

Basics of Transfer Pricing

- International transactions

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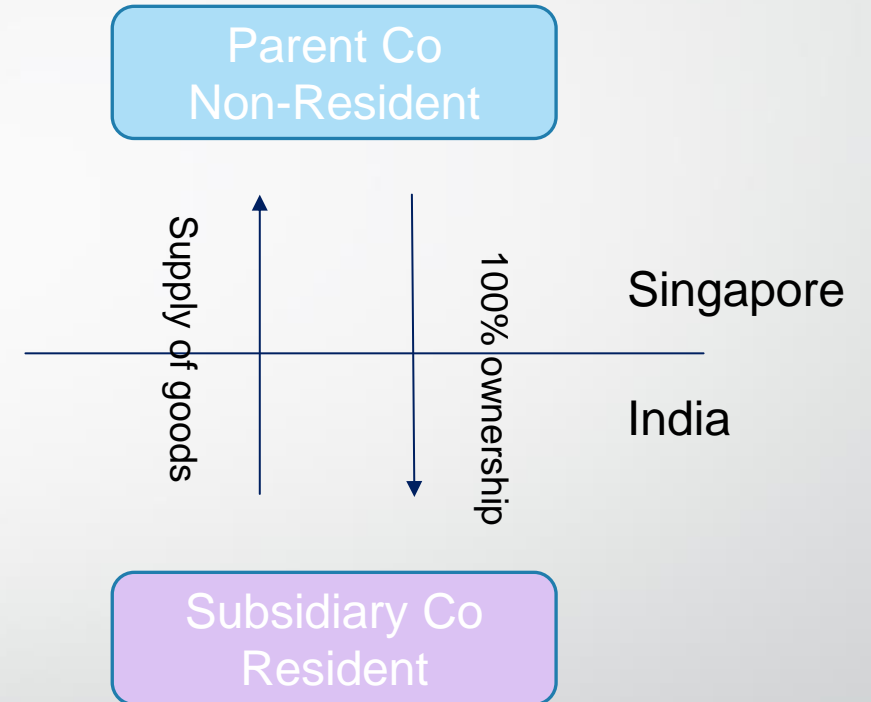
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What is Transfer Pricing & Need of Transfer Pricing

What is Transfer Pricing & Need?

- A pricing mechanism for transfer of goods / services between related entities:
 - ✓ **Tangible goods** – Raw materials, components, spare-parts, semi-finished / finished goods, assets, etc.
 - ✓ **Intangible goods** – trademarks, tradenames, patents, etc.
 - ✓ **Services** – IT / Itenables, management, marketing support, engineering, after sales services, etc.
 - ✓ **Loans** – interest on loans, guarantee fees
- Due to the special relationship between related companies, the transfer price may be different than the price that would have been agreed between the unrelated companies



