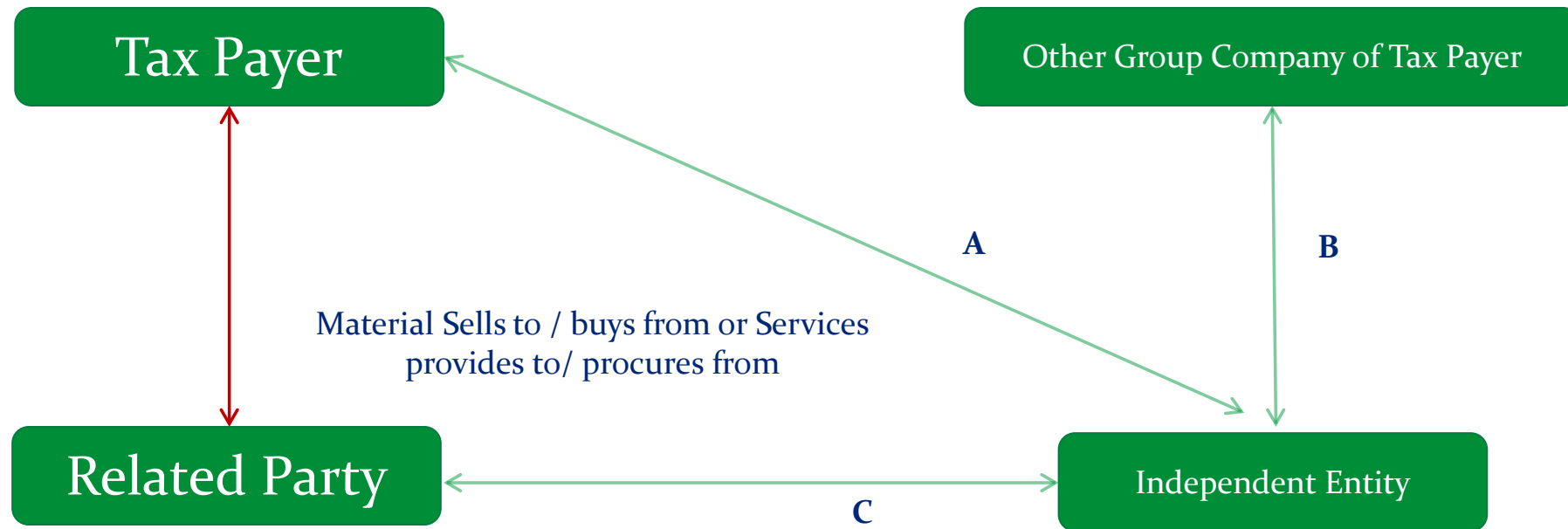


Comparable Uncontrolled Price (CUP)

- Internal CUP
 - Comparison of tested transaction with the transaction where the taxpayer or the other party sells or buys a particular product or service to or from an unrelated enterprise under similar terms and circumstances in comparable quantities and markets.
 - If A Ltd. purchases chemical X from B Ltd. (related party) as well as C Ltd. (unrelated party), then price paid to unrelated party can be used for benchmarking if other terms are comparable
 - A Ltd. purchases chemical X only from B Ltd. However, if B Ltd. sells chemical X to A Ltd as well as C Ltd., then it can also be used for benchmarking if other terms are comparable
 - Interest paid to related party and to other parties

Comparable Uncontrolled Price (CUP)

- Internal CUP (Transactions A, B & C)





Comparable Uncontrolled Price (CUP)

- External CUP
 - Comparison of tested transactions with Independent enterprises sell or buy a particular product or service under similar terms and circumstances in comparable quantities and markets
 - Sources of External CUP
 - Metal / Commodity / Stock Exchanges
 - Customs Data
 - Yields earned by Bonds listed on Stock Exchanges
 - Loan transactions database
 - Royalty transactions database



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - Identify “potentially” comparable transactions
 - Preference to be given to internal comparable as comparability standards can be established in *toto* in such case
 - Alternatively, identify external sources which can provide transactional level information for the underlying transactions
 - Comparability Analysis
 - Many factors determine the comparability of transactions under the CUP method, including, most important, the similarity of products and terms / conditions.
 - Identify the differences in the underlying transaction and the uncontrolled transaction(s)



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - The differences could include following items on the list, which is non-exclusive
 - **Quality of the product.** Fineness (of precious metals), moisture (of grain), duration, absence of flaws
 - **Contract terms.** The scope and terms of warranties provided, volume of sales or purchases, credit terms, transport terms, choice of forum, choice of law
 - **Level of the market.** Wholesale, retail, other distributor arrangements
 - **Geographic market.** Place in which the transaction takes place (typically a country)
 - Date of transaction
 - Intangible property associated with the sale
 - Foreign currency risks
 - Alternatives realistically available to buyer and seller



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - Adjustment for differences
 - Make reliable and accurate adjustment for the differences in transaction
 - If reliable and accurate adjustment cannot be made, CUP should ideally be rejected as appropriate method
 - In principle, the adjustments should be made to uncontrolled transactions
 - Sometimes, especially in case of external CUP, comparison is made even if substantial comparability is established (and other comparability details are not available)
 - Generally, this is done where other methods do not provide reasonable basis to compute ALP and therefore CUP has to be adopted despite differences



Comparable Uncontrolled Price (CUP)

- Application of CUP

Level of Differences	Integrity of CUP
No Differences	This method will be the most direct and reliable method of determining arm's-length price; the best method applies to this situation.
Minor Differences	Differences are definite and reasonably ascertainable, and adjustments for differences can be made; the method will be the most direct and reliable method of determining the arm's length price; the best method applies to this situation.
More than minor differences	The CUP method can be used, but reliability of results is reduced; accordingly, the CUP method may not be the best method.
Material product differences	Reliable adjustments cannot be made; the CUP method ordinarily is not the best method.



