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OVERVIEW OF COST PLUS METHOD

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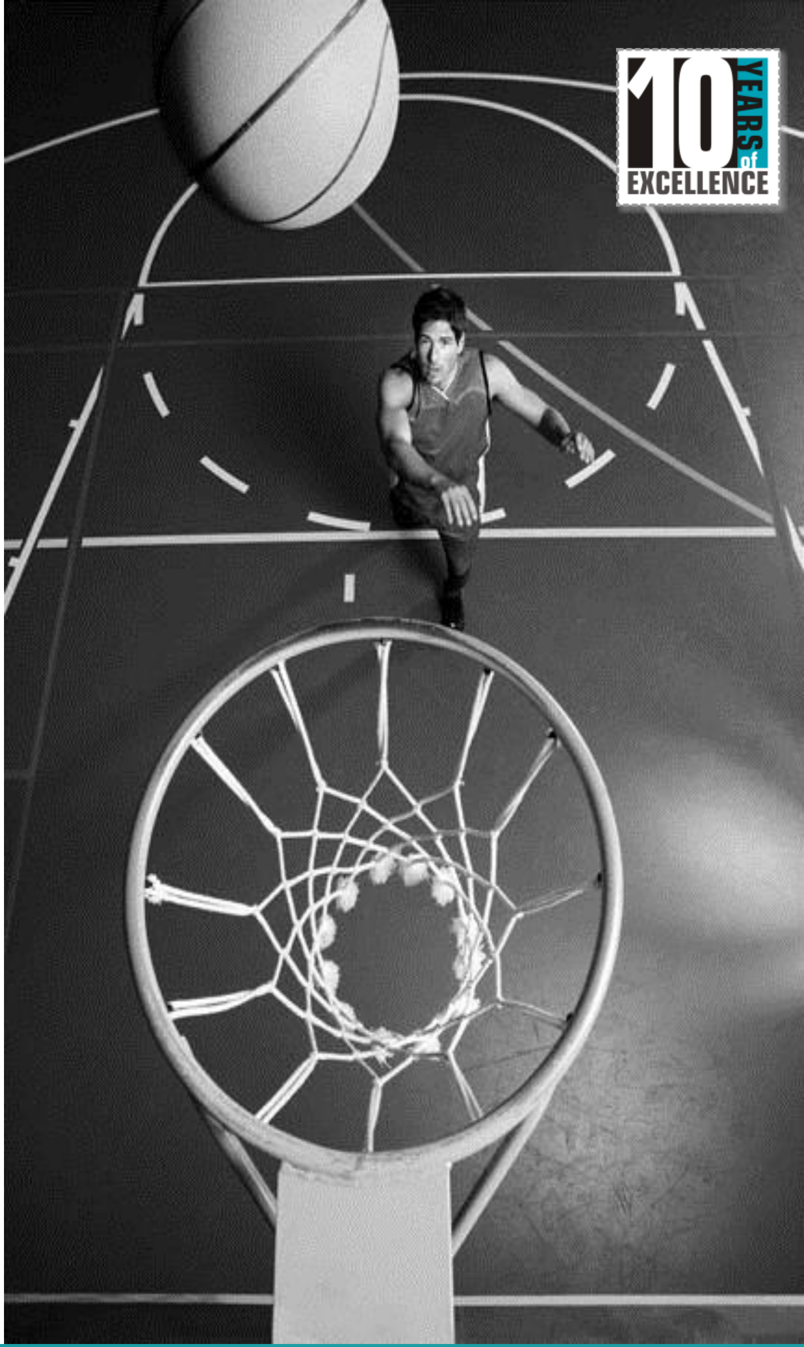

OVERVIEW OF TRANSFER PRICING METHODS

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TRADITIONAL METHODS	• COMPARABLE UNCONTROLLED PRICE METHOD • RESALE PRICE METHOD • COST PLUS METHOD
TRANSACTIONAL METHODS	• PROFIT SPLIT METHOD • TRANSACTIONAL NET MARGIN METHOD

