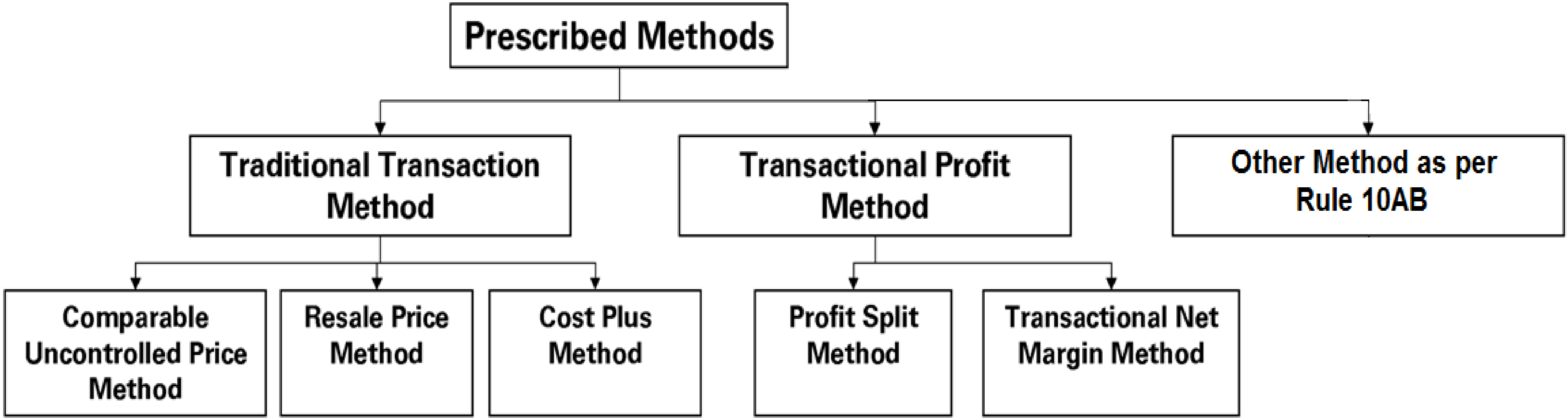
Workshop on Basics in Transfer Pricing

Transactional Net Margin Method

- CA S. Sridhar

Transfer Pricing Methods

- Section 92C prescribes five methods to compute ALP
- Indian legislation provides an option to select the most appropriate method:



As per OECD Guidelines 2008, Transactional Profit Methods were to be used as a last resort.

However, as per the revised Guidelines, MAM can be Traditional Transaction Method or Transaction Profit Method.

Most Appropriate Method (Contd.)

- Most appropriate method shall be the method best suited to the facts and circumstances of each particular international transaction and which provides the most reliable measure of an arm's length price in relation to the international transaction. **Refer Rule 10C(1) of Income Tax Rules, 1962 ('the Rules').**

- Factors considered for selection of the most appropriate method – **Rule 10C (2) of the Rules**
  - Nature and class of international transaction
  - Class of associated enterprise and functions performed
  - Availability, coverage and reliability of data
  - Degree of comparability between the International transaction
  - Extent to which reliable and accurate adjustments can be made
  - The nature, extent and reliability of assumptions for application of the method.

Transactional Net Margin Method ('TNMM')– Rule 10B(1)(e) of the Rules

the net profit margin realised by the enterprise from an international transaction is computed with reference to an appropriate base;

↓

the net profit margin realised by the said enterprise or by unrelated enterprises from a comparable uncontrolled transaction is computed having regard to the same base;

↓

appropriate adjustments are undertaken to account for economic and other differences;

↓

the margin thus computed above is considered for computing the arm's length price.

OECD Transfer Pricing Guidelines, 2010

- Examines the net the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction.
- An appropriate Net Profit Indicator (‘NPI’) should be established to evaluate and compare internal/external comparables.
- Still needs to meet comparability criteria
- Not appropriate where each party makes valuable, unique contributions
- May be appropriate where one party makes all the unique contributions involved in the transactions and other party does not make unique contributions
- The lack of valuable and unique contributions involved in particular transaction does not imply that TNMM is the most appropriate method.

Strengths of TNMM

- NPIs are less affected by transactional differences than is the case with price, as used in the CUP method.
- NPI's more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.
- Mitigates the problem of classification of expenses in gross and operating expenses.
- "one-sided" method and hence only one party needs to be tested –avoids problems relating to examination of records of both parties to a transaction.

