Transfer Pricing Basics with Case Studies

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Indian Member of
Global Network of Transfer Pricing Firms
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Speaker Profile

Founding Partner at Amicus (Law Firm) and Tax Counsel/ Advisor with more than 15 years of experience in Transfer Pricing and International Taxation

Tax/ Transfer Pricing Advisor
Ashutosh has successfully represented several multinational companies before tax authorities in Transfer Pricing/ International Tax audits and provides Transfer Pricing planning / documentation services

- Transfer Pricing Documentation, preparation of Local, Master-files and CbCR
- Transfer Pricing Planning & Profit Benchmarking
- Transfer Pricing Audit Defense
- Transfer Pricing Litigation (before Transfer Pricing Officers and higher Courts)

Tax Counsel (Tribunal/ High Court)
Regularly argues Tax/ Transfer Pricing matters before Tax Tribunal / High Court. Some of the cases argued by Ashutosh before Delhi Tribunal.

- De Diamond (Auto) – whether manufacturing and trading constitutes one business (Delhi Tribunal)
- Pyramid It Consulting (Software & Staffing) – Accept-reject of comparables (Delhi Tribunal and High Court)
- Astra Business Services (Software) – Exclusion of branded comparables
- Corbus IT Consulting (Procurement) – Interest imputation on receivables
- Renu Creations – Best Judgement Assessment

Rated as the Transfer Pricing Lawyer of the Year by Finance Awards (2017) Recommended by Legal 500 (2014-2020) for Transfer Pricing advisory and dispute resolution services

Education: SRCC, Eco(Hons), LLB, LLM, New York University School of Law (Tax & Corporate Law)
Contents

- Basic Concepts - Why Transfer Pricing Regulations?
- Scope and Applicability of Indian Transfer Pricing Regulations (International & Domestic)
- Transfer Pricing Methods
- Case Studies on CUP/ RPM and TNMM
- Transfer Pricing in the Current Environment (Covid Impact)
Basic Concepts
General Definitions

- **Transfer Price**: price at which different divisions of a multidivisional organization transact with each other

- **Transfer Pricing**: pricing of inter-divisional transactions, particularly cross-border transactions

- **Arm’s length price**: price at which independent enterprises enter into comparable transaction(s)

- **Transfer Pricing Planning – Exante Concept**: setting the price in advance of the transaction or before closing the books

- **Transfer Pricing Compliance – Filing/Maintaining Forms or Documents on due dates normally after the transaction has taken place**
Transfer Pricing - A Business Perspective

Optimization of global tax cost

Profit - Shifting

Parent (Country A)
High Tax Jurisdiction

Subsidiary (Country B)
Low Tax Jurisdiction
Indian Transfer Pricing Regulations – Scope and Applicability
Indian Transfer Pricing Regulations

- Introduced in 2001 with objective of preventing profit shifting from India
- Applicable to cross-border transactions between related parties (arm’s length principle applies exceptionally to domestic related party transactions.
- Requires taxpayers to set inter-company prices in line with arm’s length principle
- Taxpayer must maintain adequate documentation to prove arm’s length nature of inter-company transactions
- Non compliance can invite stringent penalty under law
- Overseas jurisdictions also require compliance with arm’s length principle under their respective transfer pricing regulations (must be complied with as well.)
Indian Transfer Pricing Regulations - Key Provisions

- **Charging section (s92)** = Income + International Transaction.

- **International Transaction (s92B)** = Associate Enterprise + At least one entity should be non-resident.

- **Associated Enterprise (s92A)** = One of the 13 conditions in s92A should be met.
Charging Section 92

Income + International Transaction

Associate Enterprise

Conditions (a) to (m)
Section 92A

At least one NR
"Any Income arising from international transaction shall be computed having regard to the arm’s length price."

Charging section (s92) = Income + International Transaction

*Example- Issue of Shares.

*Shell/ Vodafone Rulings.