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - Benchmarking
 - Benchmarking could be on the basis of Price or Pricing Methodology (linked to a benchmark like LIBOR, LME prices, etc.)
 - Uncontrolled Price (or pricing methodology) represents ALP
 - If there are more than one uncontrolled price, arithmetic mean is to be considered as ALP
 - Variation up to 5% of transaction value permitted
 - If variation is beyond that, adjustment for the full difference is to be made
 - Downward adjustment not permitted



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - Practical difficulties
 - It is hardly possible to find perfect CUP for Direct Price Comparison.
 - Where the international transactions are too complicated or interlinked with each other to be benchmarked on isolated basis, the CUP cannot be applied.
 - The accuracy of adjustment always be questionable.
 - Number of adjustment would reduce the integrity or comparability of transaction under CUP.
 - CUP requires close similarity between products which is difficult under External comparison.



Comparable Uncontrolled Price (CUP)

- Application of CUP
 - Practical difficulties
 - Accurate adjustment for difference in Geographic segment is not possible to perform.
 - There are some differences like business relations, future expectations, use of Trademark and other marketing intangibles, specific circumstance, etc. which cannot be accurately adjusted.
 - CUP may become practically redundant for transactions in some specific products like Products made to order, Pharmaceutical products, newly developed products, etc.
 - Comparability of cross border transactions and domestic transactions is difficult.
 - Most of external data sources are based on international transactions and hence may not be suitable to SDT

Comparable Uncontrolled Price (CUP)

Example 1

Particulars	Related party	Unrelated party
Price paid (inclusive of taxes)	INR 25,000	INR 23,500
Delivery terms	CIF	FOB
Quantity	100 pcs	110 pcs
Availability of CENVAT	No	Yes
Quantity	100 pcs	110 pcs
Freight cost	-	INR 1,200
Insurance cost	-	INR 700
CENVAT	-	INR 2,000

Comparable Uncontrolled Price (CUP)

Example 1 – Computation of ALP

Particulars	Related party	Unrelated party
Price paid (inclusive of taxes)	INR 25,000	INR 23,500
Adjustments for differences -		
<i>Delivery terms – Freight Cost</i>		INR 1,200
<i>Delivery terms – Insurance Cost</i>		INR 700
<i>Quantity</i>		-
<i>CENVAT</i>		(INR 2,000)
Arm's Length Price		INR 23,400

Comparable Uncontrolled Price (CUP)

Example 2

Particulars	Related party	Unrelated party
Price paid (inclusive of taxes)	INR 25,000	INR 23,500
Delivery terms	CIF	FOB
Quantity	100 pcs	110 pcs
Availability of CENVAT	No	Yes
Quantity	100 pcs	110 pcs
Freight cost	-	INR 1,200
Insurance cost	-	INR 700
CENVAT	-	INR 2,000
Credit Period	90 days	Upon Dispatch
Interest rate on working capital	12% p.a.	-

Comparable Uncontrolled Price (CUP)

Example 2 – Computation of ALP

Particulars	Related party	Unrelated party
Price paid (inclusive of taxes)	INR 25,000	INR 23,500
Adjustments for differences -		
<i>Delivery terms – Freight Cost</i>		INR 1,200
<i>Delivery terms – Insurance Cost</i>		INR 700
<i>Quantity</i>		-
<i>CENVAT</i>		(INR 2,000)
<i>Credit Period</i> <i>(Interest on INR 23,500 for 3 months @ 12% p.a.)</i>		INR 705
Arm's Length Price		INR 24,105



Cost Plus Method



Cost Plus Method (CPM)

- CPM determines ALP by adding Gross Profit Margin (mark-up) earned in comparable transaction(s) / by comparable companies to the cost incurred by Tested Party under controlled transaction
- CPM is useful when tested party is supplying made-to-order goods (e.g. engineering goods) to its related party
 - CPM can also be considered for provision of services
- CPM determines arm's length sale price for goods or services
 - Therefore, it would be applicable primarily in case of transfer of goods / services between Tax Holiday and other units
 - In other cases, it can be applied only where the other party is considered as 'Tested Party' (i.e. full data of costs of such goods and services of other party is available with the assessee)



Cost Plus Method (CPM)

- General comparability standards apply
 - Functions, contractual terms, risks, economic conditions and class of asset or services
- CPM focuses more on functional comparability
 - Underlying principle:
 - Manufacturing activities may broadly remain same for similar class of goods
 - Gross margin reflects the remuneration of manufacturer's functions, assets and risks
 - Price of the goods that he may produce may be higher or lower but if the functions are comparable, expectation of remuneration would be similar



Cost Plus Method (CPM)

- Product comparability standard is relaxed but cannot be ignored
 - Underlying principle:
 - Manufacturing activities may broadly remain same for similar class of goods
 - However, the activities may not be universally common / standard
 - In distinction to the CUP Method, where comparability of product is inevitable essential, product comparability is less decisive when using the CPM.
 - However, the macro level comparability of Product may be decisive for application of CPM as macro level difference in product may result into difference in FAR.
 - For example: the FAR of manufacturer of engineering goods would not be comparable to manufacturer of chemical products. Since the process is likely to be materially different, FAR thereof would also be materially different and accordingly affect the Gross Margin.



