Workshop on

"Basics in TRANSFER PRICING"

Resale Price Method

and

Profit Split Method

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Situations where RPM is applicable

Most appropriate Method

Which is the most appropriate method?

- Best suited to the facts and circumstances
- Provides the most reliable measure of the ALP.

Factors to be considered in selection:

- Nature and class of transaction
- Class or classes of AE's and the FAR analysis
- Availability, coverage and reliability of data.
- Degree of comparability and
- Extent to which reliable and accurate adjustments can be made

Most Appropriate Method

Method		Transactions
Comparable Uncontrolled Price Method	CUP	Loans, Royalties, Service fee, Transfer of tangibles etc
Resale Price Method	RPM	Distributors doing insignificant value add to products
Cost Plus Method	CPM	Manufacturing operations / Provision of services
Profit Split Method	PSM	Transactions involving provision of integrated services by more than one enterprise / transfer of unique intangibles.
Transaction Net Margin Method	TNMM	Many cases like transfer of semi-finished goods, distribution of FG where RPM cannot be applied etc

Judicial Rulings

ITO vs. L'Oreal India P. Ltd (ITA No. 5423/Mum/2009)

1. The Tribunal upheld the use of Resale Price Method over TNMM where assessee bought products from AE and resold them without further processing;

2. ITAT agreed with the CIT(A)'s observation that there is no order of priority of methods to determine ALP. ITAT noted that OECD Guidelines stated that in case of distribution and marketing activities, when the goods are purchased from AEs which are sold to unrelated parties, RPM is the most appropriate method.

Steps in
ALP determination

ALP determination using RPM - Steps

Step 1 - The price at which property purchased or services obtained by the enterprise from an AE is resold or are provided to an unrelated enterprise, is identified

ALP determination using RPM - Steps

Step 2 - Such resale price is ***reduced*** *by the amount of a* ***normal gross profit margin*** *accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the* ***same or similar property*** *or from obtaining and providing the same or similar services, in a* ***comparable uncontrolled transaction****, or a number of such transactions.*

ALP determination using RPM - Steps

Step 3 - The price so arrived (i.e. after deduction of normal gross profit margin) is further reduced by the ***expenses incurred by the enterprise in connection with the purchase*** *of property or obtaining of services.*

ALP determination using RPM - Steps

*Step 4 - The price so arrived at is adjusted to take into account the **functional and other differences, including differences in accounting practices**, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, **which could materially affect the amount of gross profit margin in the open market.***

ALP determination using RPM - Steps

Step 5 - The adjusted price computed as per the Step 4 is taken as ALP.

PRACTICAL ILLUSTRATION

ABC India Limited – RPM Analysis

ABC India Limited ('the Company') is engaged in business of import and sale of computers, laptops and printers. The Company is a 100% subsidiary of ABC Inc., USA. The Company purchases laptops from ABC Inc., USA at negotiated rates and sells to independent customers in India under its own terms and conditions.

The Company also trades in Computers and Printers which it procures from independent vendors in USA and sell to its own customers in India under its own terms and conditions.

Below is the P&L account of the Company.

ABC India Limited – RPM Analysis

Particulars	(in Rs)	Particulars	(in Rs)
Opening Stock		Sales	
Computers	500	Computers	8,000
Printers	200	Printers	2,000
Laptops	800	Laptops	11,000
Purchases (Imports)		Closing Stock	
Computers	5,000	Computers	800
Printers	1,300	Printers	250
Laptops	6,000	Laptops	1,200
Gross Profit c/f	9,450		
Total	**23,250**		**23,250**
Gross Profit b/f			9,450
Salary Costs	2,000		
Rent	1,000		
Freight Outward	250		
Travel and Conveyance	300		
PBITD	5,900		
Total	**9,450**		**9,450**

ABC India Limited – RPM Analysis

Other relevant information:

1. Credit period of 2 months is allowed for customers of computers and printers and hence 2% extra margin towards interest cost is factored in sales prices
2. Purchase of materials accounted at landed costs. It is estimated that around 20% of the purchase cost reported in P&L is towards customs duty and clearance charges
3. Delivery of computers and printers made at Company's cost. For laptops, the customers collect the goods from the Company premises
4. For laptop purchases, the Company has incurred ocean freight (around Rs 300) whereas for computers and printers the terms of import are CIF Chennai.