*Government Circulars.
Associate Enterprises (s92)

An Enterprise

- a) Holds $\geq 26\%$ voting power
- b) Holds $\geq 26\%$ voting power in each entity
- c) Advanced Loan $\geq 51\%$ of B.V. of asset
- d) Guarantees $\geq 10\%$ of total borrowing
- e) & f) Appoints/appointed $\geq 50\%$ of BOD
- g) Provides $\geq 90\%$ of raw Material
- h) Manufacture/Processing wholly dependent on intellectual property
- i) Sales and prices of product are influenced
- j) Entities controlled by same individual or relative
- k) Entities controlled by HUF or its members
- l) Holds $\geq 10\%$ interest
- m) Have mutual interest among entities
**Illustration 1**

- A Ltd. directly holds $\geq 26\%$ of voting power in B Ltd.
- B Ltd. directly holds $\geq 26\%$ of voting power in C Ltd.
- Hence, A Ltd. **Indirectly** holds C Ltd.
- Therefore,
  - A Ltd. and B Ltd. are AEs
  - B Ltd. and C Ltd. are AEs
  - A Ltd. and C Ltd. are AEs
Illustration 2

- Mr. X holds > = 26% of voting power in A Ltd.
- Mr. X also holds > = 26% voting power in B Ltd.
- Therefore, **A Ltd. and B Ltd. are Associated Enterprises (AEs)**
Illustration 3

- Mr. X has a 100% shareholding in A Ltd.
- Mr. Y and Mr. Z has 90% and 10% Shareholding respectively in B Ltd.
- Mr. Y has a control over B Ltd. and Mr. X has a significant influence on A Ltd.
- Since Mr. X is relative of Mr. Y (Son), A Ltd. and B Ltd. are Associated Enterprises (AEs)
Illustration 4

- A Ltd. Owner of Intangible Property such as trademarks, copyrights etc.
- B Ltd. Wholly dependent upon trademarks, copyrights etc. of A Ltd.
- Therefore, A Ltd. and B Ltd. are AEs
Specified Domestic Transactions

2012
- Extends Transfer Pricing Regulations to ‘specified domestic transactions’ (‘SDT’)
- SDT exceeds INR 5 crores (INR 50 million)

2015
- Threshold increase to INR 20 Crores (INR 200 million) for AY

2017
- Omitted payments to persons referred to in sec. 40A(2)(b)
The ‘Economics’ Underlying the Methods
### Equations for Transfer Pricing Methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Equation</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td><strong>Transfer Price (TP)</strong></td>
<td></td>
</tr>
<tr>
<td>RPM/ CPM</td>
<td><strong>Gross Profit</strong></td>
<td>Cost of Goods Sold = Purchases + Change in Inventory (Closing Stock – Opening Stock)</td>
</tr>
<tr>
<td>TNMM</td>
<td><strong>Net Profit</strong></td>
<td>Overheads = Communication, Printing, Travel, Insurance, Security, Electricity, Stationary etc</td>
</tr>
<tr>
<td></td>
<td>= Sales – COGS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>= (TP X QTY) – COGS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>= (TP X QTY) – COGS – Overheads</td>
<td></td>
</tr>
</tbody>
</table>
Price versus Profit Testing

**Objective – Test Transfer Price**

- **Price**
  - = Transfer Price (TP)
  
  or
  
- **Gross Profit**
  - = [(TP x QTY) – COGS] - 1st Extraneous Variable

  or
  
- **Net Profit**
  - = [(TP x QTY) – COGS – OVERHEADS] - 1st Extraneous Variable
  
  or
  
- 2nd Extraneous Variable
OECD Hierarchy in Methods

- CUP – most direct but severe data constraint
- CPM/ RPM – relative dilution but more feasible
- TNMM – diluted testing but most practical
- PSM – applied in cases of joint development of ‘intangibles’

2009/2010

Hierarchy replaced by ‘most appropriate method’ standard
- Also enshrined in Indian Regulations
Comparable Uncontrolled Price Method (CUP)
CUP Basics – Internal vs External

- Most Direct Method for testing ALP
- Strict comparability in products, contractual terms, economic terms, etc.
- Two types of CUPs available - Internal CUP & External CUP
- Calls for adjustments to be made for differences which could materially affect the price in the open market e.g.:
  - Difference in volume/quality of product
  - Difference in credit terms
  - Risks assumed
  - Geographic market
- Preference to Internal CUP over External CUP
CUP Case Study