Cost Plus Method (CPM)

- Application of CPM
 - Determine the Direct costs of the goods
 - i. e. direct costs incurred in manufacturing the goods to be supplied to related party
 - This should include all direct costs including appropriate allocation of manufacturing overheads
 - If the functions performed by the manufacturer in the transactions are similar, they can be aggregated and total costs may be determined
 - Identify “potentially” comparable transaction(s) / companies
 - Preference to be given to internal comparable as comparability standards can be established in *toto* in such case
 - This may be possible where the assessee manufactures made to order engineering goods for related party as well as third parties
 - Alternatively, identify ‘potential’ external comparable companies using databases like Prowess or Capitaline



Cost Plus Method (CPM)

- Application of CPM
 - Comparability Analysis
 - Many factors determine the comparability of companies under the CPM, including, most important, the similarity of functions, assets and risks (product similarity also relevant at broad level).
 - Work out Gross Profit Margin of comparable transaction(s) / companies
 - Gross Profit Margin should consider all direct income and costs linked with the identified sale transactions
 - Rebate / drawback available on the sale is also considered direct income
 - Commission, octroi, packing charges, freight, etc. are generally considered direct expenses
 - Marketing expenses are considered indirect expense and therefore not to be reduced.
 - In applying CPM, it is crucial that the compared profit mark-ups relate to a comparable cost base. If differences materially influenced the mark-up, then the ability to make reliable adjustments for these would affect the reliability of the results.
 - It is important to select data of cost: whether from Financial or Cost accounting.



Cost Plus Method (CPM)

- Application of CPM
 - Adjustment for differences
 - Adjustments may be required in the GP of comparable transaction(s) / companies for material difference in FAR or other factors affecting gross profit margin
 - Following types of adjustments may be particularly relevant to the Cost Plus method.
 - **Working Capital.** Inventory, debtors and creditors (collection cycle)
 - **Contractual Terms:** Warranties provided, Sales or purchase volume, Credit terms, Transport terms
 - The complexity of the manufacturing process or of the assembly operations
 - Manufacturing, production, and process engineering
 - The extent of the procurement, purchasing, and inventory control activities
 - **Cost structures.** The age of plant and equipment
 - **Business experience.** Whether the business is in a start-up phase or is mature
 - **Management efficiency.** As indicated by expanding or contracting sales, or by executive compensation over time



Cost Plus Method (CPM)

- Application of CPM
 - Benchmarking
 - Add comparable Gross Margin
 - Add comparable Gross Margin (%) on tested transaction costs
 - The resultant amount would be arm's length sale price
 - Variation up to 5% of transaction value permitted
 - If variation is beyond that, adjustment for the full difference is to be made
 - Downward adjustment not permitted



Cost Plus Method (CPM)

- Application of RPM
 - Practical difficulties
 - Appropriate adjustment for difference in market conditions, management efficiency, sales economies, exclusive rights etc. is difficult to make
 - Difficulty in identifying identical or similar FAR profiles.
 - A major difficulty in applying the CPM is that it requires extensive information about the cost base used in comparing the mark-ups of the controlled and uncontrolled transactions in order to achieve reliable results.
 - Indian companies are not required to disclose Gross Margins earned in their financials
 - Identification of Gross Margin based on limited disclosure on financials is rather unreliable at times
 - Difference in accounting policies may also affect the GM.
 - CPM loses its reliability when there are significant intangibles and high risk are involved.



Cost Plus Method (CPM)

- Application of CPM
 - Strengths
 - CPM is the best method when internal comparable transactions are available and appropriate cost information is available for each transaction
 - Certain Adjustments more reliably by made in respect of difference in payment terms or delivery terms.



Cost Plus Method (CPM)

- Illustration
- Company A has two units, one eligible and another non-eligible unit.
- Non-eligible unit (NEU) is engaged in the manufacture of electrical goods of varied range. One of such goods is heating element which it sells to the eligible unit (EU).
- EU is engaged in the manufacture of electrical heaters where it uses the heating element purchased from the NEU as a raw material.
- NEU is not selling the heating element to any of its other customers
- Few comparable companies are available which are engaged into selling similar products (electrical goods).
- In the current scenario, Cost Plus becomes the most appropriate method wherein, the NEU charges EU a price which is calculated by adding a reasonable mark up the cost of production of such goods.

Cost Plus Method (CPM)

- Illustration - Application of Cost plus and its adjustments

Situation	Application of cost plus
1. Relatively complete data is available regarding the FAR, contractual terms, accounting consistency etc. for comparable companies	Since all the material differences between controlled and uncontrolled transactions have been identified, effect of differences is ascertainable and reliable adjustment can be made for the same to arrive at ALP i.e., comparable gross profit mark up.
2. NEU accounts for SGA costs which are not charged to the EU with respect to the activity carried out between the two units, however the comparable companies do account for such SGA costs.	The gross profit margins of the comparable companies may be adjusted for the SGA costs accounted for, in case the data is not sufficiently available for the same, the reliability of the results may decline reducing the appropriateness of Cost Plus
3. NEU manufactures heating element with the materials sent by EU, whereas comparable companies purchase their own materials, hence inventory carrying risk is higher in case of comparable companies.	This is a functional difference coupled with the difference in risk undertaken, which requires appropriate adjustment for the carrying cost of inventory borne by the comparable companies.



