Transfer Pricing Basics with Case Studies

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Indian Member of ALTUS ALLIANCE

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)

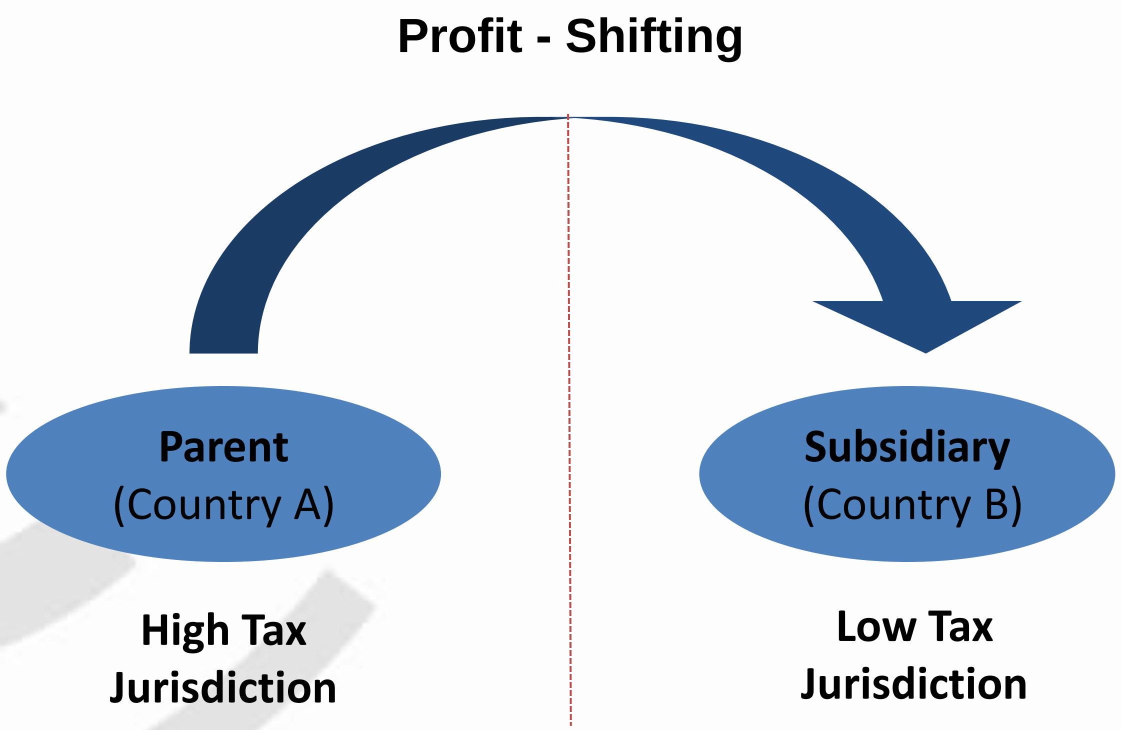
Basic Concepts

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



Indian Transfer Pricing Regulations – Scope and Applicability

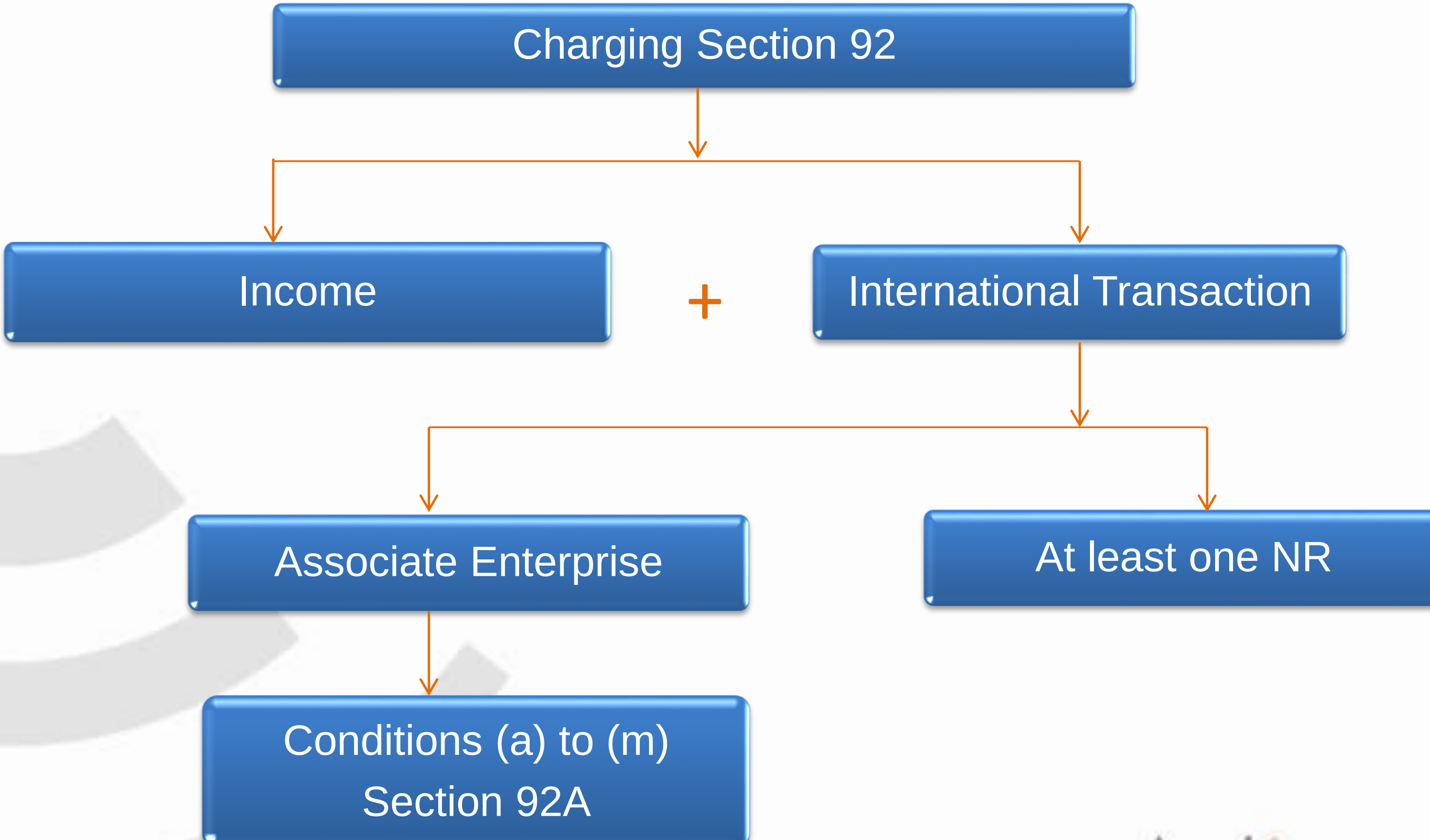
Indian Transfer Pricing Regulations

- 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