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OVERVIEW OF TRANSFER PRICING METHODS

- The Transfer Pricing Guidelines issued by OECD in 1995 regarded traditional methods as preferable to other methods
- The Transfer Pricing Guidelines issued by OECD in 2010 removed the hierarchical approach and observed the both traditional and transactional method can be applied in an equally reliable manner
- Rule 10C of The Income-Tax Rules, 1962 ("The Rules") postulates the use of the most appropriate method which is best suited to the facts and circumstances of each international transaction
- A traditional method can be used when "below the line" expenses (such as service charges, royalty fees, or inadequate allocation of revenues and other transactions) that are not related to the international transactions has a significant impact on the margins of taxpayer
- Transaction profit methods are used to approximate the arm's length conditions when traditional methods cannot be reliably applied

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SELECTING THE MOST APPROPRIATE METHOD

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- Rule 10C(2) of the Rules prescribes that the following factors should be considered in selecting the most appropriate method
  - the nature and class of the international transaction;
  - the class of associated enterprises (“AEs”) entering into the transaction and the functions performed, assets employed and risks assumed by such enterprises;
  - the availability and reliability of data necessary for application of the method;
  - the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into transactions;
  - the extent to which reliable and accurate adjustments can be made to account for differences between the international transaction and the comparable uncontrolled transaction; and
  - the nature, extent and reliability of assumptions required to be made in application of a method.

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COST PLUS METHOD

COST PLUS METHOD

- Rule 10B(1)(c) of the Rules discusses on the application of Cost Plus Method. The Rules state that
  - the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an AE are determined;
  - the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
  - the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;

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COST PLUS METHOD

- the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii); and
- the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise.

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DETERMINING THE ARM'S LENGTH PRICE

DETERMINING THE ARM'S LENGTH PRICE UNDER COST PLUS METHOD

Step 1: Identifying the direct and indirect cost of production

- Direct and indirect costs that are directly attributable to international transactions undertaken with the AEs should be considered
- Direct and indirect costs are not specifically defined / classified in OECD

Step 2: Identifying the gross profit markup earned in uncontrolled transaction (Contd..)

- Comparable uncontrolled transactions should be identified
- Comparable transaction can be internal comparable or external comparable
- Cost Plus Method requires high degree of comparability

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DETERMINING THE ARM'S LENGTH PRICE UNDER COST PLUS METHOD

Step 2: Identifying the gross profit markup earned in uncontrolled transaction (Contd..)

- Adjustments should be carried out for any difference in functions performed
- Any additional functions performed by the taxpayer should be benchmarked separately
- No adjustment is required for differences merely reflecting the efficiencies

Step 3: Determining the transfer price of the international transactions

- The arm's length gross profit margins determined should be adjusted for any differences in the functions performed
- The adjusted mark-up is then added to the actual cost incurred by the taxpayer in determining the transfer price