Resale Price Method



Resale Price Method (RPM)

- RPM computes purchase price paid to related party based on its resale price to unrelated party
- RPM is typically useful to determine ALP of purchases made by the distributor (trader) from related party
- RPM presupposes that the distributor does not carry out any material value addition activity
 - Distributor should be carrying out only distribution activities
 - Marketing & Promotion are considered value additive unless they are routine in nature (or insignificant in quantum)
 - When the distributor owns intangibles, RPM would ordinarily not be useful
 - RPM is difficult to apply if the product purchased loses its identity at the time of resale
- RPM can be easily used on aggregate basis where the distributor distributes various products of similar class
 - In case of CUP separate analysis for every product was necessary



Resale Price Method (RPM)

- General comparability standards apply
 - Functions, contractual terms, risks, economic conditions and class of asset or services
- RPM focuses more on functional comparability
 - Underlying principle:
 - Distributor is remunerated for its functions
 - As it does not carry out any value adding activities
 - Gross margins earned by distributor is reflection of functions performed, risks assumed, and assets employed
 - The reseller which performs more functions and assumes more risks or employs more valuable assets than the other reseller should earn a higher gross margin to cover additional costs and, as the case may be, earn a respective additional profit.
 - Therefore, to apply RPM comparable with similar functions need to be identified



Resale Price Method (RPM)

- Product comparability standard is relaxed but cannot be ignored
 - Underlying principle:
 - Distribution activities may broadly remain same for similar class of goods
 - However, the activities may not be universally common / standard
 - In distinction to the CUP Method, where comparability of product is inevitable essential, product comparability is less decisive when using the RPM.
 - However, the macro level comparability of Product may be decisive for application of RPM as macro level difference in product may result into difference in FAR.
 - For example: the FAR of Reseller of Pharmaceutical products and Reseller of Automotive component may be different which may affect the Gross Margin.
- The other factors which affects comparability are
 - contractual terms, exclusive rights,
 - geographical segment, market environment,
 - business strategies, etc.



Resale Price Method (RPM)

- Application of RPM
 - Determine the resale price
 - i. e. price at which the goods / services are sold to unrelated party after being purchased from related party
 - If the functions performed by distributors in the transactions are similar, they can be aggregated and total sale value may be determined
 - Identify “potentially” comparable transaction(s) / companies
 - Preference to be given to internal comparable as comparability standards can be established in *toto* in such case
 - This may be possible where the assessee is distributor of chemical products and out of 20 – 25 products that he deals into, 6 products he purchases from related party
 - Alternatively, identify ‘potential’ external comparable companies using databases like Prowess or Capitaline



Resale Price Method (RPM)

- Application of RPM
 - Comparability Analysis
 - Many factors determine the comparability of companies under the RPM, including, most important, the similarity of functions, assets and risks (product similarity also relevant at broad level).
 - Work out Gross Profit Margin of comparable transaction(s) / companies
 - Gross Profit Margin should consider all direct income and costs linked with the identified sale transactions
 - Rebate / drawback available on the sale is also considered direct income
 - Commission, octroi, packing charges, freight, etc. are generally considered direct expenses
 - Marketing expenses are considered indirect expense and therefore not to be reduced.
 - In case of more than one comparable, arithmetic mean of GP would be considered



Resale Price Method (RPM)

- Application of RPM
 - Adjustment for differences
 - Adjustments may be required in the GP of comparable transaction(s) / companies for material difference in FAR or other factors affecting gross profit margin
 - Following types of adjustments may be particularly relevant to the resale price method.
 - **Working Capital.** Inventory, debtors and creditors (collection cycle)
 - **Contractual Terms:** Warranties provided, Sales or purchase volume, Credit terms, Transport terms
 - **AMP Activities.** Advertisement, marketing and promotion
 - The Level of the Market.
 - Foreign Currency Risks



Resale Price Method (RPM)

- Application of RPM
 - Benchmarking
 - Reduce Direct Expenses
 - From sale price, reduce all direct expenses incurred by the assessee (except the purchase price)
 - Reduce comparable Gross Margin
 - Further, reduce comparable Gross Margin (%) on tested transaction sales
 - The resultant amount would be arm's length price
 - Variation up to 5% of transaction value permitted
 - If variation is beyond that, adjustment for the full difference is to be made
 - Downward adjustment not permitted



Resale Price Method (RPM)

- Application of RPM
 - Practical difficulties
 - Appropriate adjustment for difference in Market conditions, Management efficiency, Sales economies, exclusive rights etc. is difficult to make
 - Difficulty in identifying identical or similar FAR profiles.
 - Reliability of cost of goods sold and its components in the case of uncontrolled transaction.
 - Indian companies are not required to disclosed Gross Margins earned in their financials
 - Identification of Gross Margin based on limited disclosure on financials is rather unreliable at times
 - Difference in accounting policies may also affect the GM.
 - RPM is difficult to apply where distributor involves “IPR” or makes value addition to that.



Resale Price Method (RPM)

- Application of RPM
 - Strengths
 - RPM may be the best method where there is insufficient product comparability for the application of the CUP Method.
 - Certain Adjustments more reliably by made in respect of difference in payment terms or delivery terms.

Resale Price Method (RPM)

- Example

- A Ltd is a distributor of IT products
- A Ltd purchases desktops from its related party, P Ltd.
- A Ltd also trades in laptops manufactured by X Ltd
- *P Ltd as well as X Ltd would supply the warranty replacements free of costs to A Ltd.*

Particular	P Ltd (AE)	X Ltd
Purchase Price of A Ltd.	INR 15,000	INR 22,000
Sales price of A Ltd.	INR 18,000	INR 26,000
Other Expenses incurred by A Ltd.	INR 500	INR 700
Gross Margin	INR 2,500	INR 3,300
Gross Margin % on sales	13.89%	12.69%

Resale Price Method (RPM)

Particulars	Amount (INR)
Sales Price of Laptop in India	26,000
Expenses incurred by A Ltd.	700
Purchase Price	22,000
Gross Profit	3,300
A's GP on Sales (%)	12.69%