- Practically advantageous when one parties to the transactions is complex and has many interrelated activities or when it is difficult to obtain information reliable about one party to the transaction.
- Comparability (including functional) analysis must always be performed to characterize parties and selection of method.

Weakness of TNMM

- There are factors that has less substantial effect on gross margins and prices but has substantial effect on net margins.
- Availability of third party data at the time of undertaking controlled transactions.
- Lack of enough specific information on profits attributable to comparable uncontrolled transactions
- Tax authorities likely to have more data than taxpayers because of their examinations of other cases.

- Many factors unrelated to transfer price may affect net profits and in conjunction with one method, can affect overall reliability of TNMM if an insufficient comparability analysis is used.
- Difficulties in determining an appropriate corresponding adjustment particularly where it is not possible to work back to a transfer price.

Other Considerations – Her Majesty Revenue & Customs - INTM 463080

- TNMM most commonly used and also one of the most misunderstood methods.
- TNMM should be applied in a proper manner, considering its weaknesses.
- Adjustments should be made for minor functional differences, but many adjustments likely to impact comparability.
- If companies are inherently incomparable, then no amount of adjustments would help.
- Indiscriminate use of TNMM is of little assistance to justify the arm's length range.
- Common misconception that the requirements of comparability necessary for a correct application of the traditional OECD methods are less rigid.
- Chief weakness is that net margin of a company may have no different effect on the gross margins or the price of a transaction.
- TNMM does not necessarily reflect the correct allocation of profits as per FAR for the group as a whole as it is only a one-sided analysis.

Other Considerations – HMRC - INTM 463080 (Contd.)

- TNMM can give rise to difficulties with corresponding adjustments during the mutual agreement procedure.
- Range should be constructed by taking companies carrying out comparable transactions
- Existence of a range should not be taken to include therein companies which are not comparable or which carry out transactions which are not comparable.