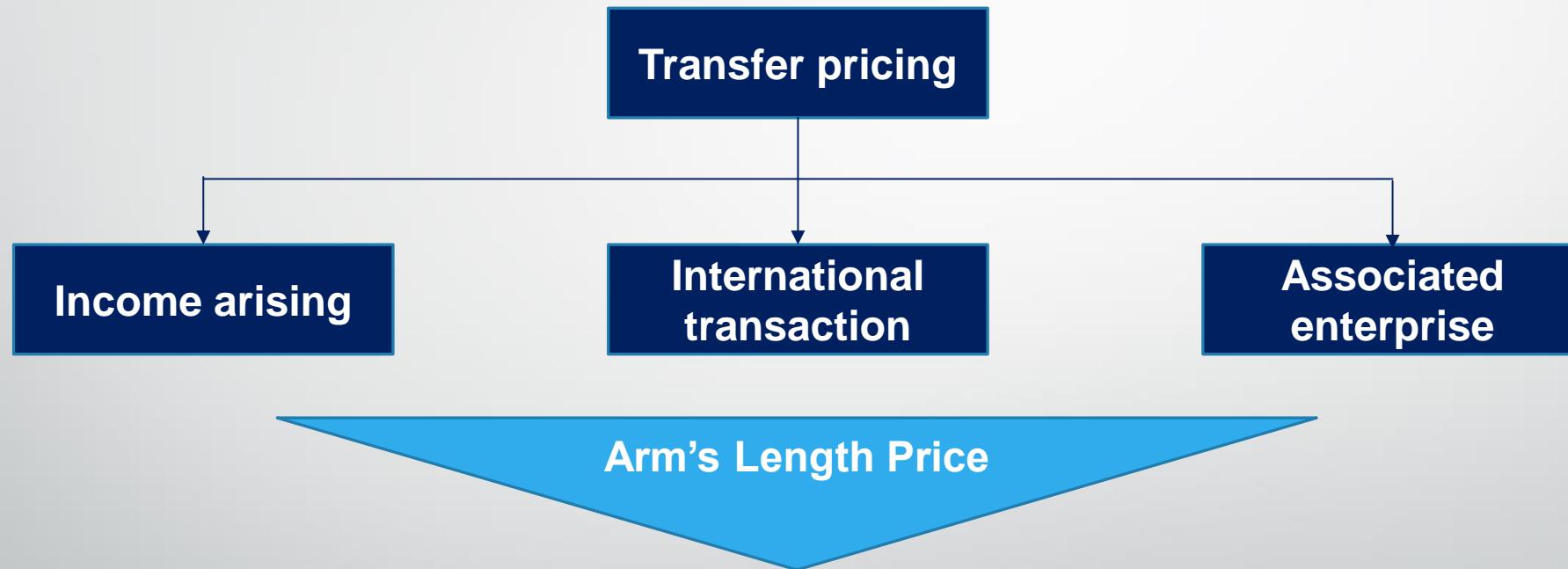
To prevent shifting of profits by manipulating the prices

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Concepts of Transfer Pricing

Concepts of Transfer Pricing

