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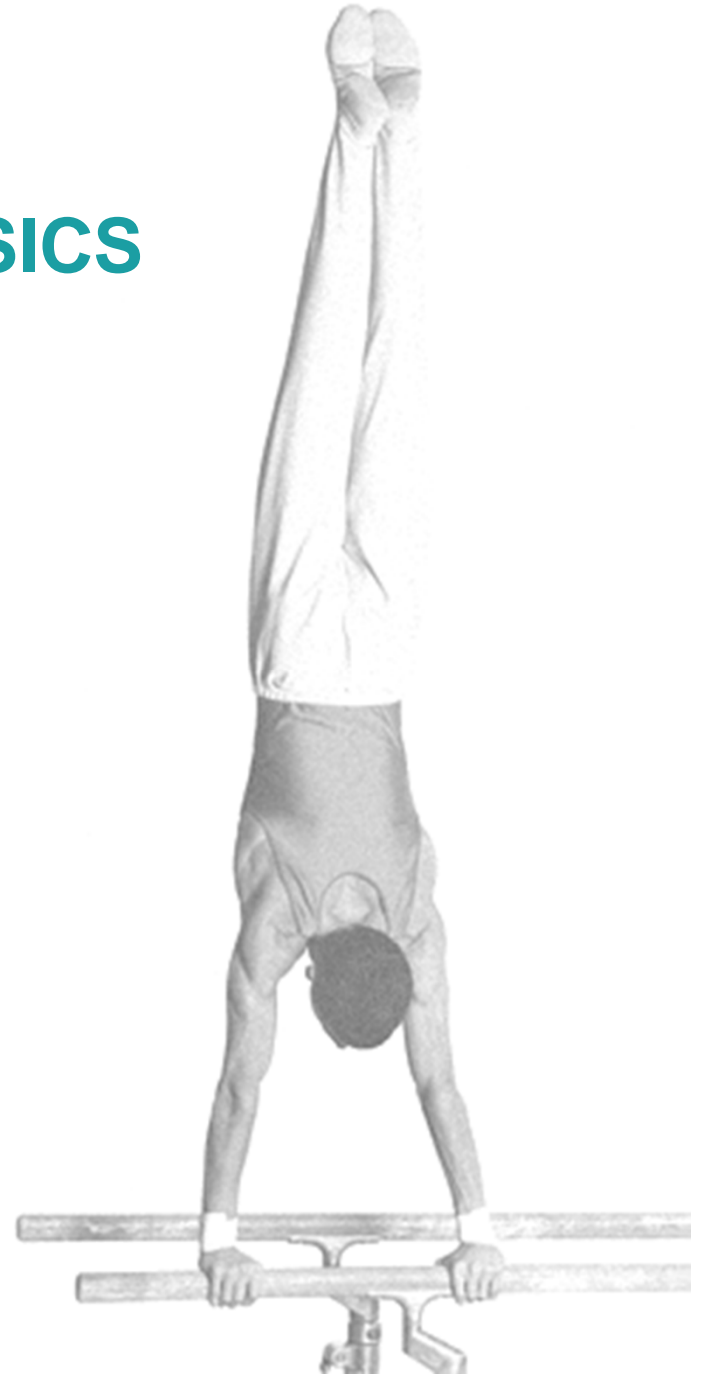
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# FIVE DAYS WORKSHOP ON BASICS IN TRANSFER PRICING

## - SESSION ON CUP METHOD

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➤ **Delhi ITAT in the case of Interra Information Technology India Pvt Ltd.**

*“while adjudicating transfer pricing cases, we are of the opinion that there is no legal binding precedence on the issue of selection of most appropriate method, selection of comparable companies, selection of comparables transactions for benchmarking etc. as these are fact based and vary from company to company. Relying on precedence for each and every factual argument to drive home the point of the counsels, when facts are not at all similar is causing unnecessary clogging of the system resulting in slower delivery. We suggest that the law and the rules be applied first, arguments be based on them and broad proposition relied upon when situations warrant”*

## SETTING THE CONTEXT

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**Section 92:** Any income arising from an international transaction shall be computed having regard to the arm's length price.

Explanation.—For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

...

(2A) Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price.]