ABC India Limited – RPM Analysis

1. Identify the Associated Enterprise in this scenario?
ABC Inc., USA by virtue of ownership criteria

2. Identify the International Transaction?
Purchase of laptops during the year
Value of transaction is Rs 4,800 (Rs 6,000 less 20%)

3. Which is the comparable uncontrolled transaction here?
Sale of computers and printers (since they are similar products to laptops), procured from, as well as sold to independent parties.

ABC India Limited – RPM Analysis

4. What is the normal gross profit margin on the comparable transactions?

Gross profit as per Trading account	Rs	4,050
Less: Interest element factored in sales price	Rs	200
Less: Freight outward costs	Rs	250
Normal gross profit	Rs	3,600
Normal gross profit percentage		36%

At this stage only the differences in the terms of sale transactions of computers and printers vis-à-vis the sale transaction of laptops are considered. The differences in terms of purchase will be adjusted in subsequent stage.

ABC India Limited – RPM Analysis

5. What is the price at which property purchased from the AE is resold to an unrelated enterprise?

Rs 11,000.

6. What is the resultant cost of sales after deducting 'Normal Gross Profit Margin'

Rs 7,040 (i.e. Rs 11,000 less 36% Normal Gross Profit Margin).

7. What are the expenses incurred in connection with cost of purchase?

Rs 1,200 (since it is mentioned that around 20% of the purchase cost reported in P&L is towards freight, customs duty and clearance charges)

ABC India Limited – RPM Analysis

8. What are the functional and other differences, including differences in accounting practices, between the international transaction and the comparable uncontrolled transactions, which could materially affect the amount of gross profit margin in the open market?

Rs 300 on account of ocean freight.

9. What is the cost of sales after adjustments made per SI 7 and SI 8?

Rs 5,540 (i.e. Rs 7,040 less Rs 1,200 less Rs 300)

ABC India Limited – RPM Analysis

10. How is the arm's length purchase price determined?

Price as arrived in Sl 9	Rs 5,540
Add: Amount in Closing stock (80% of 1,200)	Rs 960
Less: Amount in Opening stock (80% of 800)	Rs (640)
Arm's length price of purchase	Rs 5,860

11. Is the purchase price at arm's length as per RPM?

Yes. Since the purchase price Rs 4,800 is less than arm's length price determined at Rs 5,860.

TOLERANCE LEVELS

Tolerance Level - Evolution

- For FY 0102 – No concept of Tolerance Level
- FY 0203 onwards – Proviso to Sec 92C amended to allow tolerance of ±5% in the arm's length price
- Finance Act 2009 (w.e.f. 01.10.2009) – Shift in base for computation of tolerance – shifted to transaction price.
- Finance Act 2011 - Determination of the tolerance level to be notified by Central Government

Tolerance Level - Evolution

- For FY 1112 tolerance level of ±5% for all assessee's

- For FY 1213, the tolerance levels notified as below:
  - ±1% for Wholesale traders
  - ±3% for Other assessee's

- For FY 1314, Notification No 45/2014 dated 23.09.2014
  - Retains same tolerance levels for FY 1314
  - Definition of 'wholesale trader' provided

Tolerance Level – Wholesale Trader

Notification No 45/2014 dated 23.09.2014 defines 'wholesale trading' is a transaction in trading of goods which satisfies following conditions:

- Purchase cost of FG is 80% or more of the total cost pertaining to such trading activities.
- Average monthly closing inventory of such goods is 10% or less of sales pertaining to such trading activities.

Tolerance Band – Budget 2014

- Proposed to introduce '**Range Concept**'
- Notification / manner of implementation awaited

CASE STUDIES

Case 1

ABC Limited is engaged in business of money-lending.

It borrows money as loan from its Associated Enterprises at certain percentage and lends it to his customers at a mark-up of 3% p.a.