Particulars	Amount in USD
Sales Price of Desktop in India	18,000
Less: Expenses incurred by A Ltd.	500
Less: Arm's length Resale Margin @ 12.69% of Sales	2,285
Arm's Length Purchase Price	15,215
Purchase price paid to AE	15,000

Price which should have been paid

Price which is actually paid

Resale Price Method (RPM)

- Example

- A Ltd is a distributor of IT products
- A Ltd purchases desktops from its related party, P Ltd.
- A Ltd also trades in laptops manufactured by X Ltd
- *Only P Ltd would supply the warranty replacements free of costs to A Ltd; X Ltd would supply the product without providing warranty*

Particular	P Ltd (AE) (incl Warranty)	X Ltd (excl Warranty)
Purchase Price of A Ltd.	15,000	19,000
Sales price of A Ltd.	18,000	26,000
Other Expenses incurred by A Ltd.	500	700
Gross Margin	2,500	6,300
Gross Margin % on sales	13.89%	24.23%

Resale Price Method (RPM)

Particulars	Amount (INR)
Sales Price of Laptop in India	26,000
Expenses incurred by A Ltd.	700
Purchase Price	19,000
Gross Profit	6,300
A's GP on Sales (%)	24.23%

Particulars	Amount in USD
Sales Price of Desktop in India	18,000
Less: Expenses incurred by A Ltd.	500
Less: Arm's length Resale Margin @ 24.23% of Sales	4,362
Arm's Length Purchase Price	13,138
Add: Adjustment of product differences materially affecting my gross margin	2,423
Arm's Length Purchase Price (adjusted)	15,562
Purchase price paid to AE	15,000

Price which should have been paid

Price which is actually paid



Transactional Net Margin Method



Transactional Net Margin Method (TNMM)

- General, marketing and administrative expenses are like establishment costs and therefore they do not directly affect the prices of the goods in the market
 - Therefore, Gross margin is better indicator of profitability reflecting the impact of over-pricing / under-pricing
 - However, in case where GM based methods cannot be applied, TNMM is to be used as a residual method
- TNMM tests the net margins of the tested party as oppose to gross margins in case of RPM or CPM
- TNMM becomes inevitable where the assessee has interlinked transactions of purchase and sale from / to related parties where they cannot be benchmarked isolated
 - However, in SDT only payment transactions with related parties are covered and therefore this argument may not be fully applicable in all circumstances



Transactional Net Margin Method (TNMM)

- The TNMM compares the net profit margin under controlled transactions to the same net profit margins under comparable uncontrolled transaction by the tested party in
- Alternatively can be compared with the margin earned by independent comparable companies.
- As it uses net margins to determine arm's length prices the TNMM is a less direct method than the price based method (CPM, RPM and CUP)
- Many factors may affect net profit margins but may have nothing to do with transfer pricing. E.g. Company is in set up phase and the margin is suppressed due to market conditions and not due to Related Party Purchases



Transactional Net Margin Method (TNMM)

- Procedure for application
 - Selection of the tested party
 - Period of Comparison
 - Aggregation of Transactions
 - Identification of Comparable entities
 - Profit Level Indicators
 - Adjustment Calculations



Transactional Net Margin Method (TNMM)

- Selection of Tested Party
 - An entity for which net profitability of the controlled transactions is to be tested – may not necessarily be the taxpayer
 - An entity for which the reliable data on closely comparable transactions can be identified
 - Generally a least complex entity without its own intangibles or unique assets and which only performs the routine functions For e.g., a distributor, sales agent, contract manufacturer



Transactional Net Margin Method (TNMM)

- Period of Comparison
 - As per the IT Rules, multiple year data can also be used for comparability, in order to eliminate the accounting differences, product life cycles, varying businesses and discrepancies in short-term economic conditions
 - The averages for the multiple year data can be simple average or weighted average depending upon the facts of each case.



Transactional Net Margin Method (TNMM)

- Aggregation of Transactions
 - Multiple transactions entered into by the enterprise which are so interlinked that they cannot be evaluated separately.
 - TNMM is applied by aggregating the such transactions with respect to closely linked products, similarity of functions, long-term arrangements, and intangible rights.
 - If aggregation using this criteria is not possible then on company wide basis. However, it is preferred to aggregate the transactions at the most micro level to the extent it can reliably be analyzed



Transactional Net Margin Method (TNMM)

