

CHAPTER 2 KEY CONCEPTS

CONTENT

TRANSFER PRICING	22
RELATED PARTY	25
ARM'S LENGTH PRICING	33
METHODOLOGIES TO CALCULATE ARM'S LENGTH PRICING	37
<i>Comparable Uncontrolled Price Method (CUP)</i>	37
<i>Resale Price Method (RSP)</i>	43
<i>Cost Plus Method (CPM)</i>	47
<i>Profit Split Method (PSM)</i>	50
<i>Bright Line Test Method</i>	57
<i>Comparability and Adjustments</i>	57
<i>Transactional Net Margin Method</i>	64

A systematic study of the topic warrants an understanding of certain key concepts in the legal and commercial matrix. The discussion below about various key concepts is aimed to provide a starting point to unravel the conundrum of issues related to Transfer Pricing by providing an insightful analysis of existing key concepts which is basis of challenges and root cause of disputes.

TRANSFER PRICING

The Organisation for Economic Development and Cooperation ⁴² ("the OECD") defines "Transfer Price" as the price at which an enterprise transfers

⁴² The Organisation for European Economic Cooperation (OEEC) was established in 1948 to run the US-financed Marshall Plan for reconstruction of a continent ravaged by war. By making individual governments recognise the interdependence of their economies, it paved the way for a new era of cooperation that was to change the face of Europe. Encouraged by its success and the prospect of carrying its work forward on a global stage, Canada and the US joined OEEC members in signing the new OECD Convention on 14 December 1960. The Organisation for Economic Co-operation and Development (OECD) was officially born

physical goods and intangibles or provides services to associated enterprises.⁴³ The definition of "Transfer price" in Business Economics⁴⁴ reads; "*the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.*" The economic reason for charging a correct transfer price for inter-company transactions is to evaluate the performance of the respective trading partners within the group. A correct transfer price will help business managers to derive a best possible decision about whether to procure goods and services within the group or from third party suppliers.

The term 'Transfer Pricing' is used for prices paid to inter-group entities for the goods or services sold or purchased within enterprises belonging to same group company. In most of the instances, transfer prices are disputed by the authorities for cross border transactions. Recently, Indian Authorities have also formulated some regulations for domestic transactions between related parties. Cross border transactions are important to unravel the tax evasion and probable money laundering acts. The concept of Transfer Pricing was first introduced by United Kingdom ('UK') in 1915. It has grown significant importance only in the seventies when USA formulated regulations to deal with the Transfer Pricing issue. The first comprehensive guidelines on Transfer Pricing was published by the Organisation for Economic Co-operation and Development ('OECD') countries in 1979 and United Nations ('UN') in 1979. Thereafter various reports, studies and updates, were

on 30 September 1961, when the Convention entered into force. Source .. <http://www.oecd.org/about/history/> accessed on 12-05-2013

⁴³ OECD, *Transfer Pricing guidelines for Multinational Enterprises and Tax Administration*, (1995) available at http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010/the-arm-s-length-principle_tpg-2010-4-en, (Last accessed on December 19, 2010)

⁴⁴ CHARLES T. HORNGREN AND GARY L. SUNDEM, *INTRODUCTION TO MANAGEMENT ACCOUNTING* 336 (9th ed. Prentice Hall International Inc.)

available on Transfer Pricing in the following years. From financial perspective Transfer pricing is probably the most important tax issue in the world.

Generally a price needs to be fixed for any transaction which takes place between two entities in a controlled or uncontrolled environment. The normal course of action for fixing the price in a transaction between two independent parties would consist of negotiation of the price. The agreed price takes various factors into consideration, viz., market demand, competitors move, need of the two parties, etc. The price so fixed in an uncontrolled environment is mainly driven by the market. Transfer prices are generally set within the Group for inter-group exchange of goods and services. The transfer price between two entities of the same multinational company may not be driven by the market condition. It is possible that a manipulative price is set for the transfer of goods and services, to reduce the tax burden of the Group, which is not based on the market demands. The multinational enterprises are in a position to adopt a manipulative transfer pricing policy which is not market driven and influenced.

Due to its very nature, Transfer Pricing subject has been a puzzle for all concerned. One approach is to consider Transfer Pricing as simple management tool for determining the profitability of the different entities of the Group. In such a case, it may be possible to argue that Transfer Pricing enables the managers of Group to make the best possible decision as to whether to buy or sell goods and services inside or outside the group. If management wants its branches and subsidiaries in different countries to operate as independent profit centers, then prices should not be influenced. If there has been no other consideration, then the prices would be the same as fixed in the transactions between unrelated parties. However, the researcher

observed that due to various reasons, the transfer prices may differ from those derived for transactions between independent entities.

RELATED PARTY

It is very important to understand the definition of related party since the conundrum of Transfer Pricing involves transactions between related parties. A simple definition of related party is a party (individual or group) who is related in some way to the initial party. A related party could include a family member or relative, stakeholder or a related Corporation. The principal concerns of the taxation authorities suggests that related parties would enter into transactions which unrelated parties would not in normal circumstances. Any transfer of money and property within related parties may be done in a way which will be detrimental for any unrelated stakeholders which include but not limited to revenue authorities, minority shareholders etc. Although these related party transactions are commonly viewed as conflict of interest and aimed to reduce the interest of any unrelated stakeholder, there can be also situation wherein, if the transactions are done efficiently, these transactions can be helpful to increase the profitability of the Company.

A Related Party transaction may create conflict of interest and may not be aimed at best interest of the company, especially for minority shareholders. The impact of corporate governance on related party transactions is discussed in detail in subsequent chapters of this study. Related party transactions may be aimed to siphon funds out of the company to another company, which is a related party. These transactions can be also considered as opportunity that is lost to a related party to the detriment to the shareholders and interest of the company. Thus, these conflicts of interests are inherently linked to the governance structure of a company, which can either enhance or limit the board's effectiveness. The board is responsible for

reviewing and guiding corporate strategy and for effectively monitoring management, and is accountable to the company and its shareholders.

Not all related party transactions are detrimental to the interest of a company and its shareholders. Some transactions are legitimate and serve practical and commercial purpose. Prohibiting a legitimate related party transaction may be detrimental for a Company. For example, a group company may have two entities "X"- Manufacturing entity and "Y" – a software company. Company "X" may appoint "Y" for designing and developing a performance monitoring software at a cost which is a competitive price. Not allowing such transactions may be detrimental to the Company "X". Hence related party transactions may be helpful for a company if those are done at arm's length pricing. Related party is defined under various statutes. Critical analysis of these statutes is important to understand the nature of influence that can create on these related party transactions.

Accounting standard 18 (AS-18)⁴⁵ defines related parties as below:-

- (a) Enterprises that directly, or indirectly through one or more intermediaries, control or are controlled by, or under common control with, the reporting enterprises (this includes holding companies, subsidiaries and fellow subsidiaries)
- (b) Associates and joint ventures of the reporting enterprise and the investing party or Venturer in respect of which reporting enterprise is an associate or a joint venture
- (c) Individuals owning directly or indirectly an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individuals
- (d) Key management personnel and relatives of such personnel

⁴⁵ Accounting Standard 18, available at www.mca.gov.in/ministry/notification/pdf/AS_18.pdf accessed on 18.5.2015

- (e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise

From the analysis of AS-18 it is clear that the related persons are those persons who can influence decision of the reporting enterprise.