Can we use the RPM Method to justify his arm's length price since he is not doing any value addition to the capital amount and is essentially 'trading' in finance?

Case 2

ABC Limited imports merchandise from its AE's and sells to third-party distributors in India as a trader.

It does not procure goods from any other vendors and all its purchases are from only the AE.

What can it therefore take as a benchmarking transaction?

Case 3

ABC Limited imports merchandise from its AE's and sells to third-party distributors in India as a trader. The GPM in the P&L account was found to be 40% as compared to the GPM of 18% earned by the comparables and hence it was concluded that its purchases were at arm's length price.

During assessment, the TPO called for product-wise margin details and observed that out of the 10 products purchased and sold by ABC Limited, 3 products had negative margins and 7 products yielded very high margins resulting in overall GPM of 40%.

The TPO now wants to make TP adjustment for the three products which yielded GPM which was less than the benchmarked margin.

Is the TPO's action justified?

Case 4

ABC Limited imports chemicals in 100 kg slabs from its AE’s and repacks it into packets of 200 grams each using a simple packing machine before selling it to third-party distributors in India.

The Company has obtained Excise Registration since such repacking activity is construed as manufacture under the Central Excise Laws in India.

Can the Company apply the RPM method to justify its arm’s length price? What are the considerations to be kept in mind?

Case 5

ABC Limited imports computers and network equipments from its AE's at agreed list price and sells to IT Companies in India at a price negotiated by it. Sometimes at time of order finalization, some of the customers who are registered with STPI prefer to place the order on the AE so that it can import the goods directly and save on Customs Duty cost.

In such cases, the AE's compensate ABC Limited a marketing commission for the difference between price negotiated by ABC Limited with customer and the list price provided to ABC Limited.

How would you approach to determine the ALP's in this context?

Case 6

ABC Limited procures computers and network equipments from unrelated enterprises and sells the same to its AE's.

How would you approach to determine the ALP's in this context?

Case 7

ABC Germany manufactures CD's and has been supplying to customers across the world including those in India for over a decade now. The Marketing HQ negotiates rates with the customers and enters into annual rate contracts.

On demand of its Indian customers, the Company has set up a wholly-owned subsidiary in India called as ABC India.

ABC Germany sends a bulk shipment of CD's first week of every month to ABC India @ USD 10/box. Based on the customer delivery forecast entered by the Marketing HQ in the Group ERP, ABC India invoices and delivers the CD's to the customer at average realization of USD 16/box.

How to approach the ALP determination?

Case 7 (Continued)

Functions	Role of ABC Germany	Role of ABC India
Sourcing / Production of goods	√	-
Marketing and Promotion	√	-
Pricing strategy and negotiation	√	-
Inventory planning	√	-
Warehousing of FG	-	√

CAUTIONS IN USE OF RPM

Cautions in application of RPM

1. High value addition / Manufacturer functions

2. Reseller contributes substantially to the creation or maintenance of intangibles associated with the product like trademarks owned by the AE

3. RPM yields more accurate results when realization period is short

MARKETING INTANGIBLES

Marketing Intangibles

When a licensee of a brand incurred AMP expenses in excess of comparable Companies, which are selected for the purposes of TP analysis, being measured as percentages of turnover, then the licensor of the brand, being the foreign company, would need to reimburse the Indian licensee of the brand for such excess, along with a mark up, for alleged provision of services in developing the brand of the foreign company in India.

Marketing Intangibles

- Indian Taxpayer incurs AMP expenditure
- The AMP expenditure as ratio to sales is computed
- Indian comparable engaged in similar activities are selected
- AMP expenditure as ratio to sales of comparables is computed
- Average AMP as a ratio to sales of the India taxpayer (Bright line) is determined
- The excess expenditure is considered as 'non-routine'
- Such non-routine AMP spend is alleged to be towards brand promotion and is also in the nature of rendition of services to foreign AEs.

Marketing Intangibles – Arguments

- No transaction exists in absence of agreement between taxpayer and the AE for promotion
- Advertisement done for ‘product’, not for ‘brand’
- Branding building is not the business or intention of the taxpayer, results / benefit to AE are only incidental and unintentional
- Nature and quantum of spends decided by taxpayer and not interfered by the AE
- Economic ownership lies with taxpayer
- ‘Bright line test’ in not a prescribed method.