No Income Arising- Applicability of Transfer Pricing

"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>/=26% voting power
- b) Holds>/=26% voting power in each entity
- c) Advanced Loan >/=51%of B.V. of asset
- d) Guarantees>/=10% of total borrowing
- e)&f) Appoints/appointed>50% of BOD
- g) Provides>/= 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>/=10% interest
- m) Have mutual interest among entities

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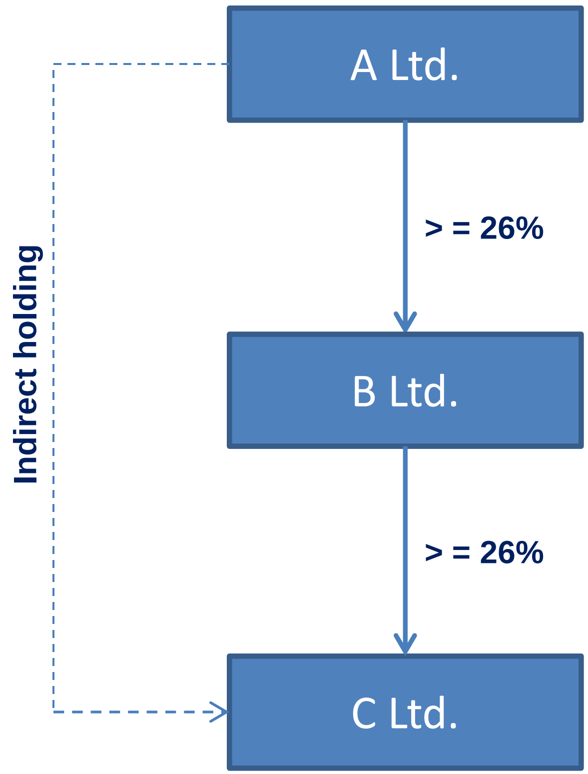
Associated Enterprise S. 92A(2)(a)