Sec 92(1) - Any income arising from an international transaction with associated enterprises shall be computed having regard to the arm's length price



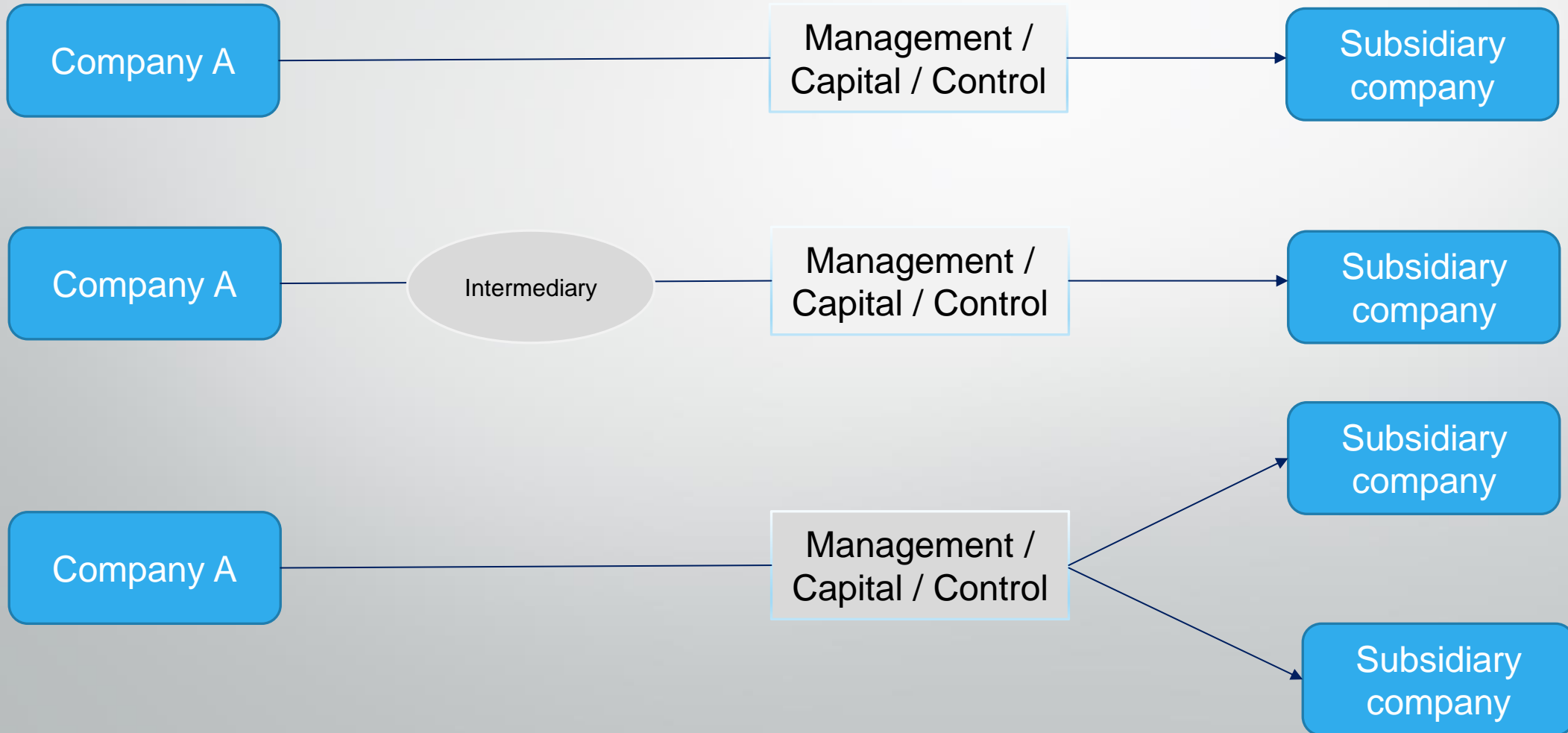
Concepts of TP – International transaction