- A Ltd. (Indian Co.) exports 1000 computer parts to B Ltd (AE) in US at INR 1.7/piece
- Z Ltd also exports 1000 computer parts to C Ltd (Non AE) in US at INR 2/piece
- Assume there are no functional and other differences, what shall be the arm’s length price?
- CUP method can be applied as all the commercial terms i.e. Qty, Product, Market are identical in both the transactions
- Arm’s length price in the case shall be INR 2/piece and hence transaction is at arm’s length price
- TPO is justified in adjusting the price of A Ltd by INR 0.3/unit

➢ A Ltd. sells computer parts to AE B Ltd.
➢ Z Ltd. sells computer parts to Non-AE C Ltd.
➢ No material differences between both transactions
Assuming there are no other functional differences, what shall be the arm’s length price?

Except for payments terms, there are no functional differences in the two transactions. Hence CUP method can be applied after adjusting the arm’s length price for difference in payment terms.

Hence arm’s length price of INR 2/unit shall be adjusted to accommodate the discount of INR 0.3/unit. Hence the adjusted arm’s length price is derived at INR 1.7/unit which is equal to the price of international transaction.

Prima facie, it may appear that I Ltd has under invoiced its AE, the international transaction is at arm’s length.
CUP – Concluding Remarks

- **Transfer Pricing Enquiry** to Start with CUP Data Finding

- **Requires Strict Comparability**

- **Nature of Services/ Product**
  - Contractual Terms
  - Geographical Market
  - Time Period

- Explore possibility of adjustment for differences for eg differential credit terms

- Courts have been pragmatic while analyzing CUP Data – “Transfer Pricing is an art and not a science’ – objective is to detect tax avoidance and not to impose a levy
RESALE PRICE METHOD
Economic Return for a Distributor

\[
\text{Sales} = \text{Gross Profit} + \text{COGS}
\]

\[
= \text{Net Profit} + \text{Value Added Expenses} + \text{COGS}
\]

\[
= \text{Net Profit} + \text{Rent} + \text{Salaries} + \text{Electricity} + \text{Other OE} + \text{COGS}
\]
RPM – Not Applicable if Significant Value Addition

**Distributor A**

No Warranty Services

Sales = Gross Profit + COGS

Sales = (Net Profit + Value Added Exp.) + COGS

= \[\text{Net Profit} + (\text{Rent} + \text{Salaries} + \text{Electricity} + \text{Other Operating Exp.}) + \text{COGS}\]

**Distributor B**

Provides Warranty Services (Value Addition)

Sales = Gross Profit + COGS

Sales = (Net Profit + Value Added Exp.) + COGS

= \[\text{Net Profit} + (\text{Rent} + \text{Salaries} + \text{Electricity} + \text{Warrant Expenses}^* + \text{Other Operating Exp.}) + \text{COGS}\]

*Warranty Expenses = Cost of spare parts + cost of manpower for repair, maintenance, etc.*

**Conclusion:**

- GP of Distributor B > GP of Distributor A
- GP increases with the increase of VAE
- Different distributors may have different value added services
- Distributors with differential value added services are not comparable
- GP margin for distributors with functional differences shall differ
Testing Questions?

- Profitability Testing
  - Profitability measure [PLI]?
    - Gross Profit?
    - Net Profit?
  - Appropriate Base [PLI]?
    - Sales?
    - Cost?
    - Others?
  - Tested Party [Which Transacting Entity to Test?]
Resale Price Method – An Overview

• RPM evaluates gross profit margin a comparable uncontrolled transaction

• Appropriate in cases involving purchase and resale of finished goods/services

• Applicable where buyer/reseller does not add substantial value to the goods

• Emphasis on similarity of functions performed & risks assumed

<table>
<thead>
<tr>
<th>Foreign Co.</th>
<th>Outside India</th>
</tr>
</thead>
<tbody>
<tr>
<td>COGS – 92.5</td>
<td>India</td>
</tr>
<tr>
<td>Resale Price – 100</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Indian Co.</th>
<th>Customer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit Margin – 7.5%</td>
<td></td>
</tr>
</tbody>
</table>
RPM - Illustration