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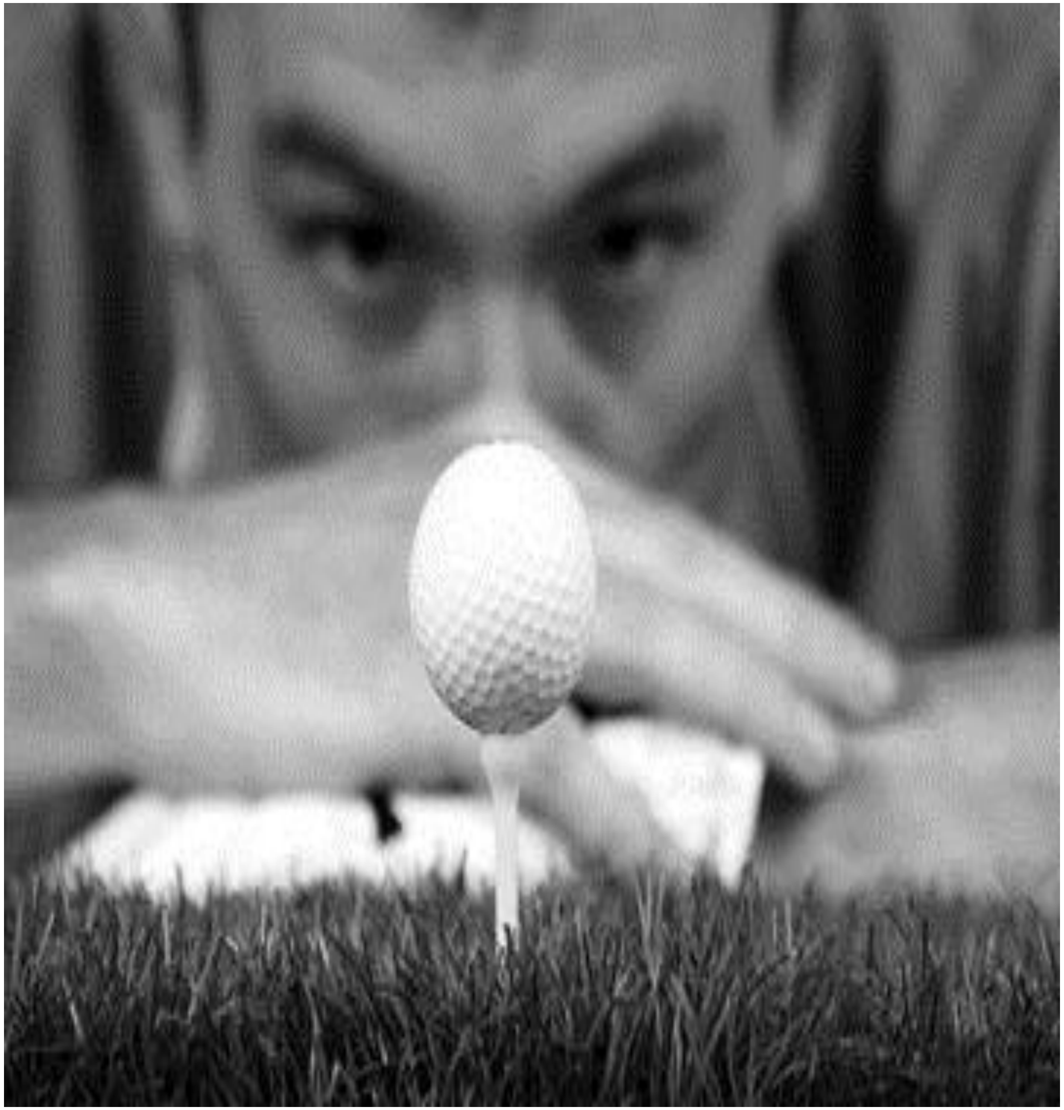
DETERMINING THE TRANSFER PRICE



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DETERMINING THE TRANSFER PRICE UNDER COST PLUS METHOD

X Ltd is engaged in the sale of auto components to its AEs. The arithmetic mean of the gross margins earned by the comparable companies is 20 percent.

The price at which the transactions should take place in order to meet the arm's length requirement is given below:

Particulars	Amount in INR
Cost of raw materials	100
Indirect cost incurred	50
Total cost base	150
Arm's length Mark-up on cost	**20%**
Mark up to be charged	30
Transfer price	**180**

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COMPARABILITY ANALYSIS UNDER COST PLUS METHOD

Rule 10B(2) of the Rules provides the relevant criterion in determining the comparability analysis

- the specific characteristics of the property transferred or services provided in either transaction;
- the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- the contractual terms of the transactions entered into between the parties; and
- conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