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## SETTING THE CONTEXT

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### Computation of arm's length price:

**Section 92C(1)** The arm's length price in relation to an international transaction [or specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe<sup>88</sup>, namely :—

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed<sup>89</sup> by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed<sup>90</sup> :

# EXPLANATION OF CUP METHOD IN THE INCOME TAX RULES

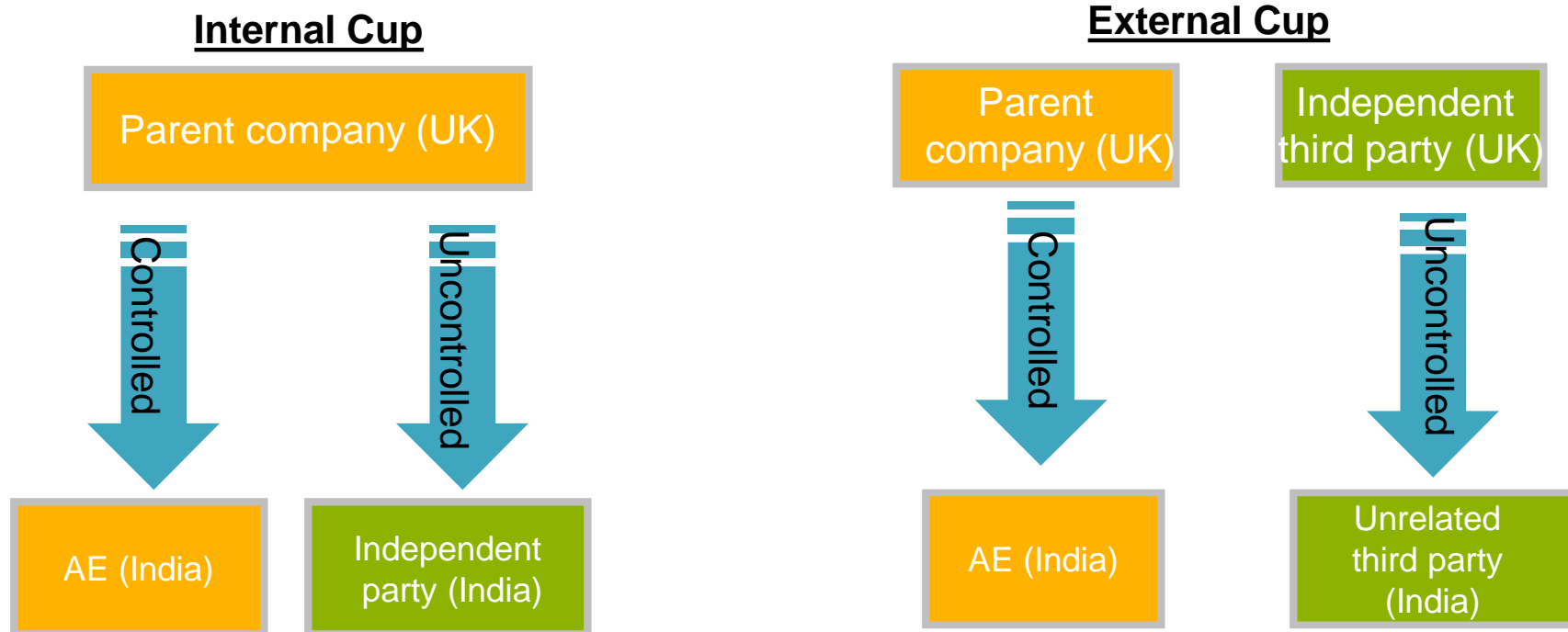
**Rule 10B(1):** For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction <sup>55a</sup>[*or a specified domestic transaction*] shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

- (a) comparable uncontrolled price method, by which,—
- i. the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
  - ii. such price is adjusted to account for differences, if any, between the international transaction <sup>55a</sup>[*or the specified domestic transaction*] and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;
  - iii. the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction <sup>55a</sup>[*or the specified domestic transaction*]

**Definition as per OECD and UN TP guidelines:** *A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.*

# EXAMPLE OF CUP

Compares **price charged** for property / services transferred in a controlled transaction with that of a comparable uncontrolled transaction