- F Co. sells finished goods to I Co.
- I Co. sells the finished goods to unrelated customers
- I Co makes a gross margin of 8% on sales

The gross margins of various Unrelated Suppliers on sales of similar goods in the Indian market are as under:

<table>
<thead>
<tr>
<th>Unrelated Supplier</th>
<th>COGS (INR)</th>
<th>Final Sales Value (INR)</th>
<th>GP (INR)</th>
<th>GP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>500</td>
<td>520</td>
<td>20</td>
<td>3.85%</td>
</tr>
<tr>
<td>2</td>
<td>700</td>
<td>750</td>
<td>50</td>
<td>6.67%</td>
</tr>
<tr>
<td>3</td>
<td>370</td>
<td>400</td>
<td>30</td>
<td>7.50%</td>
</tr>
<tr>
<td>4</td>
<td>780</td>
<td>850</td>
<td>70</td>
<td>8.24%</td>
</tr>
<tr>
<td>5</td>
<td>450</td>
<td>500</td>
<td>50</td>
<td>10.00%</td>
</tr>
<tr>
<td>6</td>
<td>600</td>
<td>670</td>
<td>70</td>
<td>10.45%</td>
</tr>
</tbody>
</table>

- Minimum: 3.85%
- 35th Percentile: 7.50%
- Median: 7.87%
- 65th Percentile: 8.24%
- Maximum: 10.45%
Transactional Net Margin Method (TNMM)
Transaction net margin method (TNMM)

- Examines net operating profit as a % of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties

- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction – Internal TNMM

- Most frequently used method in India, due to lack of
  - Availability of CUP data
  - Availability of gross margin data required for application of CPM / RPM

- Broad level of product comparability and high level of functional comparability

- Applicable for any type of transaction and often used to supplement analysis under other methods

- The application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits
A Co. is a value added oil distributor company

A Co imports oil from Parent Entity, P Co.

A Co provides doorstep delivery of oil to customers

A Co. earns a 5% net operating profit from its distribution business

Comparable companies (having similar business as that of A Co.) earn a net profit margin in the range 4% to 8%

Hence, profitability of A Co. is at arm’s length

### Table: A Co.’s Net Margin

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (Sales)</td>
<td>100</td>
</tr>
<tr>
<td>Operating Cost</td>
<td>80</td>
</tr>
<tr>
<td>Operating Exp.</td>
<td>15</td>
</tr>
<tr>
<td>OP</td>
<td>5</td>
</tr>
<tr>
<td>OP/Sales</td>
<td>5%</td>
</tr>
</tbody>
</table>

### Table: Search Results

<table>
<thead>
<tr>
<th>Margins for Comparable Co.’s</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>3.5%</td>
</tr>
<tr>
<td>Median</td>
<td>4.5%</td>
</tr>
<tr>
<td>Range</td>
<td>4% - 8%</td>
</tr>
</tbody>
</table>
Transfer Pricing Method for Cost Plus Model

- Example - Remuneration to a back office service provider on cost plus model
- Which Transfer Pricing Method to apply?
- CPM or TNMM?
- If Mark-up is applied to full cost TNMM is the correct method and not CPM
- Due to similarity in terms, Cost Plus Method (CPM) misinterpreted as most appropriate Transfer Pricing method for Cost Plus Model
- TNMM is the correct Method for Cost Plus entities and not CPM
## TNMM - Limitations

### Challenges

- Relatively low accuracy in the Profit Based Methods
- Most Diluted form of testing - Net margins are affected by factors that do not have anything to do with price setting (overheads may be completely market determined)
- Not to be applied when related party transaction constitutes small proportion of total sales or cost
- Exposes company wide profitability to Transfer Pricing Adjustment
Objective – Testing the Price of Raw Material

Q1: Has XA Ltd. Sold same RM to third Party?
No

Q2: Has XB Ltd. Purchased from third Party?
No

Q3: Has any other company in Group X Sold/Purchased from third Party?
No

Q4: How the price of RM has been fixed by Group X?
Clues
Clues

Past Third Party Sales

Cost-Plus Markup

How much is the Markup?