Sec 92B

- Transactions between **two or more associated enterprises**
- **Either or both** of whom are **non-residents**
- Transaction relates to:
 - ✓ purchase, sale or lease of **tangible or intangible property**, or
 - ✓ provision of **services**, or
 - ✓ **lending or borrowing** money, or
 - ✓ any other transaction having a **bearing on the profits, income, losses or assets** of such enterprises, or
 - ✓ mutual agreements or arrangements for **allocation or apportionment** of, or any contribution to, any cost or expense incurred
- International transaction also covers **deemed international transaction** / **specified domestic transactions**

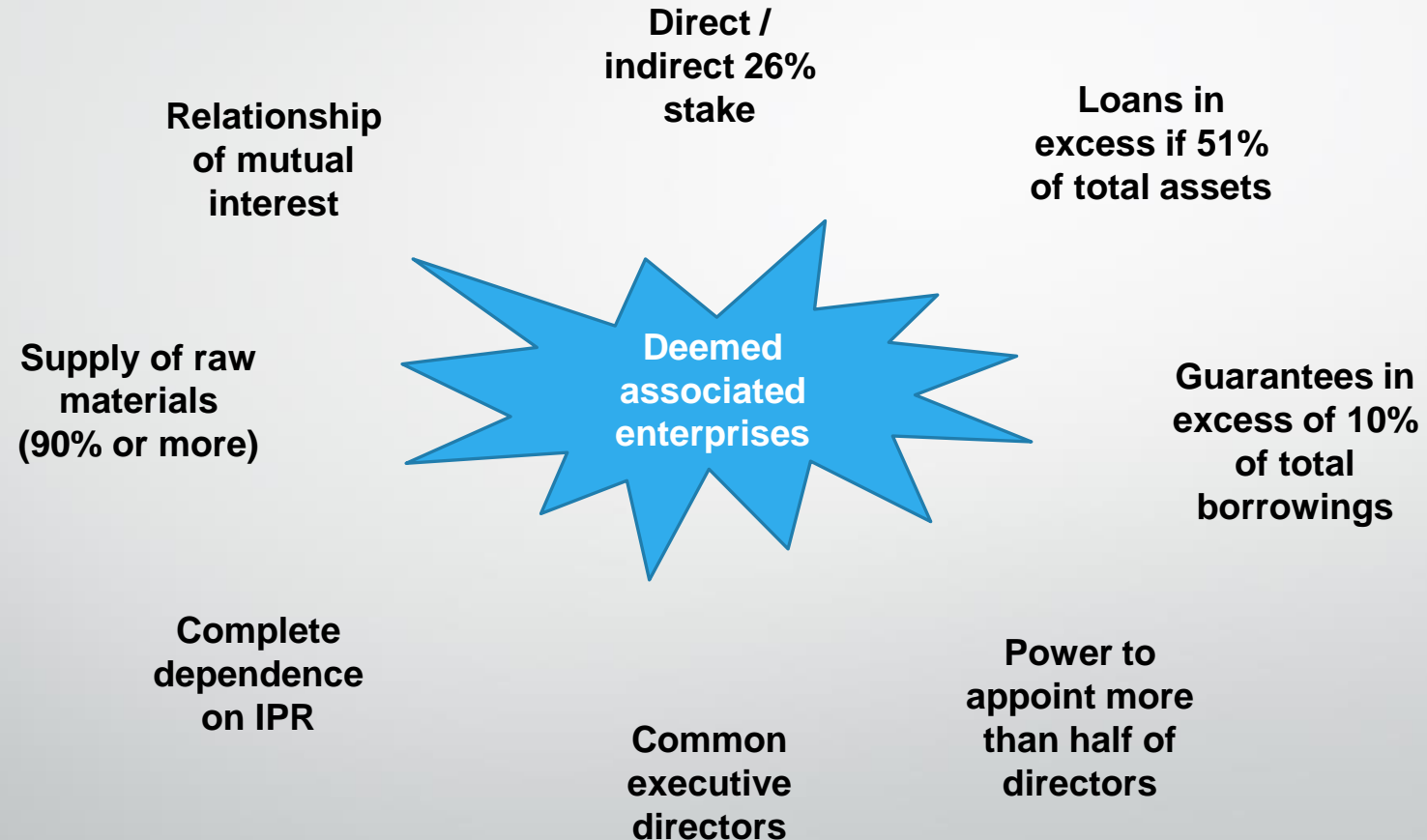
Concepts of TP – Associated enterprises

Sec 92A(1) – **Direct or indirect participation** (through one or more intermediaries) in **management, control or capital**