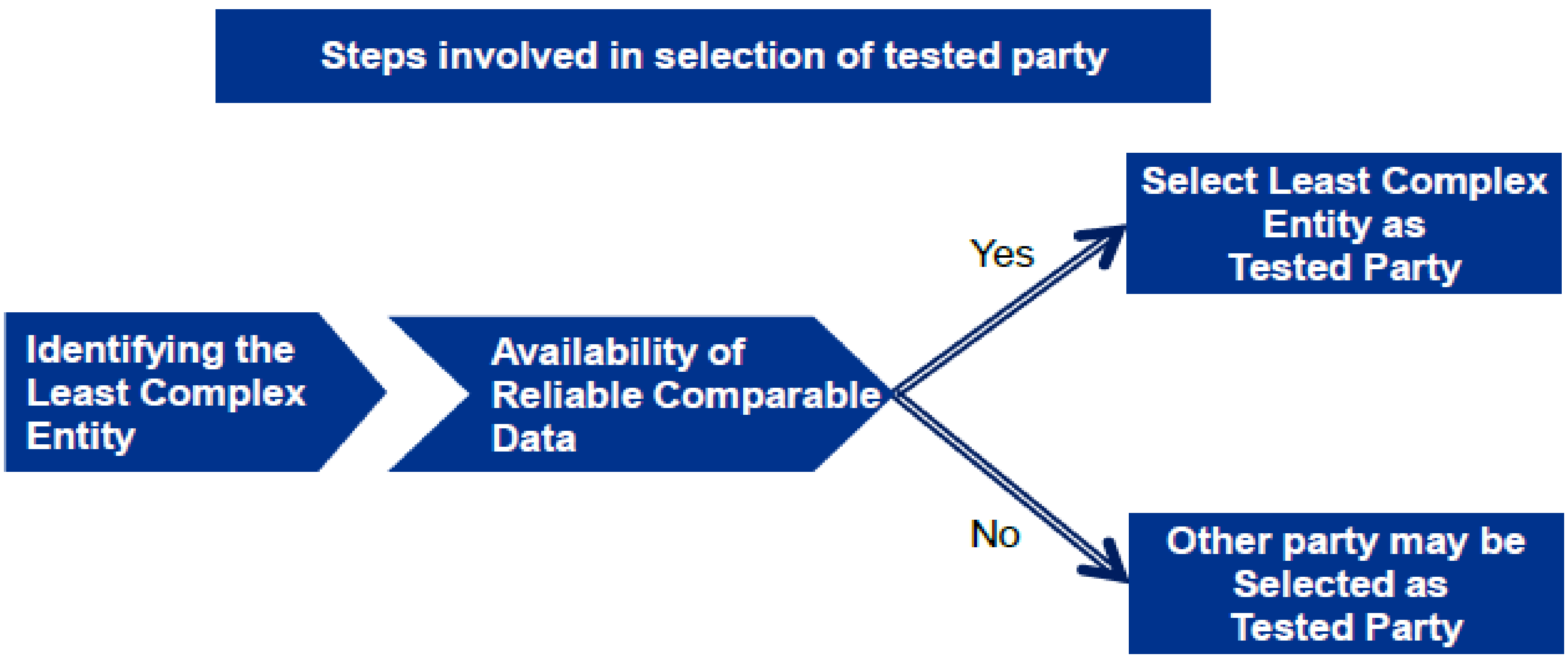
Application of TNMM

- Functions, Asset and Risk Analysis
- Characterization of the entity
- Evaluation of TP Method
- Selection of TNMM as Most Appropriate Method
- Selection of Tested Party
- Selection of Profit Level Indicator
- Comparability Analysis

Selection of the Tested Party

The term ‘Tested Party’ is not defined in the Income-tax Act, 1961

- Generally understood to mean the party to the international transaction with reference to which the comparability is undertaken
- No guidance on factors to be considered for selection of the tested party provided under the Indian law
- OECD guidelines provide useful guidance



Selection of the Profit Level Indicator ('PLI')

- Rule 10B(1)(e) (i) *"the **net profit margin realized by the enterprise** …… is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base"*
- Thus, the net profit margin is computed with reference to an appropriate base or denominator being: Costs incurred; Sales effected; Assets employed; Any other relevant base – e.g. return on value added expenses
- Factors relevant for the selection of the PLI Selection of denominator / base depends on the activity of the tested party
- The denominator should be independent of the controlled transaction

Transaction	PLI to be selected
Purchase from AE and distribution in Indian market	Return on Sales
Provision of services	Return of Cost
Capital/Asset intensive activities	Return on Assets
Routine distributor or service provider	Berry Ratio

- PLI may be directly affected by such forces operating in the industry like: threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products etc...

Selection of the Profit Level Indicator ('PLI')

- Selection of the PLI to be consistent with the comparability (including functional) analysis of the controlled transaction.
- It should reflect the allocation of risks between the parties.
- It should be focused on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed.
- It should be reasonably independent from controlled transactions.
- The degree of comparability between controllable and uncontrolled transaction including reliability of comparability adjustments that may be needed to eliminate difference between them.

Computation of Operating Profit

- Rule 10B(1)(e)(i) "*the* ***net profit margin realized by the enterprise from an international transaction*** *entered into with an associated enterprise is computed…*"
- Only items having direct nexus with the transaction / activity under consideration ought to be considered
  - Income / expenses from financing / investing activities and income taxes to be excluded
  - Exceptional and Extraordinary item of non recurring nature to be excluded, but may still need to be evaluated.
  - Forex gain or losses depending on risk profile of the entity.

Income / Expense	Case Law	Held as operating?
Interest Income	*Marubeni India Pvt Ltd*	No
Foreign Exchange gain / loss	*SAP Labs India Pvt Ltd vs. Asstt. CIT ((2011) 44 SOT 156 (Bang))*	Yes
Dividend Income	*TNT India Pvt Ltd vs. Asst.Commissioner of Income Tax (ITA No.1442 / (BNG) / 08)*	No
Provision for doubtful debts / advances	*Telecordia Technologies India P. Ltd vs. ACIT (ITA No. 7821 / Mum / 2011)*	No

Steps involved in Comparability Analysis – Chapter III of OECD

Years to be Covered

Industry Analysis of tax payer

Functional Analysis

Selection of Method and PLI

Determination of data on External Comparable

Review of Internal Comparable

Selection of Potential Comparable

Economic Adjustment

Determination of ALP

Use of Appropriate Filters

- ✓ “the **net profit margin realized** by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or ….”
- ✓ FAR analysis of the comparable companies critical to select appropriate comparable transactions
  - ✓ Generally captured in various quantitative filters applied
  - ✓ Qualitative filters to be selected based on the activities and ratios of the tested party

- ✓ In practice both quantitative and qualitative criteria's are used to select or reject potential comparables. Illustrative list from OECD Guidelines are as follows:

- ✓ Size criteria in terms of Sales, Assets or Number of Employees.
- ✓ Intangible Criteria like - R&D to sales, Intangible/total assets
- ✓ Criteria related to export sales – Foreign sales to total sales
- ✓ Criteria in relation to inventories
- ✓ Other criteria such as – Startup companies, bankrupted companies etc..