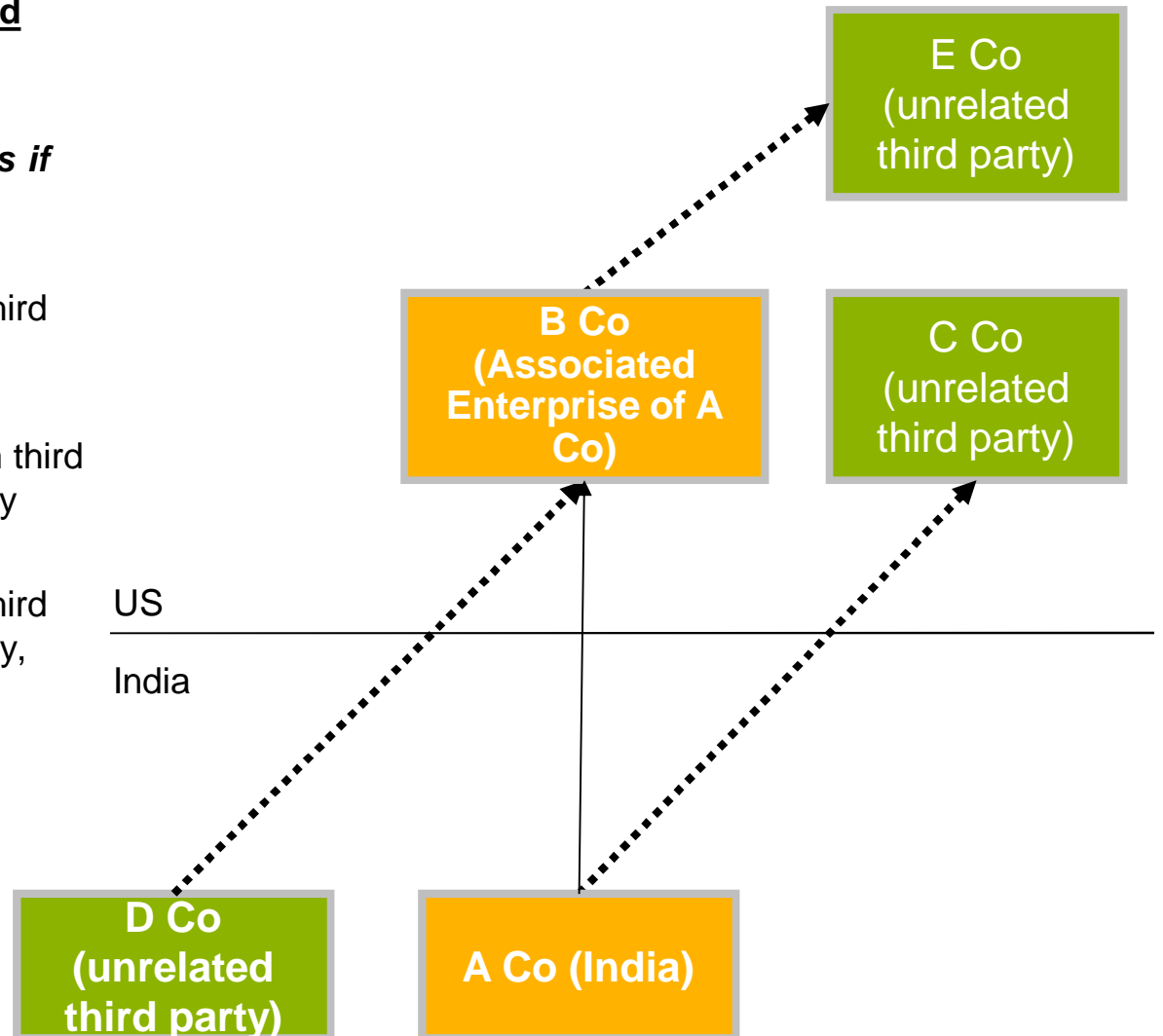


# EXAMPLE OF CUP

A Co renders services to B Co its related party:

*In this regard, the following transactions if exist can be regarded as potential CUP*

- A Co renders comparable service to third party in US or comparable geography
- B Co obtains comparable service from third party in India or comparable geography
- B Co renders comparable service to third parties in US or comparable geography, (based on certain evaluations)