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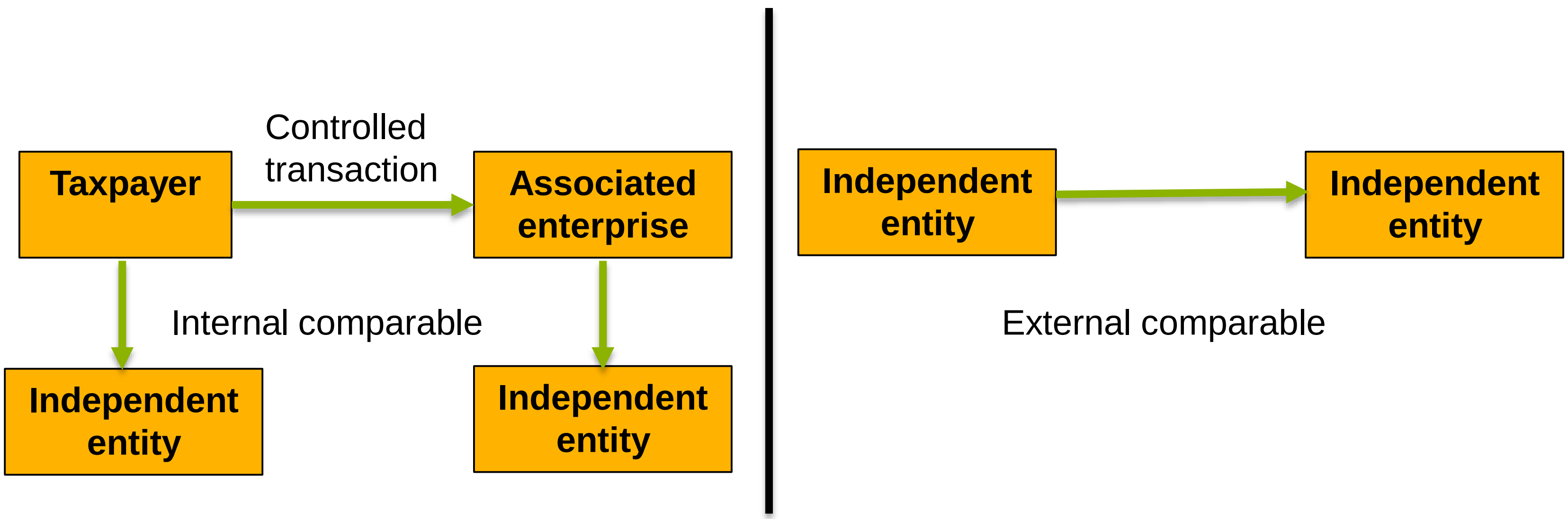
COMPARABILITY ANALYSIS UNDER COST PLUS METHOD

- An uncontrolled transaction refers to the transactions entered into by the taxpayer in transacting with an independent enterprise (internal comparable) or the transactions entered into between two independent enterprises (external comparable)

Internal comparable | **External comparable**



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COMPARABILITY ANALYSIS UNDER COST PLUS METHOD

- While the internal comparable transactions would be readily available with the taxpayer, the external comparable companies can be identified using benchmarking process from the Prowess and CapitaLine databases
- The related party manufacturer or service provider should be considered as the 'tested party' for transfer pricing analysis
- The comparable companies are selected based on their functional comparability after eliminating companies having significant related party transactions, eliminating companies for whom financial and sales details are not available etc
- Degree of comparability under Cost Plus Method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method
- However, reasonably accurate adjustments should be made to eliminate the material differences in the **value** of the products, or other factors that have **less effect on prices**

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COMPARABILITY ANALYSIS UNDER COST PLUS METHOD

- Appropriate adjustments should be made for differences in accounting principles between the controlled and the uncontrolled transactions
- Due considerations should be given for differences in the reporting disclosures of treatment of costs affecting the gross profit mark ups
- Once the degree of comparability between the controlled and uncontrolled transactions are analyzed, the gross margins earned by the comparable companies are determined
- Under Cost Plus Method, Gross profits are determined as the difference between the gross receipts from a transaction and the production costs of sales, with due adjustment for increases or decreases in inventory or stock
- Gross Profit mark-up based on cost is used as the Profit Level Indicator in measuring the profitability