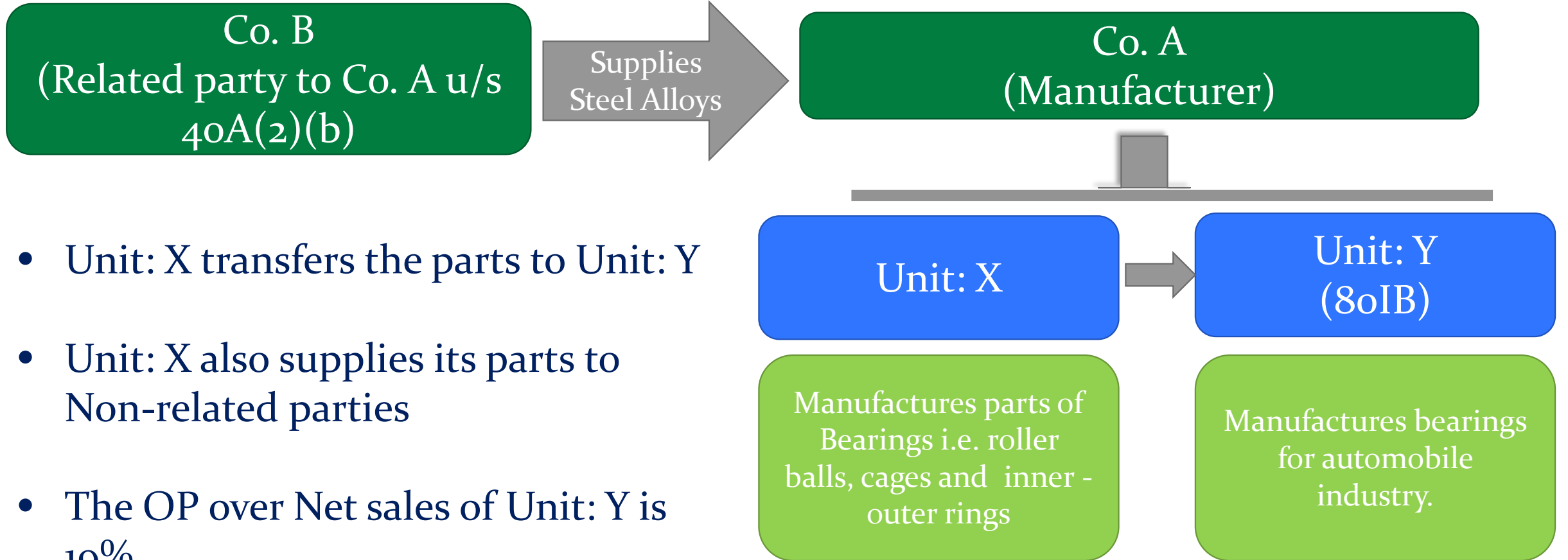
- Identification of Comparable
 - Internal or External comparison
 - External Comparison involves selection of comparable independent enterprise having similar FAR.
 - For external comparison the information which are available in public domain can only be used
 - Two databases are basically considered to be reliable for selection of such comparable i.e. Prowess and Capitaline Plus



Transactional Net Margin Method (TNMM)

- Selection of Profit Level Indicator
 - All of the profit-level indicators used in TNMM are based on operating income, which is gross profit less operating expenses
 - PBT /PBIT/ PBDIT over Net sales, Return on capital assets or capital employed, operating profit over operating cost
- Adjustment Calculations
 - Adjustment to comparable margin should be made to improve comparability. It shall be based on commercial practices, economic principles or statistical analyses.

Transactional Net Margin Method (TNMM)



- Unit: X transfers the parts to Unit: Y
- Unit: X also supplies its parts to Non-related parties
- The OP over Net sales of Unit: Y is 19%



Profit Split Method



Profit Split Method (PSM)

- PSM determines arm's length profit based on combined profits derived by related parties
- PSM is relevant
 - where different related parties are doing typical activity in value chain and external comparable with similar FAR is difficult to apply
 - Sharing of non-routine assets or entrepreneurial risks
- PSM requires extensive working to derive reliable results and therefore it is used in limited cases only
 - One of the reason for not applying PSM in international TP is that it requires substantial data and functional information of overseas entities
 - In case of SDT, since the concerned entities would be in India only, data capturing may not be that difficult
 - PSM may typically be relevant in cases of inter-unit transfers of intermediate goods between Tax Holiday and other units

Profit Split Method (PSM)

- Types of PSM as per OECD

Form of PSM	Typical TP issues	Industries where used
Overall PSM (Contribution Analysis)	Integrated and complex functions, risks and assets. Significant risks on both sides of the transaction	Financial services Telecom
Comparables PSM	Determination of royalties	Pharmaceutical industry
Residual PSM	Valuable intangibles developed on both sides of the transaction. Entrepreneurial risks on both sides of the transaction	Automotive Consumer electronics Financial services



Profit Split Method (PSM)

- Overall Profit Split Method
 - Combined operating profits are split among entities in the value chain on the relative value of the functions performed and contributions delivered.
 - Method effectively results in “rate of return” pricing when the allocation of profits is based on financial data
 - Suitable only when analysis of FAR for each entity is done in a detailed manner.
 - This method is mostly confused with the global apportionment formulas used by the organization
 - This method is well suited to groups with complex transactions where it is not possible to define the scope of functions and responsibilities clearly.
 - This may be relevant in SDT to price the inter-unit transfer of intermediate goods between Tax Holiday and other units



Profit Split Method (PSM)

- Comparable Profit Split Method
 - Combined operating profits are split among entities in the value chain on the data from observed comparable transactions between third parties.
 - The comparable transactions should meet the comparability requirements
 - There should be similarity with regards to the contractual terms
 - The combined operating profits from controlled and uncontrolled transactions should be similar and shall not vary significantly.
 - Applied specifically in royalty analysis using the NPV of forecasted financial data of the licensor and licensee for determining the AL rates of royalty.



Profit Split Method (PSM)

- Residual Profit Split Method
 - The residual profit, i.e., portion of the profit attributable to the entrepreneurial, non-routine or residual functions is split based on the profit split principles.
 - There is a characterization of functions, risks and assets to routine and non-routine, wherein the routine functions are considered to be relatively simple and for which the comparable market data is easily available.
 - The profit is attributed to the routine functions and the arm's length character is first applied to this part of the profit.
 - The residual profit, if attributable to the non-routine / entrepreneurial functions is split on the basis as considered appropriate depending on the character of the profit
 - A common issue with this method is that there is often a very thin line between routine and non-routine functions, risks and assets.
 - This method is the most commonly used profit split method, particularly popular in automotive, consumer electronics and financial services industries.