International Accounting standard 24 (IAS-18)⁴⁶ defines related parties as- Any associates/relatives/and in close proximity with the *reporting entity* is considered to be related party. The following persons are considered to be related party under International Accounting Standard 24:

- (a) A person or a close member of that person's family is related to a reporting entity if that person:-
 - i. Controls the entity
 - ii. Can influence the decision of the entity
 - iii. Hold a Key Managerial position of the entity
- (b) In case of an organisation the following rule applies:-
 - i. Any of the group companies
 - ii. Joint venture partner
 - iii. Sister concerns or an associate of the JV
 - iv. Any direct and/or indirect relationship with the entity
 - v. The entity is a post retirement benefit plan for reporting entity or associate or joint venture of the reporting entity
 - vi. The person identified in (a) has significant control over the key managerial person of the entity. The close members of the family

⁴⁶ IAS 24 – Related Party Disclosure, available at www.iasplus.com/en/standards/ias24 last accessed on 18.5.2015

expected to have control includes spouse, children, dependents and domestic partners.

Analysis of the IAS-24 makes it clear that influence on business decision plays an important role for defining a related party for the business. The assumption behind this accounting and reporting standard was that related party transactions are normal in current business scenarios. Therefore it is assumed in this standard that the entity has an ability to affect the financial and operating policies of the investee through presence of control, joint control or significant influence. A related party relationship could have an effect on the profitability and financial health of a company. The researcher is of the opinion that related parties may enter into transactions that unrelated party would not enter in a normal circumstance. More importantly the profit and loss and financial position of an entity may be affected by a related party arrangement even if related party transactions are not recorded in books of accounts. The mere existence of the relationship may be sufficient to affect the financials of an entity. For example, a subsidiary may terminate relationship with a trading partner after its parent company acquired another company engaged in the same activity in which the former trading partner was engaged. Alternatively, one may refrain from acting because of the significant influence of another – for example, a subsidiary may be instructed by its parent not to engage in research and development. The above virtual transactions are quite common and that may result into even loss to the exchequers of a host country which is discussed in detail in the subsequent chapters in this study.

Companies Act, 2013⁴⁷ defines related parties as below:-

Section 2(76) read with rule 3 of Companies (Specification of definitions details) Rules, 2014, defines a related party as under:

⁴⁷ Companies Act 2013, available at www.mca.gov.in/Ministry/pdf/Companies_Act_2013.pdf accessed on 18.5.2013

“Related Party”, with reference to a company, means—

- a director or his relative;
- a key managerial personnel or his relative;
- a firm, in which a director, manager or his relative is a partner;
- a private company in which a director or manager is a member or director;
- a public company in which a director or manager is a director or holds along with his relatives, more than 2% of its paid-up share capital;
- any corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
- any person on whose advice, directions or instructions a director or manager is accustomed to act:

The impacts of compliance for related party transactions under new Companies Act, 2013 are mainly:-

- a. Increased transparency for related party transactions (RPT) which are now more aligned with the arm's length principle. Transfer pricing is already a focused area for tax authorities globally.
- b. Enhanced accountability for Key Management
- c. New responsibilities for the board of directors and key management

Related party in Income Tax 1961 is termed as “associated enterprise”. For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, “associated enterprise”, in relation to another enterprise, means an enterprise —

- (a) Directly or indirectly or through intermediaries participates in the management of the company

- (b) The same person who is managing or controlling an enterprise also manages or controls the other enterprise

For the purpose of identifying an associated enterprise the following factors needs to be considered:

- (a) Direct or Indirect shareholding of not less than 26%
- (b) Directly or Indirectly holds voting rights of not less than 26%
- (c) In case loan extended by one enterprise exceeds 51% of the fixed assets
- (d) In case the guarantee provided by one enterprise exceeds 10% of the total borrowing of the other company.
- (e) More than 50% of the Board of Directors or executive Directors are appointed by the other entity
- (f) More than 50% of the Board of Directors or executive Directors of the two entities are appointed by the same entity.
- (g) The business processes, manufacturing processes of one entity is completely dependent upon the technical know-how, patents and other supports from another entity.
- (h) More than ninety percent of the input required for the manufacturing carried out by one company are supplied by other entity or it's designated supplier. It is also important to note here that the other entity should be in a position to influence the price and supply to the entity.
- (i) The entity is not independent to decide its customer or the price. The other entity decides and influences the selling decision.
- (j) Both the enterprises are controlled by and individual or by his relatives or members of a HUF.
- (k) Where one enterprise is a firm and the other enterprise holds not less than ten per cent interest in such firm.

(l) Any other relationship of mutual interest, as may be prescribed.

The Central Excise Act, 1944 defines persons shall be deemed to related, if:-

- A) They are inter-connected undertakings
- B) They are relatives
- C) Amongst them the buyer is a relative and a distributor of the assessee or sub-distributor or such distributor
- D) They are so associated that they have interest, directly or indirectly, in the business of each other.

For the purpose of valuation for payment of **Customs duty**, generally transaction value is considered for duty purpose subject to buyers and sellers are not related. Rule 2(2) of Customs valuation (Determination of price of imported goods) Rules 2007 deals with related party relationship. For the purpose of these rules, persons shall be deemed to be related only ⁴⁸if:-

- 1) They are officers and directors of one another's business
- 2) They are partner in business
- 3) They are employer and employee
- 4) Any person directly or indirectly owns, controls or holds five percent or more of the outstanding voting stocks or shares of both of them
- 5) One or other directly or indirectly controls the other
- 6) Both of them directly or indirectly controlled by third person
- 7) Together they directly or indirectly controls a third person
- 8) They are member of the same family

⁴⁸ II Compendium of Community Customs Legislation, Chapters 9-12 (1988) available at <http://aei.pitt.edu/41571/1/A5674.pdf> (Last accessed on December 10, 2012)

Specified Domestic transactions (not being international transaction) between associated enterprises will be subject to transfer pricing w.e.f., 1st April 2014 (Section 92A(2) of IT Act)). In accordance with these provisions, persons covered under Section 40A (2b) are considered as related party. The persons mentioned below are considered as related party as per this provision:

1. Company, Firm, AOP or HUF:
 - a. Any Director of the Company, Partner of the firm, or member of the association, or family or any relative of such director, partner or member;
 - b. Any Person in whose business or profession the assessee or director or partner or member of the assessee or any relative of such person has a substantial interest
2. All Assesseees-
 - a. Any Individual who has substantial interest in the business or profession of the Assessee;
 - b. A Company, Firm, AOP, or HUF having a substantial interest in business or profession of the assessee or any director, partner or member of any such person or any relative of any such director, partner or member;
 - c. A Company, firm, AOP or HUF of which a director, partner or member has a substantial interest in the business or profession of the assessee or any director, partner, or member of any such person or any relative of any such director partner or member

From all the analysis of related party definition under different statutes discussed above, it is observed that related parties are persons defined under these statutes as individual and Companies who can exert control on each other. A related party transaction is increasingly under scrutiny by

taxation authorities since Companies are in a position to adopt an abusive transfer pricing mechanism for related party transactions, due to which different unrelated stakeholders may sustain losses. To avoid such situations, all the legislations have been enacted to ensure, through strict rules and regulations that related party transactions are done at an uncontrolled environment and prices for such transactions are set at arm's length.

From the above analysis of various statutes, it is concluded that related party transactions is a concern that many markets around the world shares. Concentrated ownership and widespread use of company groups is a common feature of listed companies in India. The decision for concluding a transaction should be done in an uncontrolled environment for protection of minority interest. India has over the years introduced several legislations including introduction a new Companies Act in 2013, to improve corporate governance standards. However, the researcher is of the opinion that further measures are needed to promote greater accountability of controlling shareholders.

ARM'S LENGTH PRICING

Arm's length pricing principle requires that prices charged between related parties for sales of goods and services should be similar to the price that an independent party would have charged in the same circumstances⁴⁹. For example, the price of a Raw Material sold by "X" to "Y", both are associated companies (Related parties) should be equivalent to market price, i.e., the price to be charged to an unrelated enterprise. To explain the term "Arm's Length pricing", it can be explained as a pricing with distance and with no close connection.