Illustration 1

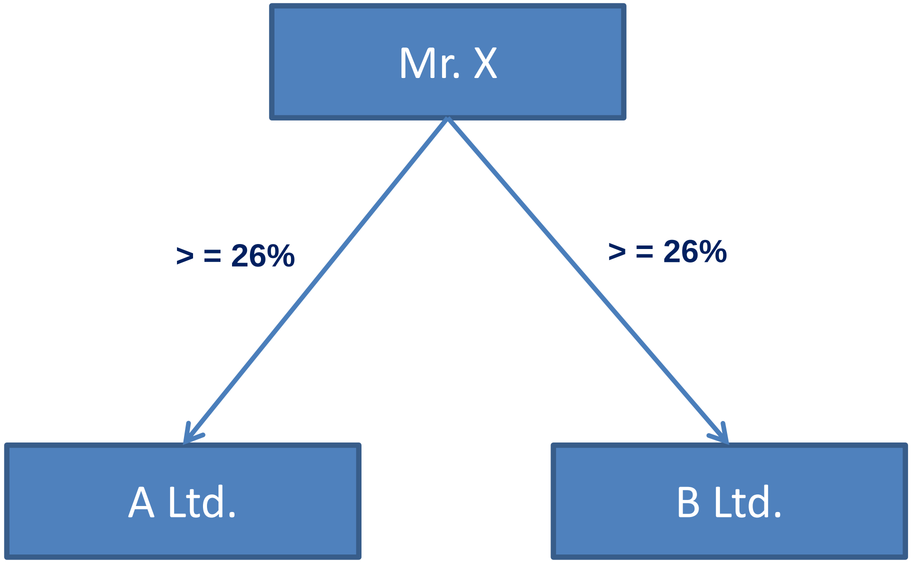
- A Ltd. directly holds > = 26% of voting power in B Ltd.
- B Ltd. directly holds > =26% of voting power in C Ltd.
- Hence, A Ltd. **Indirectly** holds C Ltd.
- Therefore,
  - **A Ltd. and B Ltd. are AEs**
  - **B Ltd. and C Ltd. are AEs**
  - **A Ltd. and C Ltd. are AEs**



Associated Enterprise S. 92A(2)(b)

Illustration 2

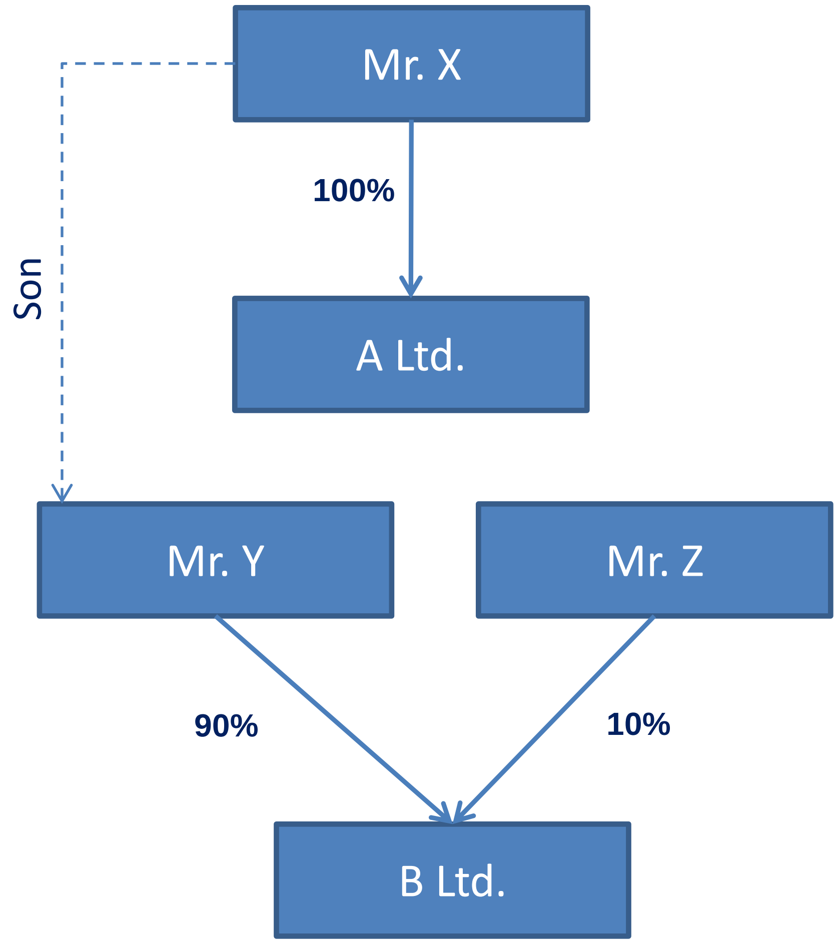
- Mr. X hold > = 26% of voting power in A Ltd.
- Mr. X also holds > = 26% voting power in B ltd.
- Therefore, **A Ltd. and B Ltd. are Associated Enterprises (AEs)**



Associated Enterprise S. 92A(2)(j) or (k)