Use of Appropriate Filters

- ✓ Some of examples of qualitative filters are as follows

Transactions	Filters
Significant export transaction of tested party	Select companies having particular level of export sales
Limited risk distributor	Select companies having low ratio of inventory to total sales.
Contract Manufacturing	Select companies having low ratio of R & D to total sales
Service involving significant human capital	Select companies having significant ratio of wages to total sales

- ✓ Other commonly used filters are
  - ✓ Turnover range
  - ✓ Net Fixed Assets to total assets
  - ✓ Related party transactions
  - ✓ Positive Net worth
  - ✓ Marketing Cost
  - ✓ Level of value added expenses
  - ✓ Abnormal factors etc..

Economic Adjustments

- ✓ Rule 10B(1)(e)(iii) “***the net profit margin*** *……. arising in comparable uncontrolled transactions* ***is adjusted to take into account the differences****, if any, between the international transaction and the comparable uncontrolled transactions…..”*
- ✓ Economic adjustment may be required for the following factors
  - ✓ Risk profile – Captive vs Entrepreneurial entity
  - ✓ Working capital differences – To adjust difference in time value of money
  - ✓ Rates of depreciation
  - ✓ Capacity utilization
  - ✓ Start-up costs and
  - ✓ Difference in functions etc..

Judicial Precedents on Economic adjustments

Working capital adjustment

- Philip Software Centre (P) Ltd v ACIT [2008] 26 SOT 226
- Demag Cranes & Components
- Capgemini India Pvt Ltd
- Sony India Pvt Ltd

Start-up Cost

- DCIT vs Quark Systems (P) Ltd (2010) 38 SOT 307
- Skoda Auto India (P) Ltd vs ACIT [2009] 30 SOT 319
- Vertex Computer Services India (P) Ltd 34 SOT 512

Depreciation

- E.I Dupont (P) Ltd vs DCIT [2011] 16.Taxmann.Com 352
- Global Vantage (P) vs DCIT – Delhi
- Amdoc Business Services Pvt Ltd – Pune
- Schenefenakar Motherson Ltd

Other adjustment granted by ITAT includes

- ✓ Marketing Function - R.B.S Equities Private Ltd
- ✓ R&D functions - Firmenich Aromatics (India) Pvt Ltd
- ✓ Low Domestic demand – Gujarat Guardian Ltd
- ✓ ESOP Cost – Capgemini
- ✓ Difference in accounting – Philips software Centre P Ltd

- ✓ Extraordinary depreciation – Raksha Technologies P Ltd.
- ✓ Intangibles and Risk – Sony India Pvt Ltd
- ✓ Relocation cost - Transwitch India Pvt Ltd.
- ✓ Star-up phase – NSK India Sales Ltd
- ✓ Abnormal Foreign Exchange – Honda Trading Corpn.

TYPICAL ISSUES IN TNMM

Entity Level Comparison or transaction level comparison

- ✓ Rule 10B(1)(e)(i) '"**net profit margin realized** by the enterprise **from an international transaction** entered into with an associated enterprise……""
- ✓ Taxpayer has to maintain segmental accounts separately for controlled and uncontrolled transactions
- ✓ Various expenses to be allocated between AE and non AE segment using appropriate cost drivers/allocation keys
  - ✓ Direct expenses are to be identified to the respective segment
  - ✓ Indirect expenses should allocated using appropriate allocation keys like sales, head count, area occupies, time incurred etc.,

- ✓ The following judicial pronouncement held that use of entity level margins is not appropriate and segmental data is required:
  - ✓ **UCB India Pvt Ltd vs. ACIT (ITA No.428 / Mum / 2007)**
  - ✓ **Iljin Electronics India P. Ltd. vs. Asst Commissioner of Income Tax (ITA No.438 / Del / 2008)**
- ✓ Audited segmental data will be preferred over unaudited segmental data.