⁴⁹ The researcher observed from various guidelines issued by Income Tax department, OECD and various court ruling.

Although the principle can be explained very easily, calculation and articulation of arm's-length pricing is complex. The factors that can influence the calculation of Arm's length pricing may include nature of transaction, circumstances, payment terms, geographic location, risk factors etc. Also in some cases goods which are sold to associated enterprises in a particular country is not sold to any third parties. This also creates difficulties in availability of comparable market price. Similarly services provided by group companies may not be compared if service entities within groups do not provide services to any third parties.

Considering the above, deriving a correct arm's length pricing is difficult considering the information needed to verify and proving the appropriateness of such arm's length pricing to the authorities. To remove the difficulties, Tax Provisions of various countries and OECD have recommended various processes and rules to calculate the arm's length pricing for intercompany transaction within group companies.

It is clear that the arm's length principle is determined by applying the circumstances of a controlled transaction in an uncontrolled transaction. It means that with the same circumstances the pricing by a third party would be similar to what is charged by the related parties. OECD guidelines allows to compare a near similar transaction of a controlled transaction but not recommended to use the exact industry average. Generally the following factors are considered while verifying the arm's length pricing while comparing with the pricing in uncontrolled situation:-

- i. The nature of transaction
- ii. Functional analysis including asset employed and risk undertaken
- iii. The commercial terms

- iv. Volume of business and geographic location
- v. Any special pricing needed for start-up business

As per Rule 10(C) of the Income Tax rules, 1962, an appropriate method is the method which suits the function and environment of each transaction and should provide the most reliable method for determination of arm's length pricing.

The sub rule (2) of the said rule suggests that while selecting the most appropriate method, the following factors should be taken into consideration:

- I. The type of transaction;
- II. Functional and risk analysis;
- III. The quality of data on which Company relied upon to establish the pricing;
- IV. Comparability Analysis with the uncontrolled transaction;
- V. The adjustments made for various factors like volume, nature of cost etc.
- VI. The articulation of assumptions made for the comparability study

The concept of Arm's length principle is also provided in Article 9 of the OECD Model Tax convention, which is mainly considered for drafting bilateral treaties. Although the OECD guidelines has acknowledged the facts that it is quite difficult to establish and articulate the application of the arm's length principle, but it has mentioned that there are various best practices available which can be considered for application of arm's length principle.

Analysis of the Transaction: OECD publication⁵⁰ set out the procedure to analyse the transaction for setting up an arm's-length principle and reviewing the same by the taxation authorities:-

- a) The tax authorities should scrutinize the actual transaction for understanding the structure of the said transaction.
- b) Although analysis of transaction by transaction is preferred but since it is not practical, grouping of transaction is also acceptable for any analysis
- c) It is not always possible to use a single price or margin, therefore, a range is always acceptable
- d) The guideline also suggest to analysis the data for the year in scrutiny alongwith previous year's data
- e) In its latest publication, OECD⁵¹ has recommended to use the most appropriate method in each of the circumstances after careful consideration of the most appropriate methods recommended by OECD earlier. While selecting a most appropriate method, OECD has recommended considering various elements including but not limited to availability of information to articulate the application of arm's length pricing. OECD in its guidelines has further commented that although the ultimately important objective is to apply a most appropriate method, in case CUP method can be applied in an equally reliable manner, the CUP method is preferred. "CUP" referred to Comparable Uncontrolled Price.

⁵⁰ OECD, Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration (2010) available at http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010/the-arm-s-length-principle_tpg-2010-4-en (Last accessed on May 25, 2013) (hereinafter in this chapter 'OECD Guidelines')

⁵¹ *ibid*

Methodologies to calculate arm's length pricing

Income Tax Act, 1961 has mentioned best practices and methodology which can be applied for determination of Arm's length pricing, such as:-

- a. Comparable Uncontrolled Price Method (CUP)
- b. Resale Price Method (RSP)
- c. Cost Plus Method (CPM)
- d. Profit Split Method (PSM)
- e. Bright Line Test Method

Comparable Uncontrolled Price Method (CUP)

Under this Method:

- a. the price charged sale of goods and services in comparable uncontrolled transaction, or a group of such transactions;
- b. In case of material difference between the nature of transaction and between the assessee Company and comparable company, the adjustment should be made for making the comparability more accurate;
- c. The adjusted price derived as above to be considered as arm's length pricing

The comparable uncontrolled price (CUP) method is considered as most appropriate and direct method for ascertaining arm's length price for related party transactions. As per CUP method, the prices charged for each transaction are compared with price charges by an entity in an uncontrolled environment. However, globally, it is realized now that identifying acceptable comparable information is not easy for applying CUP method. Even OECD has acknowledged in its' publication that it might be difficult to determine the accurate information for applying CUP method. However OECD has strictly recommended that wherever possible CUP method needs to be applied. The

extent of the OECD's support for the CUP method can be seen from the comment that ⁵² "every effort should be made to adjust the data so that it may be used appropriately in a CUP method"

CUP method is preferred over other methods where the comparable information is available. The CUP method may be applied using both internal and external comparables. When pricing information about a transaction between two unrelated parties, for a similar goods or services and under similar condition, is available, the price may be considered as External comparables and can be used to benchmark the prices charged for a related party transaction. When goods or services are exchanged with an unrelated party, the prices charged for the same may be used to compare the prices charged for a same or similar goods or services by a related party. While selecting any such comparables, it should be verified that the transactions were entered in a similar condition.

CUP method is internationally accepted by the revenue authorities as one of the accepted methodology to determine the arm's length pricing. However adjustment needs to be made for any differences in condition of sales. The common type of adjustment needed to derive an accurate comparable price, accepted under CUP method, is discussed as below:

The commercial terms, which may include:-

- Volume of transactions. For example, a price of 1 quantity of material cannot be similar to 100 quantity

⁵² PWC, *International Transfer Pricing* (2013) available at <https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf> (Last accessed on December 20, 2013)

by Indian subsidiary should be added by the equivalent historical warranty cost to benchmark the prices with the prices charges to unrelated distributors for the similar products.

In another example, a UK based Company would manufacture various types of cheese which was calorie free when eaten with wine, would sell the cheese to related companies in Germany and unrelated companies in US. The price charged to US unrelated company cannot be considered as CUP because the "level of market" is different.

Broadly speaking, CUP can be divided into:-

- a) Internal CUP
- b) External CUP

The following diagram will help to understand the different CUPs. The assumption for the chart appended below is that there is a transaction of similar goods.

Transfer of Tangible Property

Comparable uncontrolled price methodology

From the above analysis it is revealed that the prices paid for the goods or services are compared with price of uncontrolled transaction under similar conditions. CUP is the most direct method for determining the arm's length price. However, its sensitivity on the properties of products and the accompanying circumstances and conditions make its application difficult. Even a minor change in the properties of the products, circumstances of the trade (billing period, amount of trade, branding etc.) may have significant effect on the price. Product comparability is the absolute key, in particular, physical features such as size, weight, appearance along with volume, reliability, storage requirements, and regulatory requirements and similar attributes. Also such as market, delivery and payment terms etc. are also important attributes. Where an independent enterprise buys or sells the same product as is supplied in a controlled transaction and sufficient data on the uncontrolled transaction is readily available the CUP method will always be the most suitable method. Examples of situations in which the CUP method may be used include:

- a) The interest rate charged on a loan
- b) Royalty payment
- c) Industries where CUPs are more prevalent, for example, software development where products are often licensed to a third party, and
- d) The price charged for the transfer of a homogeneous item, such as traded commodity

For the following categories of products the CUP may be used:

- i. Extracted raw materials
- ii. Harvested crops
- iii. Animal products
- iv. Fungible chemicals

- v. Other fungible goods, i.e., pen, paper, pencils, clips, computer disk etc

Important rulings: *Eli Lilly and Company v. Commissioner*⁵³- Eli Lilly and Company, a pharmaceutical manufacturer, developed two forms of painkillers which it marketed under the names Darvon and Darvon-N. It transferred Darvon products and intangibles to Lilly PR, its subsidiary operating in Puerto Rico which in turn resold to Darvon products throughout the United States in 1971 and 1973. Although Lilly supported its pricing under the resale price method, the tax court disagreed and applied the profit split methodology.