Illustration 3

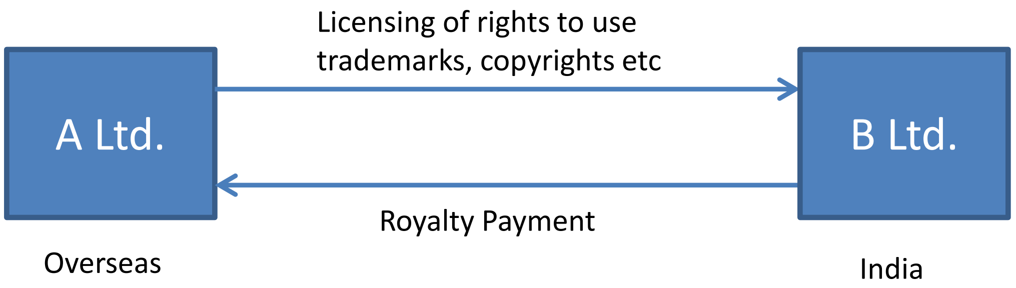
- Mr. X has a 100% shareholding in A Ltd.
- Mr. Y and Mr. Z has 90% and 10% Shareholding respectively in B Ltd.
- Mr. Y has a control over B Ltd. and Mr. X has a significant influence on A Ltd.
- Since Mr. X is relative of Mr. Y (Son), A Ltd. and B Ltd. are **Associated Enterprises (AEs)**



Associated Enterprise 92A(1)(g)

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)

Transfer Pricing Methods - Snapshot

- Transfer Pricing Methods
  - Transaction Based Methods
    - CUP
    - RPM
    - CPM
  - Profit Based Methods
    - PSM
    - TNMM
  - Residual Method
    - Other Method

The ‘Economics’ Underlying the Methods

Equations for Transfer Pricing Methods

Method	Equation	Remarks
CUP	**Transfer Price (TP)**	
RPM/ CPM	**Gross Profit** = Sales – COGS = (TP X QTY) – COGS	Cost of Goods Sold = Purchases + Change in Inventory (Closing Stock – Opening Stock)
TNMM	**Net Profit** = Sales – COGS – Overheads = (TP X QTY) – COGS – Overheads	Overheads = Communication, Printing, Travel, Insurance, Security, Electricity, Stationary etc

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 **2nd Extraneous Variable**

Dilution

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’

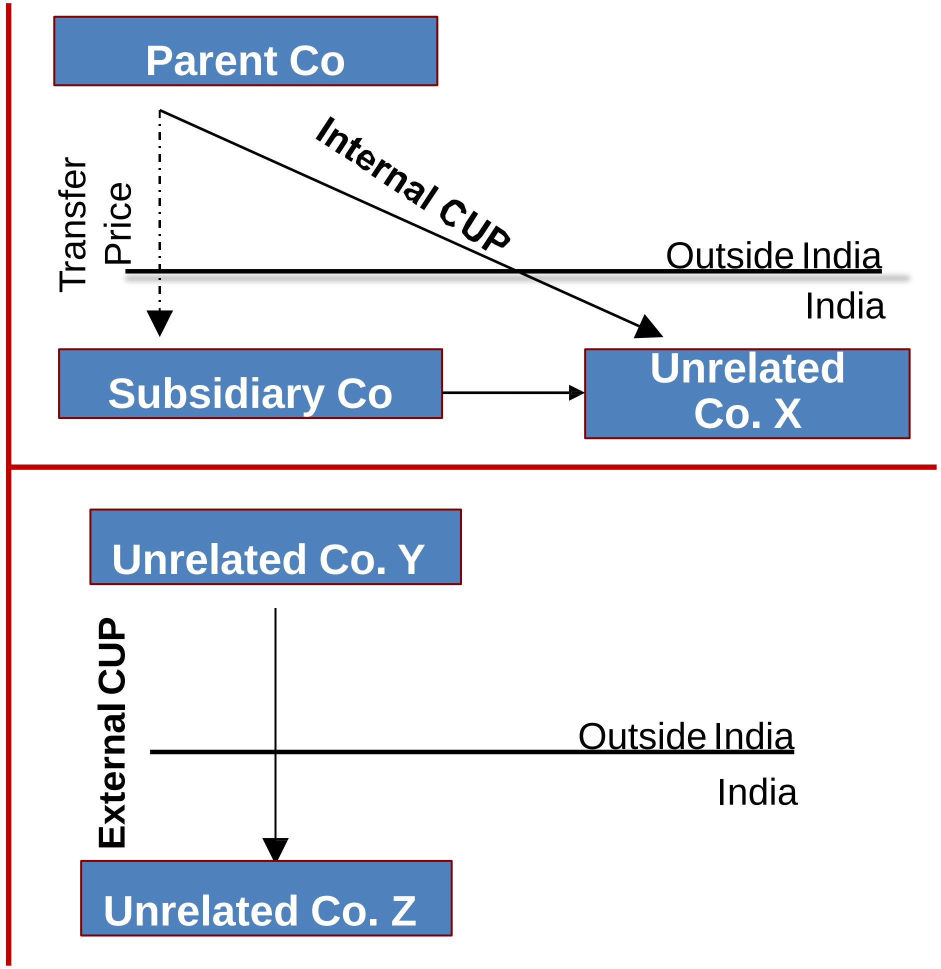
2009/2010

*Hierarchy replaced by ‘**most appropriate method’** standard - Also enshrined in Indian Regulations*