Testing the Markup

Testing Questions? – Practical Scenario (Cont)
CBDT has notified the “other method” in Rule 10AB

“Other method” refers to “price which has been

• Charged or paid or

• Would have been charged or paid

for the same or similar uncontrolled transaction, with or between non-associated enterprises

Effectively, this implies that under this “other method” “quotations” rather than prices “actually” charged or paid can also be used by the taxpayers.
## Transfer Pricing Methods - Snapshot

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP Method</td>
<td>Directly compare the price per unit of good or service</td>
<td>Most Accurate – directly tests price</td>
</tr>
<tr>
<td>Resale Price Method</td>
<td>Compare the gross margin of reseller</td>
<td>Closer to price – not influenced by overheads</td>
</tr>
<tr>
<td>Cost Plus Method</td>
<td>Compare the Gross Profit earned by manufacturer</td>
<td>Closer to price – not influenced by overheads</td>
</tr>
<tr>
<td>Transactional Net Margin Method (TNMM)</td>
<td>Compares net profit relative to appropriate base</td>
<td>Net profit dilutes the accuracy but most practical and commonly used</td>
</tr>
<tr>
<td>Profit Split Method</td>
<td>System net profit is split between transacting parties in ratio of contributions towards intangible development</td>
<td>Subjective - used only if multiple parties develop intangible and not possible to determine return for each separately</td>
</tr>
</tbody>
</table>
# Commonly Used Methods for Inter-Company Transactions

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Commonly Used Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty</td>
<td>✓ CUP ✓ TNMM</td>
</tr>
<tr>
<td>Management Fees</td>
<td>✓ CUP ✓ Other Method ✓ TNMM</td>
</tr>
<tr>
<td>Interest on Loan</td>
<td>✓ CUP</td>
</tr>
</tbody>
</table>
Transfer Pricing Planning in Covid Environment
Covid Impact on Transfer Pricing

➢ Assess Economic Impact
➢ Disclosure in Financial Statements

➢ Time Period of Economic Distress
   ➢ Year 2020
   ➢ Year 2021...

➢ Supply Chain Restructuring
   ➢ Reduce Capacity Underutilization
   ➢ Reduce Fixed Cost
   ➢ Eliminate Dead Cost

➢ Capacity Under-utilization Adjustments to Profitability
   ➢ Documentation of Economic Environment
   ➢ Measuring Excess/ idle Capacity
   ➢ Inventory Pile-up
Covid Impact on Transfer Pricing (CONT)

➢ Review Mark-up Thresholds
  ➢ Contract Manufacturers (Cost plus)
  ➢ Limited Risk Distributors (Return on sales)
  ➢ Limited Risk Service Providers (Cost plus)

➢ When to Review? Now or Year End – How to Plan?

➢ Review Financial Transactions
  ➢ Revision of Interest Rates
  ➢ Loan Moratoriums
  ➢ Liquidity Crunch leading to delay in payments

➢ Review APA Complings
  ➢ Can a Company Comply with APAs in Covid Environment
  ➢ Change in Economic Circumstances Argument
Covid Impact on Transfer Pricing (CONT)

- Government Intervention
  - Revise Safe Harbour Norms – Existing Profitability Thresholds Impractical and Unrealistic
  - Review Concluded APAs – Critical Assumptions underlying APAs dislodged
  - Review Criteria for Reference of Case for Transfer Pricing Scrutiny
  - Adopt Pragmatic Approach in audits rather than Target Driven
  - Amend Transfer Pricing Regulations
    - Broaden the arm’s length range to Inter-quartile Range
    - For FY 2020 – being the first impacted year use single year data and not multiple year data for comparables
  - Specific Transfer Pricing Guidance from OECD likely
THANK YOU

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Visit us at www.amicusservices.in

Let’s stay strong and fight back:

▪ Stay home, stay safe
▪ Maintain Social Distancing
▪ Eat Healthy
▪ Exercise
▪ Think Positive
▪ Follow Government Guidelines

Remember nothing lasts forever, better days are coming, but they will come faster with faith.