In late 1972 the patent on the principal Darvon compound expired and in 1973, numerous pharmaceutical companies entered the market with similar Darvon like products. Thus for the year 1973, unlike the previous 2 years, there appeared to be the comparables uncontrolled sales.

In the tax court, both Lilly and the commissioner agreed that CUP method be applied but the issue that arose before the court was the comparability between controlled and uncontrolled sales as adjustments could not be made on account of differences arising on account of credit terms, supply of raw material, packaging, product quality and patent. However, at the end the tax court rejected the CUP method because the differences between controlled and uncontrolled transaction could be accounted for by a reasonable number of adjustments.

Resale Price Method (RSP)

Under this method-In case of a trading business (Mainly), to identify the price at which a goods is resold to third party which was purchased from a related party;

⁵³ 1996 (84) TC 185

- a. The price received from the third party for such and goods is then reduced by the gross margin earned by a comparable company in a similar circumstances;
- b. the price so derived is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
- c. The price arrived at (c) above is further adjusted for the adjustment needed for the removing the disparity between the nature of transaction and enterprises selected for comparability study;
- d. the adjusted price arrived in (d) above should be considered as an arms-length price from the associated enterprise;

Resale price method is applied for trading and resale transactions. To calculate an Arm's length pricing, the prices charged by reseller is reduced by the appropriate gross margin for the similar transaction and further reduced by the expenses incurred by such reseller for resale activities. The process is discussed below with help of an example:-

Company "A", who acts as a distributor in India for an US based entity, sells goods at INR 100/-. It purchases finished goods from its related parties situated in US. The gross margin earned by a similar unrelated reseller in India is 10% on its sale value and Company "A" incurs INR 5 as expenses on such reselling activities in India. In this circumstance the appropriate arms' length price for this transaction will be as below:-

Example of Resale Price Maintenance Method:

Price Charged by Company "A"	INR 100

Less: Gross Margin for similar business (Say 10%)	INR 10
Less: Expenses Incurred by Company "A"	INR 5
Derived Arm's length Price	(INR 100-10-5)= INR 85

The OECD guideline recognizes that there are difficulties in obtaining the gross margin figure earned by similar businesses for application of RPM. Generally it is found that gross margin considered for a comparable company and business conditions in which they operates are the contentious issues which lead to disputes between corporates and taxation authorities.

Applicability of RPM: The RPM can be applied in circumstances below:-

1. The use of RPM is ideal for distribution activity
2. Transactions involving purchase and resale of tangible property
3. RPM is most appropriate in a situation where the seller adds relatively little value to the goods and does not alter the goods physically before it resale. It is important to note that packing, labelling or minor assembly does not constitute physical alteration.
4. RPM is applied in such cases where a reseller does not use intangible assets to add value. It is very difficult to determine the resale margin, in case the ultimate seller adds significant value to the goods sold. The determination of margin become more complex when the seller creates an intangible property like marketing intangible, through its activities.

Example: An overseas Company manufactures finished components in Switzerland and sells to its related and unrelated distributors in India and China and pays distribution commission for the same. From the comparable

study it is revealed that unrelated distributors are earning at least 25% commission. On further investigation it is revealed that the related party in India also provides after sales service for the period under warranty. The cost for this service was approximately 3% of the sales value. Therefore, it was concluded that the related party should earn at least 25% + 3% on its sales.

Difficulty in application of RPM: Available Indian databases do not provide data on gross margins and therefore detecting gross margins/sales realized by third parties proves usually difficult either due to lack of available information or by the differing GAAPs (Generally Accepted Accounting Principles).

Important rulings: *El Dupont De Nemours & Co v. United States*⁵⁴- Dupont was the first case to directly consider risk and its effect on price. Dupont interposes a Swiss sales subsidiary, DISA, between it and its independent overseas distributors with which it had previously dealt directly. Dupont's transfer price policy for sales to DISA was Cost plus a percentage of the profit, if DISA could sell the product for more than this amount. However, when the total cost to make and sell was greater than DISA's selling price, the transfer price was Dupont's cost minus DISA's anticipated costs. In effect, DISA retained 75% of any profit, but if it sold at a loss, it would recover its costs so that the entire loss would be borne by Dupont. Moreover, Dupont funneled a large volume of sales through DISA. The third party sales did not call for large expenditure by DISA.

The taxpayer argued that the resale minus method supported its transfer pricing. The court rejected the taxpayer's position, based on the inadequacy of the taxpayer's comparables. It stated that the claimed selling expenses were far greater than normal selling expenses.

⁵⁴ 608 F2d 445 (Ct. Cl. 1979), certden 100SCt 1648

In upholding the IRS's code 482 on allocation of risk, the court said that DISA was not exposed to entrepreneurial risk. The court reasoned that DISA was not exposed to the either operating loss or loss associated with an involuntary termination of its services.

Cost Plus Method (CPM)

Under this method

- a. All cost (Direct and Indirect) cost for production of goods and services needs to be considered. It needs to be reiterated that all indirect cost also needs to be considered also;
- b. A normal (Comparable) mark-up as per industry standard or average needs to be added to the cost arrived as above;
- c. The gross margin needs to be added should be adjusted for all functional and other differences between the tested party and the comparable company;
- d. The cost as per (a) above to be added by the adjusted gross margin as mentioned in (c);
- e. The amount derived as per (d) above to be considered as arm's length principle for the related party transaction

The cost plus method is the easiest and conservative method amongst all methodologies discussed so far. However the cost plus methodology, when applied in a cross-border transaction, is not so conservative in case the seller of the goods and services and receiver of the same is situated in two separate tax jurisdiction since the tax authorities of receiving entity may not agree to the fact that selling entity is earning profit and receiving entity is sustaining losses, if such a situation arise. The acceptable methodology by the taxing authorities of the selling country will be to derive arm's length pricing under cost plus methodology which includes a mark-up on all direct and indirect cost incurred by the seller while charging a price to the receiver.

The major drawback of the Cost plus methodology may be observed in such cases where the seller and receiver of the goods and services are situated in two different tax jurisdictions. Further the shortcoming of applying such methodology may be observed in accurately determining the efficiency of a unit. Generally Cost plus methodology is applied for determining prices of contract manufacturing and sale of services. However the Cost plus methodology needs a careful selection of the costs considered in deriving the price and comparable mark-up determined for adding to such costs. The acceptability of mark-up is quite critical here since the biggest reason of dispute under the cost plus methodology is the mark-up considered by the selling entity. Further the cost plus methodology may be acceptable for the revenue authorities of the selling entity only and the tax authorities of receiving unit may reject such method, if losses are incurred by the receiving entities.

It is to be noted that while applying the mark-up under cost-plus methodology, the selected comparable, which were selected for determining the appropriate mark-up, may not need to produce and sell the similar goods. The nature of business here is important than the nature of products.

For example, an accounting service provider should be compensated for its category of services and not the exact nature of services rendered. The mark-up earned by a shared service organisation should be similar irrespective of their nature of services. For example, for selection of comparables, an accounting firm can select a legal firm for the mark-up purpose.