## **CASE STUDY – Advise whether Bajaj Autos international transaction is at arm's length**

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### **Facts of the Case:**

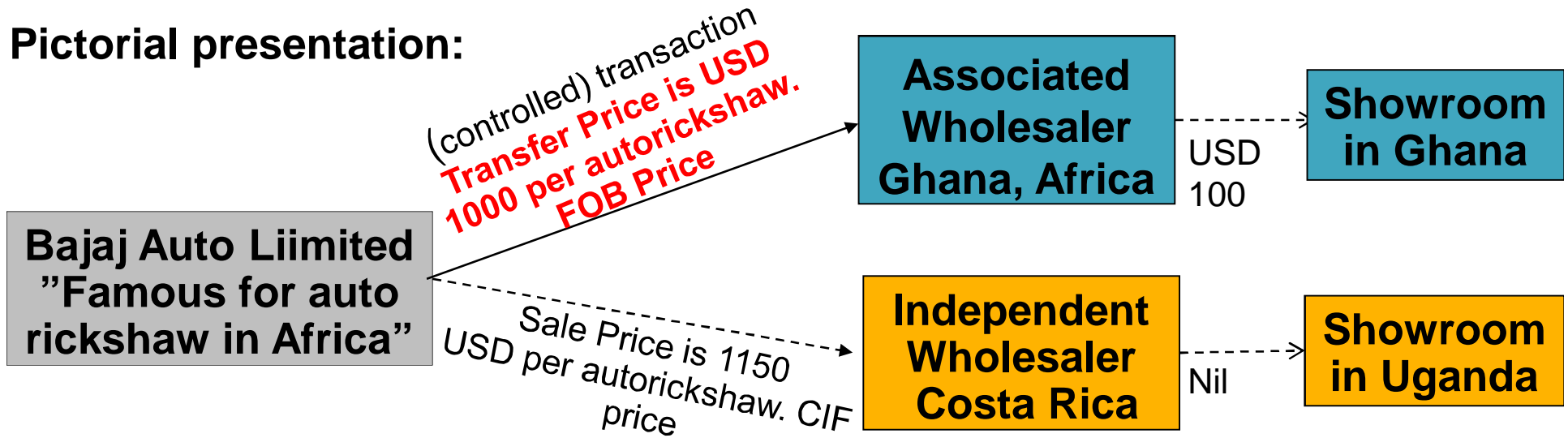
Bajaj Auto Limited, among others, a producer of autorickshaws sells the same to its associated wholesaler (distributor) in Ghana, Africa for distribution of the said automobile in Ghana **for USD 1000 per autorickshaw**. Under the contractual arrangement made with the associated wholesaler, delivery is ex factory ie free on board.

The associated distributor in Africa **incurs transportation and other carriage costs of 100 USD per authorickshaw**.

Bajaj Auto Limited, also sells identical autorickshaws to an independent distributor in Uganda, Africa for distribution of the same in the said location. The price charged by Bajaj Auto to the independent distributor is **USD 1150 per autorickshaw**. In the contractual arrangement with the independent wholesaler, delivery is c.i.f. (cost, insurance, and freight included, i.e. the seller arranges for the carriage of the goods and bears the transportation costs).

# CASE STUDY – Advise whether Bajaj Autos international transaction is at arm’s length

Pictorial presentation:



Particulars	Amount	Remarks
Selling price to third party	1150	This is CIF price and the price applied for sale to related party is FOB price.
Reduce Transportation cost	-100	
FOB price of autorickshaw to third party distributor	1050	Bajaj is selling to Associated wholesale at a lower price when compared to third parties.
FOB price of autorickshaw to associated distributor	1000	Do this mean transaction is not at arm’s length ?

# APPLICATION OF CUP METHOD IN PRACTISE

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- Loan in USD given by Indian parent to its overseas subsidiary. Interest charged is Libor plus 2 percent. Appropriate benchmark ?
- Corporate guarantee given by Indian parent to its overseas subsidiary. The Indian parent has also obtained a bank guarantee during the year for a similar sum. Appropriate benchmark ?
- Indian entity is selling goods to its related party in Dubai and during the year also sold same goods to unrelated parties in India for a lower price. Comparable under CUP ?
- Indian manufacturer engaged in manufacturing sanitary wares sold goods to its related party in Dubai for distribution of the same and during the year the Indian manufacturer also directly sold comparable items to a construction company in Dubai. Comparable under CUP ?
- An Indian entity has a wind turbine farm. The electricity generated is sold to its associated enterprises. The said Indian entity also sells electricity to Electricity Board at certain price specified by the government. Comparable under CUP ?
- Comparability of selling price of Micromax and Apple phones ?