BENCHMARKING OF COMPARABLES

Benchmarking of Comparables

- Could be internal as well as external
- Source of data for external comparables
- Filtering criteria
  - Functional comparability
  - Size of operations
  - Availability of financial information
  - Extent of Related Party transactions

QUESTIONS?

Situations where PSM is applicable

Situations where PSM is applicable

1. Provision of integrated services
2. Transfer of Unique intangibles

International transactions which are
so interrelated
that they
cannot be evaluated separately
for determining ALP of any one transaction

Provision of Integrated Services

1. Cross Border M&A transaction involving two Associated Advisory Firms

2. Bidding of a contract with onshore and offshore activities by a MNC Group

3. Inter-Country point-to-point logistics services rendered by a Global Logistics Group

Transfer of Unique intangibles

1. R&D Companies

- Centres which are entrepreneurial in nature;
- Centres which are based on cost-sharing arrangements; and
- Centres which undertake contract R&D

Determining ALP using PSM

Approach to PSM – Total Profits Split

1. Determine the Combined Net Profit of the AE's
2. Evaluate relative contribution made by each of the AE based on the FAR analysis
3. Quantify the relative contribution based on external reliable market data on unrelated enterprises performing comparable functions under similar circumstances
4. Split the Combined Net Profit based on relative contribution
5. Split Profit in added to cost to determine the ALP

Approach to PSM – Residual Profits Split

1. Determine the Combined Net Profit of the AE's
2. Based on FAR analysis, determine the basic return appropriate to the respective entities.
3. The residual profits are then allocated again on basis of evaluation of relative contributions.
4. The Net profit allocated using above system is added to the cost to determine the ALP

Practical Illustration

Illustration 2 – Combined Net Profits

1. Identify the AE's and International Transaction?

- ABC India and ABC USA are the AE's.
- Fees of USD 20,000 shared by ABC India with ABC USA is the international transaction

2. Determine the combined net Profit

Particulars	ABC India	ABC USA	Combined
Revenue	30,000	20,000	50,000
Cost	(20,000)	(8,000)	(28,000)
Profit	10,000	12,000	22,000

Note: Revenue of ABC India is taken net of that shared with ABC USA.

Illustration 2 - Total Profits Split

Combined Net Profit ('CNP') as determined	$ 22,000
Share of CNP assigned to ABC India (FAR analysis)	70%
Amount of CNP assigned to ABC India	$ 15,400
Cost incurred by ABC India	$ 20,000
Arm's Length Revenue deduced from above	$ 35,400
Transaction Value	$ 30,000
Amount of TP Adjustment	**$ 5,400**

Illustration 2 – Residual Profit Split

Basic Return due to ABC India	$ 3,000
Basic Return due to ABC USA	$ 800
Total Basis Returns	**$ 3,800**
Combined Net Profits ('CNP') as determined	$ 22,000
Residual Profits	**$ 18,200**
Share of Residual Profits – ABC India	$ 12,740
Share of Residual Profits – ABC USA	$ 5,460
Returns allocated to ABC India (Basic + Residual)	$ 15,740
Cost incurred by ABC India	$ 20,000
Arm's Length Revenue deduced from above	**$ 35,740**
Transaction Value	$ 30,000
Amount of TP Adjustment	**$ 5,740**

Illustration 3

Initial Return for manufacturing to A	$ 6
Initial Return for manufacturing to B	$ 17
Total Initial Returns	**$ 23**
Combined Operating Profits ('COP')	$ 85
Residual Profits	**$ 62**
Share of Residual Profits – A (30/70 * 62)	$ 26.57
Share of Residual Profits – A (40/70 * 62)	$ 35.43

Total Profits allocated – A (Initial $ 6 + Residual $ 26.57) $ 32.57
Total Profits allocated – B (Initial $ 17 + Residual $ 35.43)$ 52.43

Judicial Rulings

Ruling 1 – Net Freight (Delhi ITAT - 2013)