However in case of manufacturing it is important to remember that nature of manufacturing may be quite different from each other. For example a contract manufacturing will not be similar with full-fledged manufacturing and toll manufacturing. Hence nature of activities is relatively important in case of

comparing the margins. Although the nature of goods are not important, but in some cases the mark-up for different genus of goods cannot be considered as similar. For example, mark-up for component manufacturing cannot be compared with the profit earned by a solution provider. This issue has created a significant challenge for the companies for selecting appropriate mark-up for their products. Some other differences should be also considered for determination of mark-up. For example, in case of manufacturing, the other factors like rights of intangible like product patent, process patent etc, should be considered.

Example: An Indian Company (SSPL) produces semi-finished plastics (KT) for manufacture of final product in plant situated in USA. The US Company would produce the finished products and sell globally. SSPL applied cost plus methodology for such products sold to US plant. The US Company was not purchasing such component from any other parties (related or unrelated). The patent of KT remained with US parent company.

In this case SSPL would be termed as a contract manufacturer for the US based parent company. SSPL didn't bear any material, market risk, scheduling risk or even foreign currency fluctuation risk.

SSPL was not engaged in such activities for any unrelated companies. Therefore the entire facility was assigned to the related party. In this case, SSPL need to apply CPM by comparing the mark-up with unrelated similar contract manufacturing companies.

However, the US based parent company may not be able to justify the application of cost-plus methodology as best possible method for deriving arm's length pricing for its purchase from related party. CPM in this case may be acceptable to the Indian Tax Authorities. However, this method may not

be acceptable for the revenue authorities in US. The prices charged by the Indian affiliates may be tested by using any other methodology in US.

Profit Split Method (PSM)

It is adopted for those kind of related party transaction where transactions involved are interrelated. The example of such transactions is transfer of intangibles or there are multiple or cross transactions which needs to be separately evaluated and those cannot be evaluated for determining arm's length pricing –

- a. The combined profit for the enterprises are derived;
- b. The value addition by each of the enterprises are then ascertained by doing a appropriate functional analysis involving risk undertaken and capital employed etc. The proportion of value addition is derived from such analysis;
- c. the combined net profit earned is then divided amongst the related parties to derive their respective profitability;
- d. the profit apportioned by the above method is taken in to consideration to arrive at arm's length price to an international transaction

Profit Split method calculates arm's length pricing by dividing the combined profit of a multinational enterprise into its affiliates which are involved in a particular type of transaction in such a way that would have been done in case of a joint venture business. This method is used generally in case of those activities in this operations are highly integrated and any other methods cannot be applied. Ideally speaking, for every product or services where various stages of the final product are manufactured or delivered at separate location and finally the finished product is sold by a final distributing company, the prices to each location should be dependent upon the value addition done by them at each stage. For example, in case of car

manufacturing operation, if various parts of the car are manufactured at different location under separate tax jurisdiction and finally the car is sold from a final distribution company, then the tax authorities at various locations may not be able to determine a correct and appropriate method for determination of arm's length price. In this case, profit split method would be the best and most appropriate method for determination of arm's length pricing. The profit can be divided amongst the affiliates based on their contribution to the entire chain of activities. Another example to the profit split application can be logistics service. In this case, the collection of fees is done at one location and final delivery is done by another location. In this case also profit split can be an ideal mechanism to derive the arm's length pricing.

However the challenge in this method is how to determine the actual contribution made by different parties. Since there will be no third party comparison available for calculating and comparing the profit split made between the units, it will be very hard to establish the correctness of profit split methodology. Since the accuracy of Profit split method depends upon correctly capturing the contribution made at each stage by different entity, it is very difficult to document the contributions made by each entity. The internal data and judgment is required for establishing the correctness of profit split ratio. This method is considered to be superior to any of the biased method like Cost plus method. However the application of this method is relatively difficult in absence of any reliable comparable transactions between unrelated companies.

In Profit Split method, the operating Income is divided amongst the affiliates in the entire chain. Any Indirect Income is excluded from the calculation. For Operating Profit, Net Operating Income from the particular operation or Gross Profit may be also considered for calculation purpose.

The application of Profit Split method is subject to debate globally. In some cases a cross check is conducted to verify the results achieved from any of the one-sided method by applying profit-split method in the given transaction.

OECD is not explicit in recommending Profit Split Method and rather has discouraged to use Profit Split method as secondary method in case no valuable contributions are made by both the parties of transaction. However in the year 2010, OECD in its revised guidelines has included a significant portion on examples of application of profit split method. It led to concern that this guideline actually endorses Profit Split method. However OECD has indicated that it does not endorse Profit Split method in vast way.

Example of application of Profit Split Method: EIL was a US based Company which would manufacture Pumps and Motors for various equipment to be used in construction segment and would supply to Indian manufacturers through its distributors located in India. Due to longer delivery lead time, customers were compelled to keep additional inventory to ensure uninterrupted supply of material for production. Hence the customers felt the need of JIT⁵⁵ approach. EIL decided to set-up a Test and Assembly section in India wherein all the components required for Pumps and Motors would be supplied by EIL and Indian entity would be involved in assembly, test the product and supply to the customers located in South East Asia. In this situation both the entities would be involved in the manufacturing process at different stages and contributed significantly for the entire operation. Although the intangibles would remain with EIL, the Indian entity was provided necessary technical and process knowledge support for adoption of the manufacturing process. In this case, adoption of Profit Split methodology would be ideal.

⁵⁵ Just in Time is an approach adopted for Inventory management wherein Inventory for any businesses are minimized through proper planning.

EIL India's result

Particulars	EIL (India)	EIL (US)	Consolidated
Sales	100	75**	100
Cost of sales	(75)	(60)	(60)
Gross Profit	25	15	40
Selling	(20)	(0)	(20)
General & Admin	(8)	(1)	(9)
Operating Income	(3)	14	11

**Sales from EIL – US to EIL-India was eliminated in consolidated statement

The losses sustained by the Indian entity would not be acceptable to the Indian taxation authorities and the pricing policy (Cost Plus, in this case) adopted by the company may be considered by Indian authorities as biased and one-sided. Higher selling and admin cost may be considered as the main reason for the losses sustained by the company. However, it is observed that all the cost related to front-end activities, which includes costs to maintain customer relationship, settlement of warranty claims and after sales service cost etc., is borne by the Indian entity. Hence the cost incurred by the Indian entity is not matching with the Income. In such a case, Profit Split method should be adopted for determination of appropriate arm's length price. However, it will be quite difficult to prove the distribution of profit between both the entities in US under profit split method, in case the costs incurred in India is not accepted by the US authorities.

In Profit Split method, based on the value addition done by each entity is derived for allocation of the operating profit from the operation. The factors may include the functions performed, risk undertaken and capital and other resources employed by each of the entities for performing the business activity. The idea of identifying the business activities performed by each of the entities is to identify the factors that would have been considered for sharing profits between two unrelated venture partners in a similar

circumstance. However, it is not necessary that all the entities involved in this business operation would earn an equal profit. It is also not expected that profits will be equally shared under this methodology or would be shared arbitrarily.

There are some allocation method prescribed under various guidelines,

- (i) The comparable profit split
- (ii) The residual profit split

Comparable Profit Split: In case data is available for the unrelated parties, the comparable profit split method is applied and the allocation percentage of the comparable unrelated business in similar circumstances is used to derive the share of each entity on the operating profit.