# APPLICATION OF CUP METHOD IN PRACTISE

- Assessee sells automobiles to A its related party in US at USD 15000. To benchmark its transactions, the Assessee refers to its related party operating in India which has also sold comparable automobiles to its related party in US at USD 15000 - which has been accepted by the Revenue authorities to be at arm's length. Can the price charged by the said Indian related party be used as a benchmark for the transaction undertaken by the Assessee with A?
- An Indian entity wanted to buy certain spare parts. It obtained a quotation from an unrelated party in US and also obtained a quotation from its related party located in US. Since the related party quoted a lesser price for identical goods, the Indian entity purchased the spares from its related party. Advise on the benchmarking of the transaction of the Indian entity.
  - Use of rack rates (practise of Revenue, in vogue, for benchmarking loan and guarantee transactions);
  - Use of rates mentioned in product price catalogue / industry reports;
  - Use of rates in commodity exchanges; (relevant for commodity trading)
  - Use of Custom valuation;
  - Use of limit specified under the RBI/ FEMA guidelines or Companies Act as benchmark
  - Use of Valuation report certified by chartered accountant as the basis for benchmarking (Relevant in the context of transfer of shares of an Indian entity by the foreign parent, transfer of intangibles among group entities etc.,)

## APPLICATION OF CUP METHOD IN PRACTISE

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- An Indian entity is engaged in rendering of call centre services to its holding company, benchmarks its transaction under CUP method based on hourly charge-out rate per employee for similar (though not identical) services rendered to third parties. The TPO however is able to identify a company which is engaged in exactly the same function as the Indian entity and therefore wished to benchmark the Indian entity under TNMM. Further the TPO is of the view that CUP method may not be suitable for service industry. Your views ?
- Indian entity is engaged in rendering software development services to its parent at INR 1000 per hour chargeout. Indian entity also renders similar services to third parties at INR 1000 per hour and therefore benchmarks the transaction to be arm's length. In the course of assessment, the TPO is able to find that an other company X is engaged in rendering similar services to third parties at INR 1500 per hour and therefore the same should also be considered as a comparable. Your views ?

# THOUGHTS ON BENCHMARKING OF CERTAIN TRANSACTIONS UNDER CUP METHOD

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- Interest on loan;
- Corporate guarantee fee;
- Payment of Royalty fees;
- Recovery of warranty costs etc.,
- Purchase of capital equipment;
- Payment of technical services fee / secondment charges;
- Allocation of management service charges;
- Cost recharges from Group companies;
- Cost recharges to Group companies;
- Import of components;
- Rendering of software development and ITES services.

## AUDIT EXPERIENCE

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- 100 % CUP availability;
- Use of secret comparables (Information on competitor prices obtained by TPOs by exercising powers u/s 133(6);
- Information available with Customs authorities;
- Preference of Indian comparables over foreign comparables;
- Benefit of an expenditure being questioned by the transfer pricing authorities;
- Looking into overseas pricing and profit information of AEs;
- CUP – ordering date or invoice date.

## LEARNINGS ON CUP METHOD SUMMARISED

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- Preferred method because it is the “most direct and reliable way to determine the arm’s length price;
- Very high degree of comparability required;
- In practice, it is often difficult to find uncontrolled transactions similar enough such that no differences have a material effect on the price or where accurate adjustment can be made for the differences;
- Rule 10AB Method can be used, where based on strict interpretation of the language, CUP cannot be applied;
- Best applied when:
  - Where the same product is bought/sold under comparable circumstances from/to the associated enterprise & independent enterprise(s) (internal comparable)
  - Where an independent enterprise buys/sells the same product as the associated enterprise in comparable circumstances (external comparable)
  - For some commodities and some financial transactions



## **CASE STUDY – Advise the Assessee, on the benchmarking methodology it could use and the arm's length nature of its international transaction**

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### **Facts of the Case:**

SIRC Software Pvt Ltd was incorporated in India in 2011 and is engaged in rendering of e-publishing services to its Associated enterprises in US. Right from the inception date and during the relevant FY 2013-14 the company has incurred losses. The Assessee explains that due to downturn in the US economy and due to heavy start up cost, the Company has been incurring losses since 2011 till date.

Advise the company on the benchmarking of the transaction.

**Comprehensive functional and economic analysis is the key**