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COMPARABILITY ANALYSIS UNDER COST PLUS METHOD

- Arithmetic mean of the three year weighted average margins earned by the comparable companies are determined
- The Indian Transfer Pricing Regulations allows the use of multiple year data of the comparable companies in determining the ALP
- Further, where the arm's length price is determined using more than one price, a variation not exceeding 3 percent of the value of the international transaction from the arm's length price is allowed under Section 92C(2)

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COST PLUS METHOD – FEW ILLUSTRATIONS

A Limited is engaged in the manufacture of computer accessories and sells them to its AEs. The comparable company B Limited is also a domestic manufacturer engaged in the manufacture of computer accessories

- **Scenario 1**: B Limited is much more efficient in its manufacturing processes than A Limited, thereby enabling it to have lower costs
- **Scenario 2**: A Limited accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to AEs. However, the gross profit markup of B Limited reflects supervisory, general, and administrative expenses as they are accounted for as costs of goods sold
- **Scenario 3**: A Limited uses materials imported from its AEs in its manufacturing process. B Limited on the other hand, purchase the material domestically
- **Scenario 4**: In addition to the sales function, B Limited also performs annual maintenance contract, which is not performed by A Limited

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CHALLENGES

CHALLENGES IN APPLYING COST PLUS METHOD

- Identifying the direct and indirect costs
- Availability of segmental details
- Availability of comparable data
- Adjustments on the cost plus margins to factor the comparable difference is difficult to perform
- Cannot aggregate other international transactions such as royalty payment, payment of management fees, sharing of common expenses with the gross profit margins
- Taxpayer cannot take advantage of the foreign currency fluctuation

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ANNEXURES

OVERVIEW OF TRANSFER PRICING METHODS

A Limited manufactures and sells certain electronic goods to its AE for INR 100 and has incurred the following expenses

Expenses	Amount in INR
Sales	100
Material cost	40
Power and fuel	15
Royalty	15
Management fees	10
Other administrative expenses	30
Gross profit	**45**
Net profit / (loss)	**(10)**

Expenses incurred in relation to AE transactions

Expenses that are not related to AE transactions

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OVERVIEW OF TRANSFER PRICING METHODS

A Limited sells auto components to AEs amounting to INR 100. The international transactions entered into with the AEs include purchase of capital equipment, purchase of raw material, sale of finished goods, payment of royalties and payment towards management support services

Expenses	Amount in INR
Sales	100
Material cost	30
Royalty	10
Management fees	5
Other administrative expenses	25
Net profit / (loss)	**30**

Includes the transactions entered with AEs as well as Non-AEs

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USE OF MULTIPLE YEAR DATA

Comparable companies	GPM 2012	GPM 2013	GPM 2014	Weighted Average
A Limited	(6.99)	6.14	(4.78)	(2.13)
B Limited	3.92	5.36	(3.68)	2.34
C Limited	10.98	9.60	4.5	7.68
D Limited	5.49	2.50	8.27	5.28
E Limited	1.86	7.30	2.93	4.29
F Limited	2.17	5.32	1.94	2.89
Arithmetic mean	**2.91**	**6.04**	**1.53**	**3.39**

- There is a significant variation in the year on year margins of the comparable companies and therefore considering the margins of only FY 2013-14 may not be the appropriate approach
- Therefore, the use of multiple year data for the purpose of ascertaining the arms length margin would be appropriate for computing the arm's length margin

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APPLICATION OF THE TOLERANCE RANGE

A Limited, engaged in the manufacture and sale of auto components has earned a GPM of 17.65 percent as against the arm's length margin of 18.50 percent

Since the ALP of 18.50 is within the tolerance range of 19.33 percent, the transaction entered into by A Limited is at arm's length

Particulars	Amount in INR	International transaction	+/- 3% variation	Adjusted margins
Sales	100			100
Total Income	**100**			**100**
Cost of raw materials	60	40	38.8	58.8
Direct and indirect expenses	25			25
Total expenses	**85**			**83.8**
Gross profit	**15**			**16.2**
Gross profit on cost	**17.65**			**19.33**

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