Residual Profit Split: Under this method, the combined profit is allocated through applying two stages of profit allocation viz., a) allocation of income for regular activities b) allocation of residual profit

Processes involved in allocating income to routine activities: The first step under residual profit method is to allocate the operating income to each of the parties involved in the particular transaction for their respective business operation. Regular activities are those activities which are performed by the respective units, which are similar nature of activities performed by an unrelated entity, which is involved in similar business activity and hence the information is available for comparable rate of return. Regular factors for profit split include Return on Assets, Services performed, contribution from intangibles, owned by unrelated taxpayer, which is engaged in similar business activities. A functional analysis is required to be performed for identification of the returns expected against various types of functions performed, risk undertaken and capital and other resources employed.

Allocate residual profit: The allocation of routine expenses will not include value of intangibles. Hence there will be some residual profit available after step 1. That residual profit would be allocated between the related parties based on their holdings of intangibles and valuation thereof. The market value of the intangibles held by each of the respective entities will be considered for allocating the residual profit. In case of unavailability of such amount, the cost for development of the intangibles can be used.

Issues in application of PSM

1. **External Data:** The external comparables are not always available for calculation allocable profit amongst the enterprises for the application of Profit Split method.

2. **Internal Data:** Profit Split methodology can be construed as the most easy and appropriate methodology for determination of arm's length principle. This is because the data required for the application of this methodology is not dependent upon any third party sources and can be derived from the internal sources. However, there are various factors which may create challenges for successfully application of this method. Some of the challenges are listed below:-
 - a) Accessing information from foreign entities
 - b) Difference in Accounting standard and therefore calculation of combined profit is not easy and will not be acceptable to the tax authorities.
 - c) Currency volatility may create challenges for calculation of divisible profit accurately
 - d) Allocation of cost for the activities may be difficult in absence of accurate cost drivers for allocation

- e) Also books of accounts are not prepared for a single activity. Thus, until the profitability of the activity is not recorded correctly, the accuracy of the combined book profit can be challenged
- f) Certain exclusion from the operating profit like any indirect income not relevant for the purpose should be identified and adjusted. For example, lease rental earned by any of the entity for renting a portion of its land to any other entity, should be excluded from profitability calculation.

Important rulings: *Lufkin Foundry and Machine Co v. Commissioner*⁵⁶-In the matter of Lufkin Foundry, the taxpayer sold goods to its Canadian subsidiary at list price less 10%. Lufkin then formed a western hemisphere trade corporate, a now defunct creation of the code entitled to a reduced rate of U.S. Tax. The western hemisphere trade corporation stepped into the shoes of the taxpayer, selling to the tax subsidiary at a price less 2%. The IRS allocated one-half of the discounts to the tax payers. In Lufkin, the tax court reviewed an internal study prepared by the taxpayer but allocated more than 50% of the group's pre-tax profit to it. The court found that the profit split profit was reasonable, characterizing the division as one that unrelated parties would arrive at.

The fifth circuit revised, stating that the tax court should have applied one of the methodologies provided in the 1968 regulations. It held that evidence of internal dealings between the taxpayers and the subsidiaries was insufficient to show that IRS was arbitrary, capricious and unreasonable.

⁵⁶ 72-2 USTC 9632 (5th Cir) 30 TCM 400 (1971)

Bright Line Test Method

Prior to April 2012, only 5 specific methods were permitted for use of comparability purpose. With the introduction of clause (f), "any other method", and introduction of Rule 10AB by CBDT, Bright line test method is also permitted. Specifically no method has been prescribed for intangibles. ITAT has been applying Bright Line Test Method which is prescribed in US Transfer Pricing legislations⁵⁷.

The Bright Line Test Method was first laid down by US Tax Court in the case of *DHL Corporation & Subsidiaries v. Commissioner*⁵⁸, which held that the expenditure incurred on advertisement and brand promotion exceeding the average expenditure incurred by the comparable companies of the associated enterprises in one country was required to be reimbursed by the overseas associated enterprise. In Indian context, Bright Line Test method represents the line, which if crossed, will lead to adverse consequences for the assessee. The TPO will be justified in making any adjustment based on such excessive expenditure.

Comparability and Adjustments

The contentious issues in Transfer Pricing procedure which lead to disputes between authorities and companies are discussed herein below. The issues discussed below are common to all methodologies. However issues are discussed with help of example using cost plus method.

Capacity adjustments: One of the adjustments needed in the cost plus method is capacity adjustment. The capacity adjustment is needed whether or not the assessee is a full-fledged manufacturing unit or a contract

⁵⁷ United States Internal Revenue Code §482-4

⁵⁸ TC Memo 1998-461, 30.12.1998

manufacturing unit. The other adjustments may be done with regard to volume, geographic market, technology etc.

The requirement of capacity adjustment is more prominent in case of a contract manufacturer. Ideally, in a normal condition, a contract manufacturer serves to various customers. Hence, cost of entire capacity is not the responsibility of a single customer. However, in case contract manufacturer entered into an agreement to keep aside a certain portion of its capacity for one of its customer, then it is important to include all the overhead cost for that capacity for the goods sold to that customer. In case all the overhead costs are charged to its customer, the price may exceed the market price, if the entire capacity was not utilized. However, in case of an exclusive arrangement, the costs need to be calculated in detail for charging back to the customer.

Example: SSPL entered into an exclusive arrangement with its parent Company. As per the contract, SSPL was not allowed to do any business with unrelated parties. In this circumstance, SSPL need to add all costs related to this particular facility for charging back to its parent company. Therefore SSPL, while deriving the arm's length price, should consider the cost of idle capacity and should not adjust the capacity underutilization while comparing its profitability. Therefore it is important for both SSPL and its parent Company to budget appropriately for the full cost and maintain SSPL profitable to avoid any dispute with Indian Tax authorities. It is very important to note here that in case of contract manufacturing, the idle cost cannot be borne by the contract manufacturer in case there is an exclusivity contract.

The researcher submits that it is also important to conduct a detail review of the costs charged to customers for such kind of exclusive arrangement.

Another type activity for application of cost-plus methodology is contract research. Where a local entity carries out any research activities for its parent company and parent company owns all the rights of the intangibles created in this process. Also the parent company bears all the risk and cost associates with a research failure. In such case all costs need to be borne by the parent company. The mark-up will be dependent upon the complexity of the activity.

Cost Allocations: The application of cost plus method is quite challenging. The challenges include determination of appropriate mark-up to be applied, determination of true cost for the cost and services etc. It is expected that companies should recover all costs associated with the goods or services exchanged over a period of time. However all costs cannot be considered for a particular year. In many cases companies need to price its products and services which are not internally driven. Due to market and economic condition, a pricing strategy may be different in each year. Therefore, the costs incurred in one year may not be directly linked to market price. For example, during prototype⁵⁹ development, the costs will be different due to volume and high conversion cost due to low first pass yield⁶⁰. Also the cost may be different during starting period of commercial production due to initial issues during trial and error method applied to set up a standard working process.

Another example of different cost in each year may be volume. During initial period, the costs may be different due to extra supervision, consultancy to establish the process and training cost. However, once the product is

⁵⁹ A prototype may be defined as a sample, model or release of a product built to test a material or concept.

⁶⁰ First Pass Yield (FPY) is the ratio of the no of units produced correctly divided by number of units taken for manufacturing.

commercialized and a standard processes are set, the efficiency would increase and cost is expected to be reduced.

Types of Cost to be considered for CPM: A question would arise while applying CPM that whether one should consider only direct cost or indirect costs to be added. Example of indirect cost may include supervision cost of Managing Director, support cost like accounting function cost etc., In case of contract manufacturing the question is whether these costs should be added or not. Similarly whether the finance cost should be included in the cost base.