Profit Split Method (PSM)

- Application of PSM
 - Practical difficulties
 - This works as post-mortem analysis and therefore provides uncertainty at the time of transaction
 - Therefore, it cannot be used as primary method to set the prices
 - Weightage given to different functions, assets and risks in the whole value chain is very subjective
 - The rigidity from the tax payer to disclose the financials from the other side while application of this method.
 - Detailed analysis of the entity-wise FAR becomes a difficult task for the group
 - Extensive data requirement to support arguments and weights given to various value drivers of business

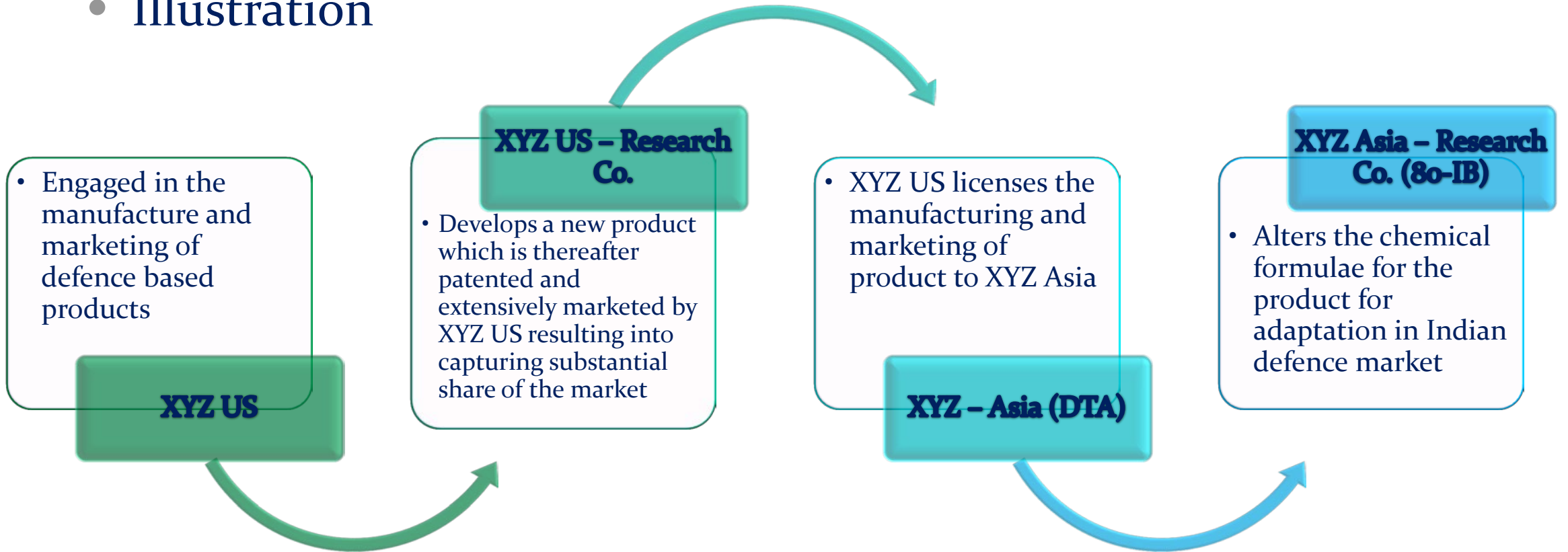


Profit Split Method (PSM)

- Application of PSM
 - Strengths
 - Important tool for pricing of complex transactions because of its flexibility and economic impact
 - The specificities of the industry and of the group can be taken into account
 - Method takes into account the economic integration and the returns associated with valuing intangibles
 - Providing information on financials from the other side up front increases the credibility of a strategy.

Profit Split Method (PSM)

- Illustration



- Residual Profit split method is most appropriate in this case

Profit Split Method (PSM)

- XYZ Asia and XYZ Asia – research co. start the manufacture and marketing of the product in the year 2012.
- For the tax year 2012 XYZ US has not incurred any expenses related to the marketing or license of the said product

Sr. No.	Particulars (in respect of the said product)	XYZ Asia	XYZ Asia – Research Co.
1	Sales for 2012	\$ 1000	-
2	Expenses for 2012	\$200	\$400
3	Residual profit	\$400	
4	Operating assets for 2012	\$300	\$500
5	Comparable companies profit margin doing similar business in India	10% on operating assets	
6	Profit split to companies	\$30	\$50



Profit Split Method (PSM)

- First stage of residual profit split has been completed by allocating profits on the most direct basis.
- The balance residual profit of \$320 will be attributable to intangibles generated by XYZ Asia (brand name in Asia) and Patent generated by XYZ US.
- To determine the relative value of intangible for attributing the balance residual profit, the most practical method may be comparing the R&D expenses incurred by the two companies on the development and capitalisation of the same in the market.
- Further the same formulae can be used to allocate the attributed profit between both the Indian companies (XYZ Asia and XYZ Asia – research co.) for the intangibles created by them.



The Residual Method



The Residual Method

- The transactions in respect of Intangible assets, IPRs, Tangible Assets, Technical know-how, R&D services are difficult to be benchmarked with conventional methods
- Rule – 10BA, provides for applying any other method that gives better picture of ALP of such transactions



The Residual Method

Examples

- Purchase of Technology based Machinery specifically manufactured.
- Sale / purchase of shares
- Lump-sum amount of Royalty for limited use of technical know-how
- Outsourcing of R&D Activities



The Residual Method

Example

- Co. A procured machinery for Manufacturing Digital Watches For Rs. 5,00,00,000
- Earlier Co. A was trading the said product imported from related parties
- The Cost of imported watches was INR: 125 per pc. The trading margin was 6%
- The estimated cost of production is INR: 90 per pc.