Facts of the case

1. The Taxpayer is a logistics service provider offering a comprehensive portfolio of international, domestic and specialized freight handling services.
2. The Taxpayer and its AE's mutually appoint each other as exclusive agents with respect to the transportation of shipments.
3. For these services, the Taxpayer and its AEs have an arrangement of profit sharing on a 50% basis of all transactions of inbound and outbound shipments.
4. Taxpayer adopted Residual PSM as Most Appropriate Method

Ruling 1 – Net Freight (Delhi ITAT - 2013)

TPO's Contention

1. TPO rejected use of Residual PSM as the MAM since sufficient information was not available to determine whether the arrangement of the profit sharing rate of 50% was appropriate or not.

2. The TPO adopted TNMM and benchmarked the net operating margin as 7.17% against 2.56% of the taxpayer and made a TP adjustment.

Ruling 1 – Net Freight (Delhi ITAT - 2013)

ITAT's Ruling

1. First stage Split - Benchmarking with reliable external market data is must.
2. Residual Profits – Based on relative contribution of the AEs, which need not be benchmarked by external market or comparable data but can be done on a scientific basis.
3. Residual PSM upheld as MAM and TNMM rejected.
4. Case set aside for fresh adjudication since RPSM not applied correctly.

Ruling 2 – Agility Logistics (Mumbai ITAT)

Facts of the case

1. The Taxpayer is a logistics service provider offering a comprehensive portfolio of international, domestic and specialized freight handling services.
2. For freight forwarding transactions, the Taxpayer adopted a policy of sharing net revenue (i.e. sum billed to customers less third-party costs) between the origin and destination Companies in 50:50 ratio.
3. Since this policy was consistently applied for both controlled as well as uncontrolled transactions, the tax payer adopted CUP Method to determine the ALP of the net revenue share to/from the AE.

Ruling 2 – Agility Logistics (Mumbai ITAT)

Revenue's Contention

1. Revenue argued that assessee has followed PSM and not TPM

Ruling 2 – Agility Logistics (Mumbai ITAT)

ITAT's Ruling

1. Scope of CUP included not only 'price' but also 'pricing mechanisms'.

2. Industry practice given recognition.

Recent CBDT Circular

CBDT Circular 2/2013 dt 26-Mar-2014

1. Clarification was needed for use of PSM as Most Appropriate Method
2. Discouraged use of TNMM for R&D activities since no correlation can be established between cost incurred on R&D activities and return on an intangible developed through R&D activities
3. <u>Availability, Coverage and Reliability of data</u> must in selection of Most Appropriate Method. Hence, reasons should be recorded before rejecting PSM and moving to TNMM / CUP
4. TNMM / CUP can be applied by selecting comparables engaged in same line of business and making upward adjustments.

CBDT Circular 2/2013 withdrawn

Justification given for withdrawal in Circular 5/2013:

> *"The Circular appeared to give the impression that there was a <u>hierarchy among the six methods</u> listed in Section 92C and that the PSM was the preferred method in the case involving unique intangibles or in multiple interrelated international transactions".*

CBDT Circular 3/2013 & 6/2013

Conditions relevant to identify a Development Centre engaged in **Contract R&D activity**:

1. Foreign principal performs most of the economically significant functions involved in the R&D Cycle
2. The Foreign principal or its AE provides funds/ capital and other economically significant assets including intangibles for R&D, apart from remuneration for the R&D activity
3. The Indian Development Centre works under the direct supervision of the foreign principal or its AE which actually controls, supervises and monitors the work
4. The Indian Development Centre does not assume or has no economically significant realized risks.
5. Rebuttable presumption that foreign principal is not controlling the risk if it is in low / no tax jurisdiction.

Cautions in use of PSM

Cautions in use of PSM

Strengths:

1. Both parties to a transaction are tested
2. Less probability of extreme profit split
3. Allocation based in division of functions

Challenges:

1. Difficult to access information of affiliates
2. Complex level of analysis and benchmarking
3. Differences in accounting standards, components of costs
4. External data considered to value contribution of enterprises may be less closely connected to those transaction than in case of other methods

QUESTIONS?