According to Indian Transfer pricing regulations, all direct and indirect cost of production incurred by the entity should be included. Going by this, it can be argued that since finance cost is not cost for production, the same should not be included in cost base. The OECD Guidelines, Paragraph 2.38, defines financing expenditures as “non-operating expenses” which are neither included in the gross margin (under cost plus and resale-minus), nor in the net margin (under the TNMM and PSM). However, the researcher submits that not only the indirect cost like finance cost but also a notional return on equity should be included in the cost since third parties would have included the interest as well. In some countries (like Netherlands), such as the specific guidelines exist on this.

Comparability: Comparability under the cost plus method is dependent on similarity of functions performed, risk borne and contractual terms, as well as on the adjustments made to the account for the effects of any such differences. Effectively most of the companies rely more on functional comparability and somewhat less on physical similarity of products produced by the controlled and uncontrolled parties.

Adjustments: In case gross profit (mark-up) is impacted due to significant differences between controlled and uncontrolled transactions, it is

recommended in every guidelines issued in this context that the differences need to be adjusted for comparability purpose. If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit mark-up, adjustments should be made to the gross-profit. Various types of adjustments may include:-

- i. The manufacturing process and its complexity
- ii. Engineering process
- iii. Inventory related controls and activities
- iv. Testing facilities and functions performed
- v. Nature of difference in selling, general and administrative expenses
- vi. Foreign currency risks
- vii. Contractual terms
- viii. Warranty Terms
- ix. Credit Terms

Comparable mark-up: In cost plus method, besides comparability needed to be established for cost, mark-up also needs to be comparable with the uncontrolled transactions. For the purpose of comparability analysis, the types and nature of expenses, functions performed, size of the business, activities involves, geographical locations, capital employed played very important role in addition to other factors.

These differences may indicate the following:

- a. The mark-up need to be adjusted for the nature of expenses and capital employed in case those are relevant to establish a comparable arm's length pricing.
- b. During comparable analysis, functional, risk and asset employed should be compared in detail for deriving an appropriate comparable

analysis. For example, in case of an accounting shared service, in case audit support and completion is included in the shared service scope, then for the cost and mark-up calculation, the functional difference should be considered. The cost and mark-up for a mere accounting service will be different than a shared service which provides data repository service along with audit support.

- c. However, in case the cost base is different due to inefficiency factor which may include but not limited to supervisory function and administrative cost, should not be adjusted for comparability purpose.

In case any of the above circumstances arises where there is a significant difference observed in the nature of cost and functions and Cost Plus method cannot be applied directly or without significant adjustment, the researcher recommends that the result of the cost plus method should be vetted by applying any other relevant method for determination of correct arm's length pricing.

A position can be taken by the corporates that certain costs which are merely payment to third parties for rendering services to the taxing unit, can be allocated by the paying unit without a mark-up. However a proper FAR⁶¹ analysis would help in demonstrating the facts.

A gainful reference to this principle can be drawn from paragraph 7.36 of the OECD guidelines that stated as under:

"When an associated enterprise is acting only as an agent or an intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up is appropriate for the

⁶¹ Functions, Assets and Risks.

performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the cost of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the services themselves. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function"

Important Ruling: *Seagate Technology INC v. Commissioner*⁶² - Seagate Technology Inc was a leading manufacturer of hard disk drives for personal computers. During 1982, Seagate formed Seagate Singapore to manufacture e-blocks and printed circuits boards (PCBs) for Seagate's use in manufacture of disk drives.

Initially, Seagate used standard cost of manufacturing of either the component parts or completed disk drives in the US as the transfer price of the products sold by Seagate Singapore to Seagate US. Thereafter Seagate began calculating transfer price based on Standard cost plus mark-up of 25% on cost. The prices would include estimated scrap, obsolescent etc., but were not adjusted for variation between actual and standard cost.

Some of the materials used by Seagate Singapore were purchased by it from third parties and sometimes Seagate Singapore subcontracted local

⁶² 102 TC no 9 (1994)

subcontractors to perform simpler assembly than Seagate Singapore was performing.

Seagate and IRS disagreed on two points:-

- a. Whether Seagate Singapore was a consignment manufacturer
- b. Whether material cost should be included in Seagate Singapore's cost base

The tax court held that Seagate did not show appropriate mark-up on completed disk drives as was appropriate for component parts sold by Seagate Singapore.

The tax court found that IRS did not apply cost plus method as set forth in TP regulations. IRS treated Seagate as a consignment manufacturer and excluded cost of materials from its calculations. The court believed that the cost of raw materials should be included in the cost base for several reasons: (1) Seagate Singapore took title of materials purchased from Seagate (2) Seagate Singapore purchased more material from unrelated parties (3) Seagate Singapore incurred material cost risks and (4) Seagate Singapore was established in part to access low cost Far-east sources of raw materials

Since the tax court found that neither the petitioner's nor the respondent's methodology was adequate, it used the next available evidence provided by both the parties and concluded reasonable transfer price which was all production cost plus 20% markup on these cost.

Transactional Net Margin Method

According to Transactional Net Margin Method (TNMM), the profits earned by the comparable companies (Tested Parties) are compared to that of the assessee to determine the correctness of the arm's length pricing. Generally the operations of the tested parties are similar in nature of the assessee's

operation. However, the factors like owning of the intangibles etc. are not considered while applying this methodology. The process allows selecting the comparable company operating in a similar environment and the average profit earned by these tested parties is compared with that of the assessee. However, since this process is quite simple to follow and widely adopted as Transfer Pricing policy, erroneous selection of comparables and profitability is quite common. The comparison of profit with unrelated parties under this methodology does not consider important factors like management efficiency, restrictions of business processes and other factors like degree of compliance to process and policies etc, which may impact the profitability of any enterprise apart from adoption of abusive transfer pricing policy.

Initially OECD responded to CPM⁶³ methodology of USA with introduction of TNMM methodology. There was an apprehension outside US about the inappropriate use of CPM and its impact. Although OECD responded to CPM with the introduction of TNMM, it has also expressed concern that in absence of proper identification of material differences between the enterprises being compared, the adjustments to the profit would not be correct. TNMM in its current form focuses mainly on the respective transactions and also puts onus on the enterprise to prove the reason of clubbing different activities under one group. If TNMM is applied on transactional level in lieu of enterprise level, it creates an opportunity and great discipline to review the transactions in detail.

TNMM methodology compares profit earned by the assessee with the profit earned by an unrelated party. While comparing the profitability, some ratios are commonly used, which are called Profit level indicator (PLI). The most common amongst all such ratios are:

- a) Net profit as a percentage of cost

⁶³ Cost Plus Methodology

- b) Net Profit as a percentage of Asset Employed
- c) Net Profit as a percentage of Sales

In one of its landmark judgment, Delhi Tribunal in the matter of *LG Electronics v. ACIT* ⁶⁴ held as below:

1. Transfer pricing legislation contemplates determination of arm's length price ('ALP') of an international transaction, which should be done for each transaction separately. The term 'transaction' has been defined in the rule ⁶⁵ to mean 'a number of closely linked transactions.'
2. ALP ⁶⁶ is required to be determined in respect of each international transaction separately. If, however, there are a number of closely linked transactions, then such closely linked transactions can be considered as a single transaction for the purposes of benchmarking. To put it conversely, the transactions which are not closely linked should be dealt separately for the purpose of determination of ALP under Transfer Pricing regulations.
3. In the instant case, the clubbing of royalty payment with other international transactions for processing them in a combined TNMM approach would defeat the mandate of the transfer pricing legislation.
4. When we consider more than one separate transaction under the combined umbrella of TNMM on an entity level, it is quite

⁶⁴ [2013]140ITD41(Delhi)

⁶⁵ Income Tax Rules, 1962 Rules 10A (d)

⁶⁶ Arm's Length Pricing

possible that a probable addition on account of transfer pricing adjustment arising from one international transaction may be usurped by the income from the other international transaction giving higher income on transacted value. That was why the legislature provided for determining the ALP of each international transaction separately.