The Residual Method

Year	Estimated Sales (Pcs)	Cost Reduction	Total Benefit
0	Cost of Machine		(50,000,000)
1	220,000	7,700,000	7,700,000
2	242,000	8,470,000	8,470,000
3	266,200	9,317,000	9,317,000
4	292,820	10,248,700	10,248,700
5	322,102	11,273,570	11,273,570
6	354,312	12,400,927	12,400,927
7	389,743	13,641,020	13,641,020
8	428,718	15,005,122	15,005,122
9	471,590	16,505,634	16,505,634
10	518,748	18,156,197	18,156,197
		IRR	17.30%

Total watches sold in previous year	200,000
Savings in Cost [125 - 90]	35
Growth Rate	10%



Comparability Search



Comparability Search on Database

- Potential Search criterion on Database
 - Identify the industry codes for the activity and extract companies engaged in that (A)
 - Ideally include all NIC Code that may cover such products
 - Don't restrict it to the activities
 - Identify the likely product names and run a Boolean search (B)
 - Identify the competitor (or likely comparable companies based on client's experience) in the database and understand its classification
 - See if that classification needs to be included in above searches



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 1: Data Availability
 - Eliminate companies for which data for the selected period is not available
 - E.g. if benchmarking is carried out for FY 2012-13, data prior to FY2010-11 cannot be used, hence where latest data available is up to FY 2009-10, the same are eliminated
 - Step 2: No Financial Data
 - Eliminate companies which does not have financial data for the concerned years
 - It may happen that database may have certain information for the relevant year but may not have the financial data. Since our analysis is to be based on financial data, companies without such data is to be excluded



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 3: No commercial activities
 - Eliminate companies which did not had commercial activities in the relevant year (i.e. sales = 0)
 - Step 4: Activity Similarity
 - Eliminate companies which does not derive substantial revenue from the activities that you are looking for
 - E.g. if you are looking at manufacturing companies, you may eliminate companies earning less than 75% revenue from manufacturing activities



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 5: Sales Threshold [Size Comparability]
 - One size does not fit everyone
 - Companies which have different scale of operations need to be eliminated
 - This can be done based on industry analysis (which identifies different scales for a typical industry)
 - If industry reports are not available, you can consider a reasonable range on both the sides of tested party's turnover (keep in mind industry)
 - E.g. 1/5th and 5 times tested party's turnover



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 6: Geographic Comparability
 - Identify if the geographic differences can play material role in pricing in the activity / industry that you are looking at
 - Also, identify the relevant geography i.e. geography of customer or geography of supplier or both
 - Apply your criterion accordingly
 - E.e. if the tested party pre-dominantly sells goods in Indian market, you may check whether companies with substantial exports are comparable or not (or vice versa) and apply filter based on facts of the case
 - Where the final goods have substantial import elements, you may consider only those companies which have reasonable imports (the cost structure of company with pre-dominantly indigenous products may be different)



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 7: Comparable Asset Base
 - In case of capital intensive industry, one of the criterion that you may apply is the Asset Turnover ratio to eliminate outliers
 - Companies with very skewed asset turnover ratio are either highly under-utilized (where asset / turnover ratio is very high) or may be doing very limited functions (where asset / turnover ratio is very low)
 - This is also a relevant criterion while benchmarking distribution companies as they generally do not have significant assets
 - Companies with huge assets in distribution companies reflect that there are idle assets not used for business and therefore may not be considered comparable



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 8: Other Value Drivers
 - Identify primary value drivers for the industry / activity
 - If there is certain basic element that you are looking at in comparable companies, apply those criteria
 - E.g. employees are the prime asset and therefore major cost in case of software or ITeS sector (ranging from 40% - 70%), therefore in that case one may eliminate companies with employee costs < 25% of the total costs



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 1: Quantitative Criteria
 - Step 9: No-Intangibles comparability
 - If tested party is contract manufacturer and uses related party's intangibles, you may apply bright-line test
 - A bright-line test suggests that company incurring more than 3% costs on research (3% on AMP costs) are developing intangibles in form of know-how (or marketing intangibles)
 - Therefore, you may apply this criterion to eliminate companies where such costs are more than 3% to eliminate such companies



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 2: Qualitative Criteria
 - Material controlled transactions
 - Companies with material controlled transaction should be eliminated
 - Sony India's Ruling – Aggregate RPT > 10-15%
 - Department at times increase to 25%
 - Functional Comparability
 - Identify whether the activities of the companies are comparable or not
 - Apply facts of the case
 - Extra-ordinary / Exceptional Events
 - Companies with extra-ordinary events are to be excluded
 - Ownership criterion
 - Companies with government ownership may not have commercial objectives and therefore should be excluded



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 2: Qualitative Criteria
 - Consistent loss-making companies
 - Consistent loss-making companies suggests problems with their commercials
 - Diminishing revenue criterion
 - Where industry has been flourishing at handsome growth, companies with diminishing revenues may be considered as outliers
 - BoxPlot Filter
 - A statistical tool to eliminate the companies which does not represent appropriate sample
 - It excludes companies with abnormal margins on both the sides



Comparability Search on Database

- Potential Search criterion on Database
 - Elimination Round 2: Qualitative Criteria
 - Sources of Information for Qualitative Criteria
 - Database itself
 - Company Annual Report
 - Company website
 - Google Search
 - BSE / NSE Website
 - Documents filed with SEBI
 - Industry Reports



TP Method & Applicability

Method	Comparability Requirements	Approach	Application
CUP	Very High	Price Benchmarking	Very difficult but most preferred method
RPM	High	GP based Price Benchmarking	Distributor / Service Provider
CPM	High	GP based Price Benchmarking	Manufacturer / Service Provider
PSM	Medium	Net Margin Benchmarking	Manufacturer / Distributor / Service Providers
TNMM	Medium	Net Margin Benchmarking	Manufacturer / Distributor / Service Providers



Questions?



Thank You



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