Comparable Uncontrolled Price Method (CUP)

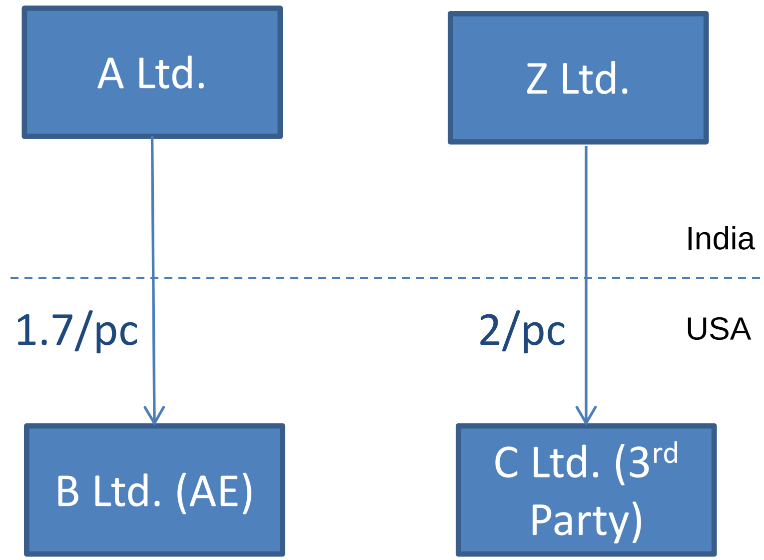
CUP Basics – Internal vs External

- 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/pc
- Z Ltd also exports 1000 computer parts to C Ltd (Non AE) in US at INR 2/pc
- Assume there are no functional and other differences what shall be the arm's length price ?
- CUP method can be applied as the 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/pc 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

Case Study (CONT) - Adjustment

A Ltd (Exports to AE)			Z Ltd (Exports to Non AE)	
Particulars			Particulars	
Qty	1000		Qty	1000
Basis	Cash		Basis	30 days Credit
Export Price	INR 1.7 / unit		Export Price	INR 2 / unit
Cash Payment fetches discount of INR 0.5 / unit in the open market				

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 twotransactions.
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

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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

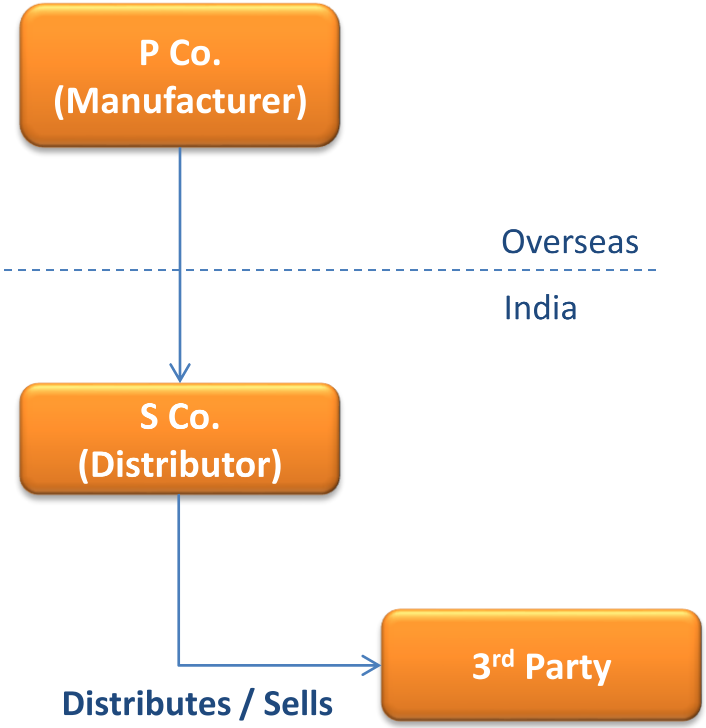
RESALE PRICE METHOD

Economic Return for a Distributor

$$\text{Sales} = \overbrace{\text{Gross Profit}} + \text{COGS}$$

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

$$= \text{Net Profit} + \text{Rent} + \text{Salaries} + \text{Electricity} + \text{Other OE} + \text{COGS}$$



RPM – Not Applicable if Significant Value Addition

Distributor A

No Warranty Services

Sales = Gross Profit + COGS

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

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

Distributor B

Provides Warranty Services (Value Addition)