5. As the international transaction of royalty payment was separate transaction and not closely linked with the other transactions (i.e., import of raw materials, service spares and export of finished goods, etc.) with which the assessee had merged it, such merger could not be allowed for the purposes of the determination of its ALP on entity level under

Prior to Year 2010, these profit based methods used to be considered as "last resort" as per OECD guidelines. However, currently OECD has recognized TNMM as one of the important procedure for deriving arm's length pricing in equal footing with any other traditional methodologies. OECD has also recognized that there might be some notional comparability defects while applying TNMM. However it has clearly stated that TNMM as a methodology should not be excluded solely because of comparability issues.

The factors required to be considered for application of TNMM include following:-

- 1) Perform a functional analysis
- 2) Identify the tested party
- 3) Identify comparables
- 4) Chose a profit measure
- 5) Determine the appropriate time period for analysis
- 6) Test the reasonableness of the result

The Indian Transfer pricing rules provides the following steps to determine the TNMM

- Step 1** The Net profit margin earned by the enterprise from related party transaction is computed
- Step 2** The net profit margin earned by an unrelated party is also derived
- Step 3** The Net profit margin earned in step 1 is adjusted for factors like capacity, capital employed, geographical market and any other relevant factors to make it comparable with the profit derived under step 2
- Step 4** The Net Profit margin derived in step 3 is then compared with the net profit margin as derived under step 2 for an unrelated party
- Step 5** The comparable net profit margin thus established is then considered as at arm's length price in relation to the international transaction.

The comparability of the net margin is determined under TNMM method by applying certain ratios. Some of those ratios are discussed below with help of examples:-

i. PLI-Return on Assets

An US based Company has two subsidiaries, one in the UK and the other in Canada. Both subsidiaries manufacture designer dolls, using

technology developed by the US holding company. Both perform no other functions. The plants in both the countries built in the same year and the UK factory is larger. The output of the UK factory is sold to holding company while output of the Canadian factory sold to a third party distributor.

US holding Company uses Return on Assets (ROA) as PLI (Profit Level Indicator) to evaluate the performance of all its manufacturing plants and companies. US holding company operates in a capital intensive industry where efficient utilization of capital assets is essential for its survival. Because ROA is used by operating management to evaluate and manage the business, it is appropriate to use ROA to determine transfer prices in the absence of data to apply transactions based methods. The Canadian subsidiary is earning a 10% return on assets employed, based on the original cost of the assets. The two factories are the only producer of this type of designer doll in the world. The designer dolls are produced by using a very unusual manufacturing process, so no outside comparables are available. The following process is used to determine the appropriate price to pay the UK subsidiary for designer dolls.

The UK factory employs assets with an original cost of \$US 30 million. Based on this cost and a 10% ROA, the UK subsidiary should earn a net profit of \$US 3 million on its total designer doll sales. The subsidiary sells 5,00,000 designer dolls per year, so the per-doll net profit should be \$US6 per doll per year.

ii. PLI-Return on Sales

X Co., an Indian distributor of food products, purchases products from its UK parent and sells to independent retailers. The Company

identified three independent health food distributors for comparison, who buys from European manufacturers and sell to independent retailers. The Company believes that the three distributors perform exactly the same function it does. Unfortunately, the distributors are privately owned and only information on sales and net profit is available. The Company therefore decides to use return on sales (ROS) as its profit level indicators. Furthermore, the company believes that ROS is the appropriate measure of net profit because it uses the measure to evaluate its sales operation.

The ROS for the three distributors are 3%, 3.5% and 4% respectively. The Company decides to use the arithmetic mean of the range, i.e., 3.5%. The selling, general and admin cost for the company was 9% of sales. Therefore the company must earn gross margin of 12.5% on its sale to earn a net margin of 3.5%. The Company's net selling price per case is \$US 8, therefore, it must earn \$US 1 per case to gain its desired net margin. The Company would then pay \$ 7 per case to its parent.

Issues in application of TNMM: There are some inherent issues in applications of TNMM. The major issue of TNMM is that the number of factors that can influence the profitability of the Company. The critical issue is that there are some factors which may impact the net margin of a company than the gross margin of the same company. For example the inefficiency of the management is embedded in Net Margin but the same may not reflect in the Gross Margin. These issues lead to inaccurate and unreliable determination of the arm's length pricing under TNMM methodology.

The availability of accurate comparables is another challenge for the application of this methodology. Various information and factors influencing

the profitability of the comparable companies are not available in the public domain. Hence the profit comparison may not be accurate in some situation.

Berry Ratio as PLI: In case of a distribution entity, the function of the entity will be simple compared to that of complex manufacturing entity. To compare the profitability of these entities, Berry Ratio is considered which compares the SG&A against gross margin. OECD has now included berry ratio as PLI. It has also recommended the situation where the ratio can be used and not to be used.

Selection of Comparables: Once the most appropriate method has been identified, one has to arrive at the correct arm's length price. The Comparable uncontrolled data need be identified which may be available either in the form of internal comparables or external comparables. Though, internal comparables may be more reliable, often the unavailability of such data requires a search for external comparables. In such instances, external databases are used wherein certain qualitative and quantitative filters are applied to arrive at a final set of comparables based on which the relevant arm's length price is determined. The various sources of financial data are discussed below:-

Indian Database: The Indian databases provide information on both public as well as private limited companies in India across various industries, where information is provided about the financial aspects, viz., balance sheet, profit and loss account of the company. The search for potentially comparable companies can be conducted on the following two Indian databases:-

- a) "Prowess"© by Centre for Monitoring Indian Economy Private limited
- b) "Capitaline"© by Capital Market Publishers India Private Limited
- c) In some instances, transfer pricing analysis can be also performed using data from alternate sources. Data available from NASSCOM©,

website of respective companies and customs data may be useful for the purpose of transfer pricing analysis

Both these databases contain financial and qualitative information on public and private Indian Companies.

Foreign Database: Data on foreign companies is available mainly from following sources.

- a) Compustat
- b) Moody's

Search Process approach: Comparable searches using public databases constitute important tools to address comparability from a transfer pricing perspective. Although the use of database searched for the purposes of documenting and defending the arm's length nature of transfer prices has become widely accepted, the requirements for such database searches differ from one country to the other.

According to the OECD guidelines, para 1.15, transfer pricing analysis should compare the terms and conditions applied in an intra-group controlled transaction with those applied in transactions between unrelated parties. In this regard, the OECD guidelines indicate that in order to be comparable, reasonably accurate adjustments can be made to eliminate the effect of any such differences

Whether controlled and uncontrolled transactions are comparable, requires one to consider the comparability. It is also necessary to analyse the nature of international transactions with the associated enterprises by performing a functional analysis.

The functional analysis procedure of transfer pricing analysis are critical to assessing factors such as activities performed, contractual terms, risks borne by respective parties, economic condition of the transaction, and nature of the property or services involved in the transaction. The analyst in its report identifies the value addition done by the taxpayer to select the independent comparable transactions that will be benchmark to establish an arm's length price for the transaction.

The Indian TPR⁶⁷ has emphasized the importance of the functional analysis in determining an arm's length price and identifying suitable entities for comparison purpose.

In order to achieve a uniform and acceptable standard regarding new searches for comparables should be performed. The following search criteria need to be considered when performing such analysis:

- a) Geography
- b) Independence (criteria)
- c) Reporting and disclosure standards
- d) Loss-making comparables
- e) Use of multiple-year data

⁶⁷ Transfer Pricing regulations