Single year data vis-à-vis Multiple year data

- Rule 10B(4) states the data to be used in **analyzing the comparability** of an uncontrolled transaction with an international transaction shall be **the data relating to the financial year in which the international transaction** has been entered into:
- **Provided** that data relating to a **period not being more than two years prior to such financial year** may also be considered if such data reveals facts **which could have an influence on the determination of transfer prices** in relation to the transactions being compared.
- Use of multiple year data – Reduces the impact of business cycles and market conditions impacting a particular year – **Also supported by OECD Guidelines**
- Multiple year data widely used due to non-availability of relevant year financial statement of companies at the time of preparing transfer pricing documentation.
- Multiple year data may be used in case prices of international transactions have been set based on the planning analysis conducted at the beginning of the year using prior year data.
- Budget 2014 suggested the use of multiple year data. The detailed rules are yet to be notified by the CBDT.

Use of Foreign Databases and tested party - Whether Acceptable?

- Foreign databases may be used in case the foreign AE is selected as the tested party.
    - *Generally used databases – OneSource, CompuStat, Factiva, etc.*
- Issues in the use of foreign databases
    - Timing difference in the date of financials of comparable companies vis-à-vis period under consideration
    - Non-availability of latest financial data
    - Non-availability of segmental profitability
    - Geographic market
- Thus, foreign database search must be appropriately and adequately documented to facilitate proper examination by tax authorities
    - ***Ranbaxy Laboratories Ltd vs. Addl. Commissioner of Income-tax (ITA No.2146 (Delhi) / 2007).***
- The Ahmedabad ITAT in the case of ***General Motors India Pvt Ltd*** has upheld the selection of the AE as tested party.
- In the case of ***Onward Technologies, Global Vantage and Aurinpro solutions***, the ITAT held that foreign companies cannot be selected as tested party.
- Recently the Department has filed an appeal before the Hon'ble Gujarat High Court against the order of Ahmedabad ITAT in the case of ***General Motors case*** and the same has been admitted by the Court.

Internal TNMM vs External TNMM

- Rule 10B(1)(e)(ii) " the **net profit margin realized** by the enterprise or by an unrelated enterprise from a **comparable uncontrolled transaction**….."
- Internal uncontrolled transactions, if available, are preferred over external comparables for benchmarking
  - High comparability standards in case of internal data as a common party is involved
  - In case internal segments are not comparable, internal TNMM may not be appropriate
  - However, reasons for non-comparability to be appropriately documented e.g. domestic market v/s export market, different level of market (wholesale v/s retail, etc..).

- **Judicial Precedents**

- Birlasoft India Ltd vs. Dy. Commissioner of Income-tax (2011 44 SOT 664 (Delhi))
- Schlafhorst Marketing Co. Ltd. vs. Assistant Commissioner of Income-tax (2011) (13 ITA 104)
- Greenland Exports Pvt Ltd vs ACIT [ITA No.2107/Mds/2011]
- Birlasoft (India) Ltd vs Dy.CIT [51 DTR 353]
- Tecnimount ICB Pvt Ltd vs ACIT [ITA No.7098/Mum/2010]

Aggregation of transactions

- Rule 10C (2) “In selecting the most appropriate method ….. the following factors shall be taken into account, namely:—(a) the nature and class of the international transaction (b) the class or classes of associated enterprises entering into the transaction……“
- The concept of class of transactions was explained by the ITAT in the case of
  - Mainetti India Private Limited vs ACIT – ITA No.1789/Mds/2011
  - Intimate Fashions (India) Pvt Ltd. vs ACIT – ITA No. 2116/Mds/2010
- Rule 10A (d) “transaction" includes a number of closely linked transactions”
- OECD Guidelines also supports aggregation of closely linked transaction.
- Business rationale which establishes the link between various international transactions to be appropriately documented
- Onus on the taxpayer to demonstrate the linkage between various transactions which are aggregated.

Aggregation of transactions – Case Study

Facts of the Case

- ABC India is engaged in manufacturer of pipes used for dripping saline water in the body of patients
- ABC Inc. is engaged in manufacturer of saline bottles and needles.
- ABC India imports saline bottles and needles from ABC Inc., packages the bottles and pipes together and sells as a “basket of product”
- Segmental P&L Accounts is follows:

Particulars	Manufacturing	Trading	Total
Sales	**100,000**	**5,00,000**	**6,00,000**
Manufacturing Expenses/Purchase cost	60,000	200,000	260,000
Employee Cost	17,000	90,000	107,000
Selling, Distribution and Depreciation	26,000	160,000	186,000
Total Expenses	103,000	450,000	558,000
Profit	(3,000)	50,000	47,000
NPM	(-)3%	10%	7.83%

Aggregation of transactions – Case Study (Contd.)