Sales = Gross Profit + COGS

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

= [(Net Profit + (Rent + Salaries + Electricity + **Warrant Expenses*** + Other Operating Exp.))] + 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

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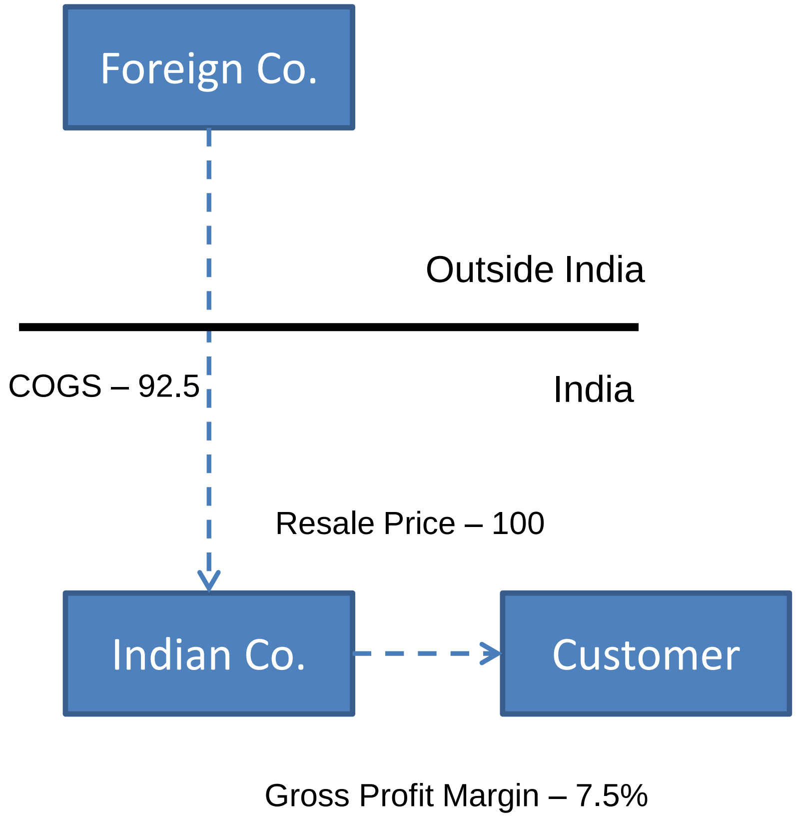
Testing Questions?

- 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

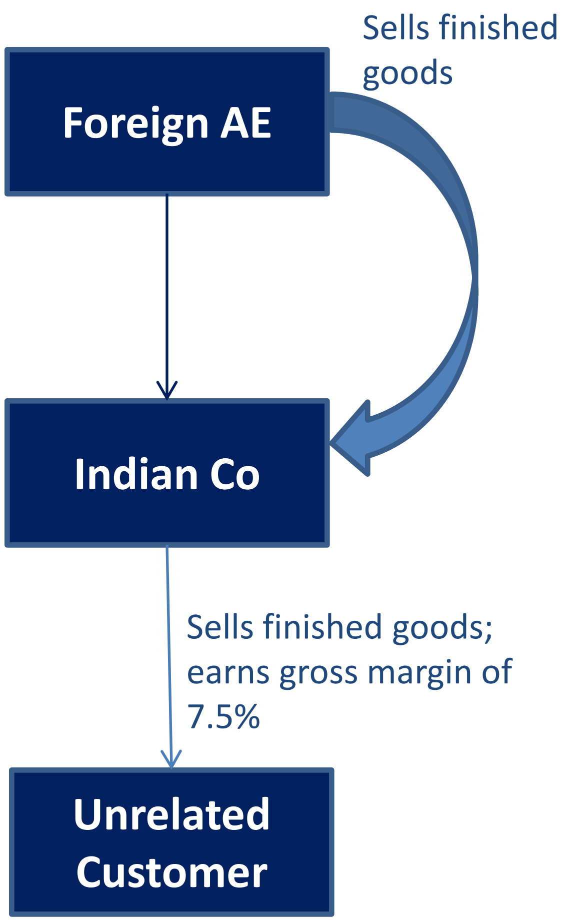


RPM - Illustration

- 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:

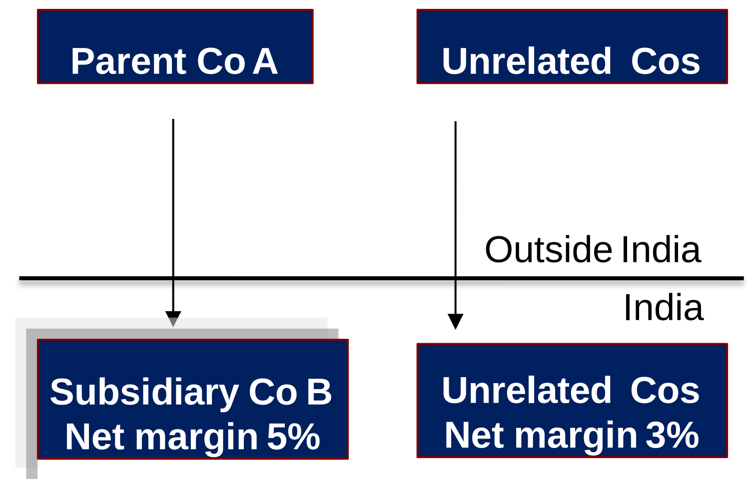
Unrelated Supplier	COGS (INR)	Final Sales Value (INR)	GP (INR)	GP (%)
1	500	520	20	**3.85%**
2	700	750	50	**6.67%**
3	370	400	30	**7.50%**
4	780	850	70	**8.24%**
5	450	500	50	**10.00%**
6	600	670	70	**10.45%**
Minimum				**3.85%**
35th Percentile				**7.50%**
Median				**7.87%**
65th Percentile				**8.24%**
Maximum				**10.45%**



Transactional Net Margin Method (TNMM)

Transactional 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



Transactional Net Margin Method (TNMM) (contd.)

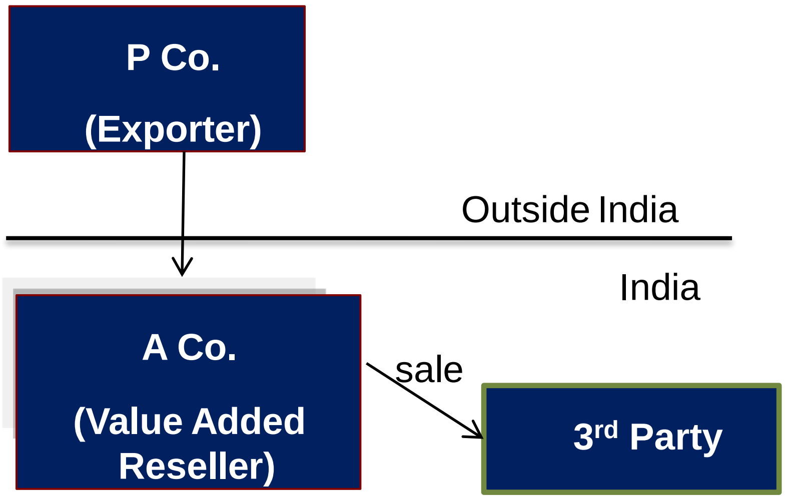


Table: A Co.'s Net Margin

Particulars	INR
Revenue (Sales)	100
Operating Cost	80
Operating Exp.	15
OP	5
OP/Sales	5%

- 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: Search Results

Margins for Comparable Co.'s	
Mean	3.5 %
Median	4.5 %
Range	4% - 8%

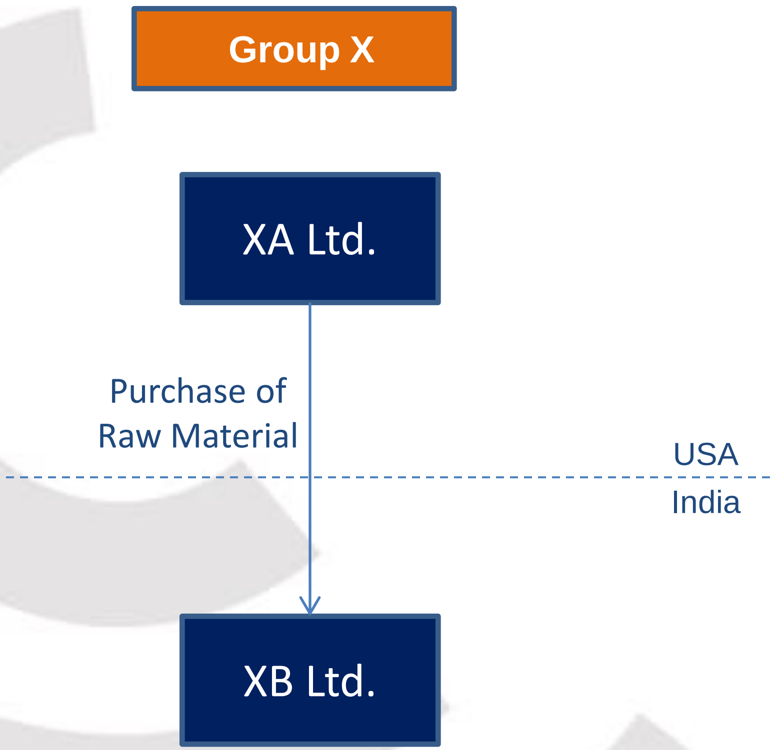
Transfer Pricing Method for Cost Plus Model