- ✓ The NPM for comparables companies for manufacturing activity is 11% and for trading activity activities is 7%.
- ✓ Results after allocation
  - ✓ Manufacturing activity – not at arm's length
  - ✓ Trading Activity – At arm's length

- ✓ **Management Strategy**
  - ✓ High Fixed costs in manufacturing segment
  - ✓ Increase in selling price may result in losing out market competitives
  - ✓ Customers not keen on purchasing products separately
  - ✓ Lower profits in manufacturing is to sustain high profitability in trading segment and earn overall healthy margins.
  - ✓ Trading activity and manufacturing activity are so closely inter-linked that separate benchmarking will not capture the commercial reality.

Issues

✓ Whether manufacturing and trading segments to be benchmarked separately or can be aggregated?

✓ Rule 10A states that – "transaction" includes no of closely linked transactions

Segregation of Transactions

- Ranbaxy Laboratories Ltd
- UCB India Pvt Ltd
- Wockhardt Ltd
- Starlite Ltd

Aggregation of Transactions

- Panasonic India Pvt Ltd
- Demag Cranes & Components
- Toyota Kirloskar Motor Pvt Ltd
- Birla Soft Ltd

✓ **OECD Guidelines 2010 supports the aggregation of closely-linked transactions**

" However, there are often situations where separate transactions are so closely-linked or continuous that they cannot be evaluated adequately on separate basis. Examples may include…………..3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction………… Ideally, in order to arrive at the most precise approximation of the fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis."

Issues (Contd.)

- ✓ **OECD Guidelines 2010 also recognizes portfolio approach for the purpose of benchmarking analysis**

“ A portfolio approach is a business strategy consisting of a taxpayer bundling certain transactions for the purpose of earning an appropriate return across the portfolio rather than necessarily on any single product within portfolio.. For instance, some products may be marketed by a taxpayer with a low profit or even at a loss, because they create a demand for other products and/or related services of the same taxpayer that are then sold or provided with high profits ”

- ✓ Appropriate documentation in respect of Management Strategy to be maintained:
  - ✓ Board Minutes
  - ✓ Market Studies demonstrating inability to increase ultimate selling price of manufactured goods
  - ✓ Customer expectation of the packaged products

Computation of Transfer Pricing Adjustment

- ✓ B Ltd – an Indian company is engaged in manufacture and sale of automobile components
- ✓ For the purpose of manufacturing, it imports certain specialized components from its AEs. However, majority of the components are sourced internally.
- ✓ The company adopted TNMM as most appropriate method for determination of arm' length price.
- ✓ As the level of imports from AEs were low, the net profit margin was not impacted by the same.
- ✓ Analysis under TNMM reflected that the margins of comparable companies (7%) was more than that of the B Ltd. However the impact of the international transactions on the margins was insignificant
- ✓ Can the transfer pricing adjustment can be attributed only to international transactions?

Computation of Transfer Pricing Adjustment

Particulars	Amount (Rs)
Sales	100,000
Purchases	
AE – Rs.5,000 Non AE – Rs.70,000	75,000
Operating Expenses	24,000
Operating Profit	1,000
NPM (%)	1%

Particulars	Amount (Rs)
Sales	100,000
Purchases	
AE – Rs.(1,000) Non AE – Rs.70,000	69,000
Operating Expenses	24,000
Operating Profit	7,000
NPM (%)	7%

- ✓ If the difference in margins i.e. 7%-1% is attributed to international transaction then, the adjustment to the purchase price works out to (-) Rs.1000 (Rs.5000 – Rs. 6,000 * (Rs.100,000 *7% - Rs.1,000) which is absurd.
- ✓ Adjustment to the import price from the AEs to be done on a proportional basis.
- ✓ Thus, adjustment works out to = Rs.400 i.e. Rs.6,000 * (5,000/75,000).

Practical Issues and Conclusion

- ✓ ALP determination is a subjective exercise. No one right answer.
- ✓ Pricing is dynamic process and hence should be acceptable within a price range over a number of years
- ✓ Lack of good quality and availability of data in external databases.
- ✓ Lack of data required for performing economic adjustments
- ✓ Classification of income and expenses as operating and non-operating
- ✓ Lack of segmental information
- ✓ Indian law demands a high level of precision by insisting:
  - ✓ Only current year data to be used
  - ✓ Only arithmetic mean to be used

To conclude, TNMM offers a practical solution to otherwise unsolvable transfer pricing issues, if it is used sensibly and with appropriate adjustments to account for differences.

Thank You


build
knowledge
experience
collaboration
opportunities
goodwill
networks
awareness