- **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

Testing Questions? – Practical Scenario



- **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

Testing Questions? – Practical Scenario (Cont)

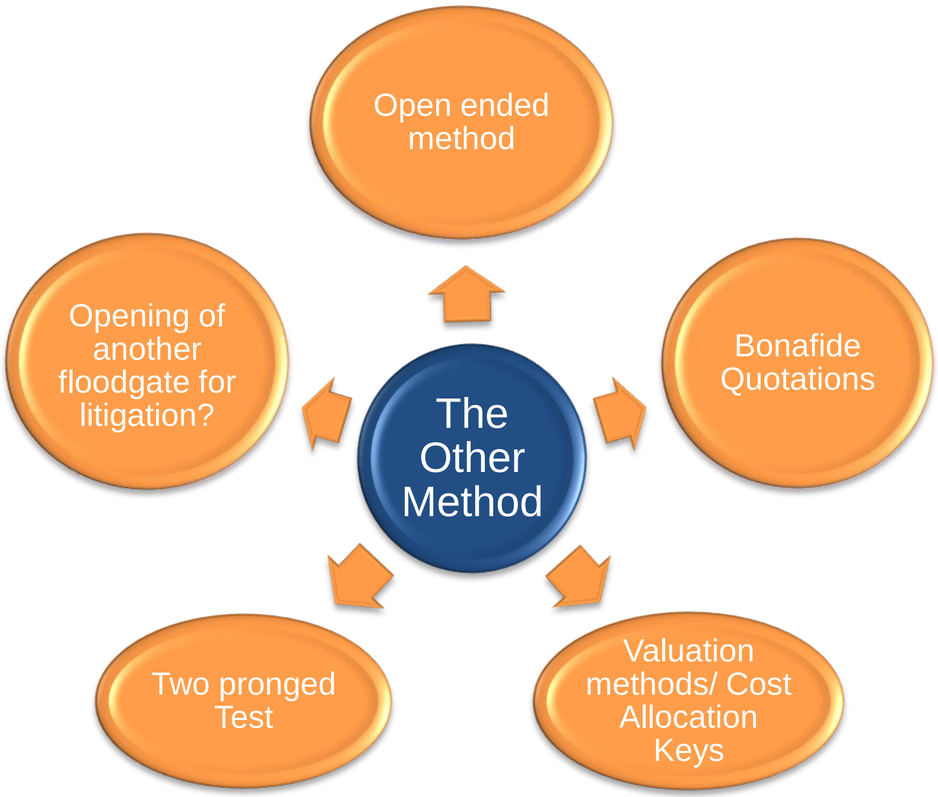
- **Clues**
  - **Past Third Party Sales**
  - **Cost-Plus Markup**
    - How much is the Markup?
      - Testing the Markup

“Other Method” (Sixth method notified by CBDT)

- 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.

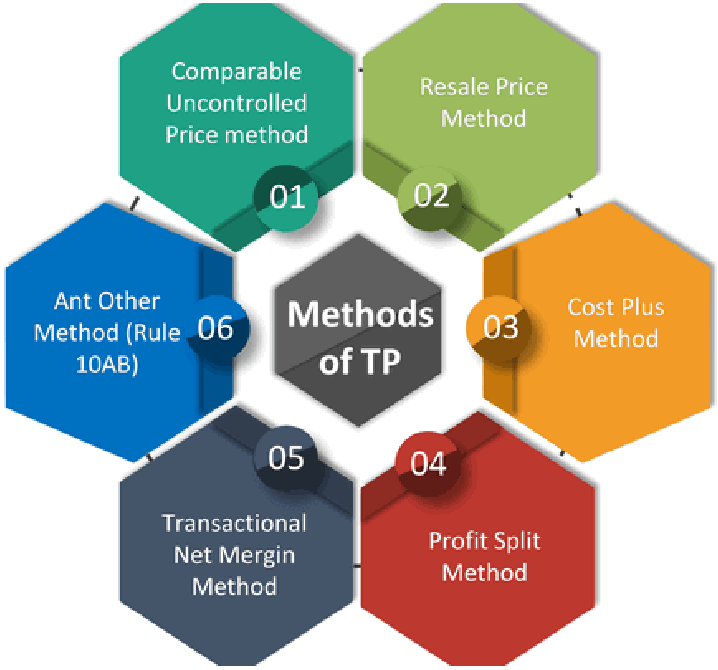


Transfer Pricing Methods - Snapshot

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

Commonly Used Methods for Inter-Company Transactions

Transaction	Commonly Used Methods
Royalty	➢ CUP ➢ TNMM
Management Fees	➢ CUP ➢ Other Method ➢ TNMM
Interest on Loan	➢ CUP



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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 Exess/ 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 Compliances
  - 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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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.

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