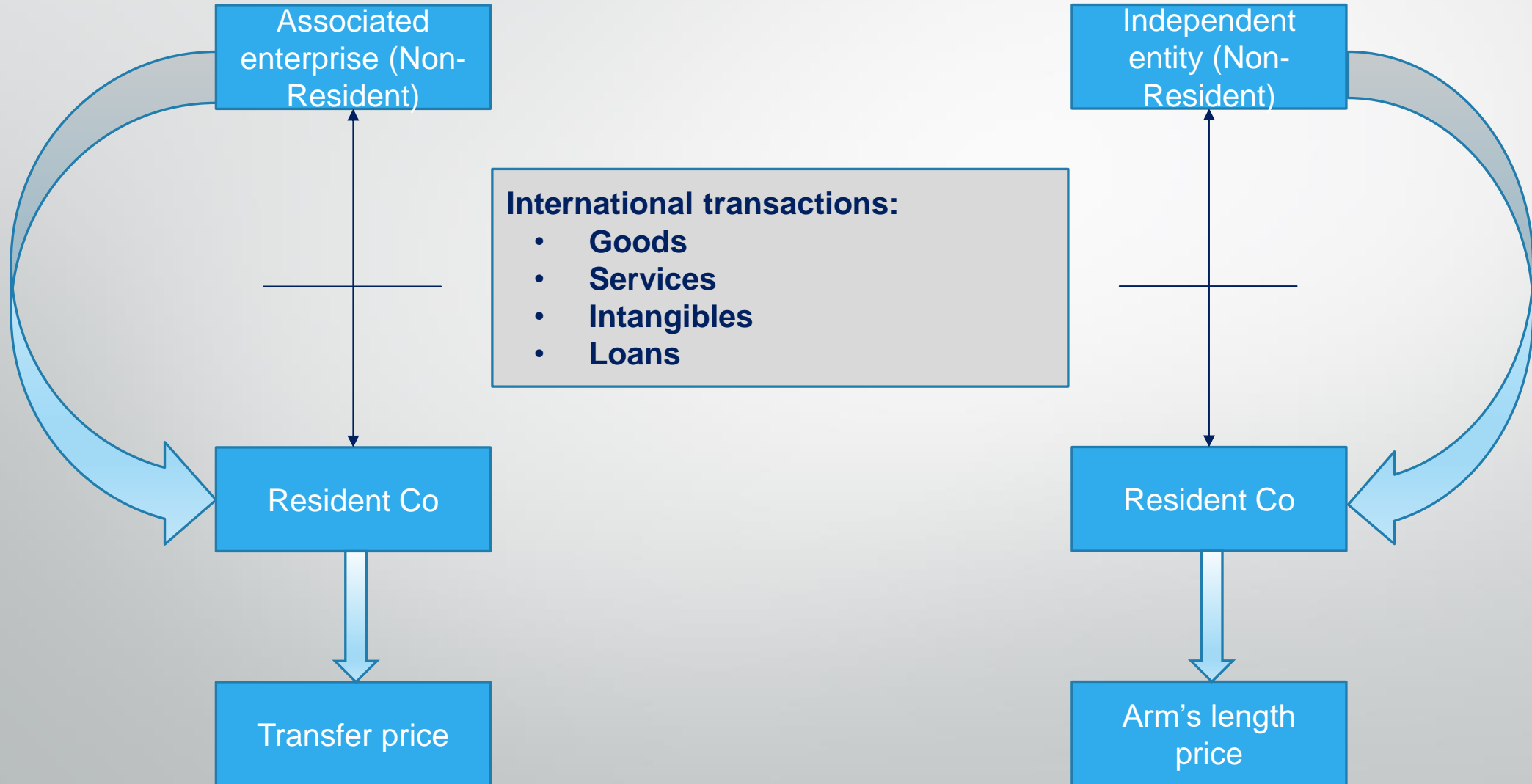


Concepts of TP – Associated enterprises

Sec 92A(2) – Enterprises are **deemed to be associated** in following specified situations

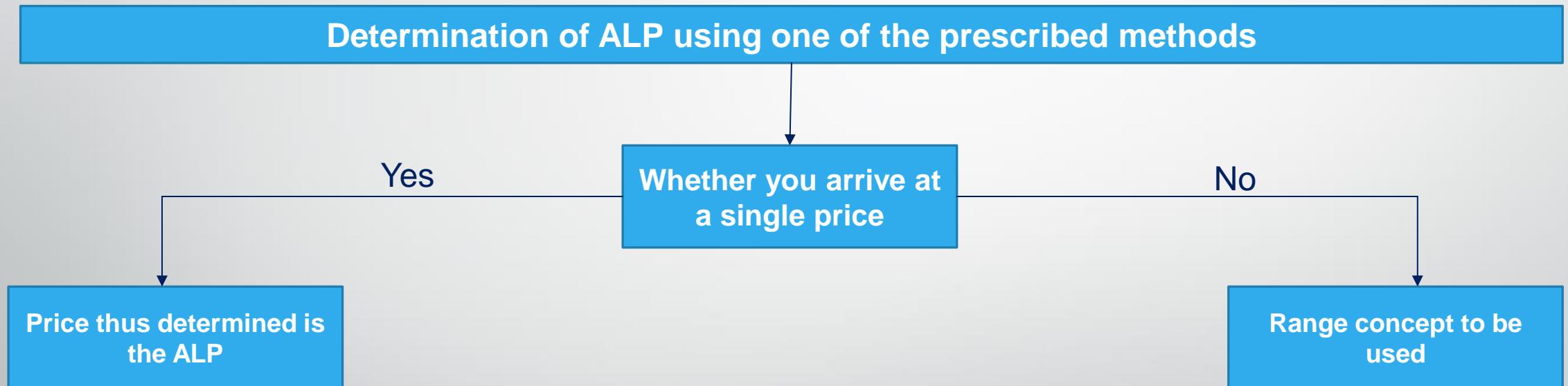


Concepts of TP – Arm's length price



Concepts of TP – Arm's length price

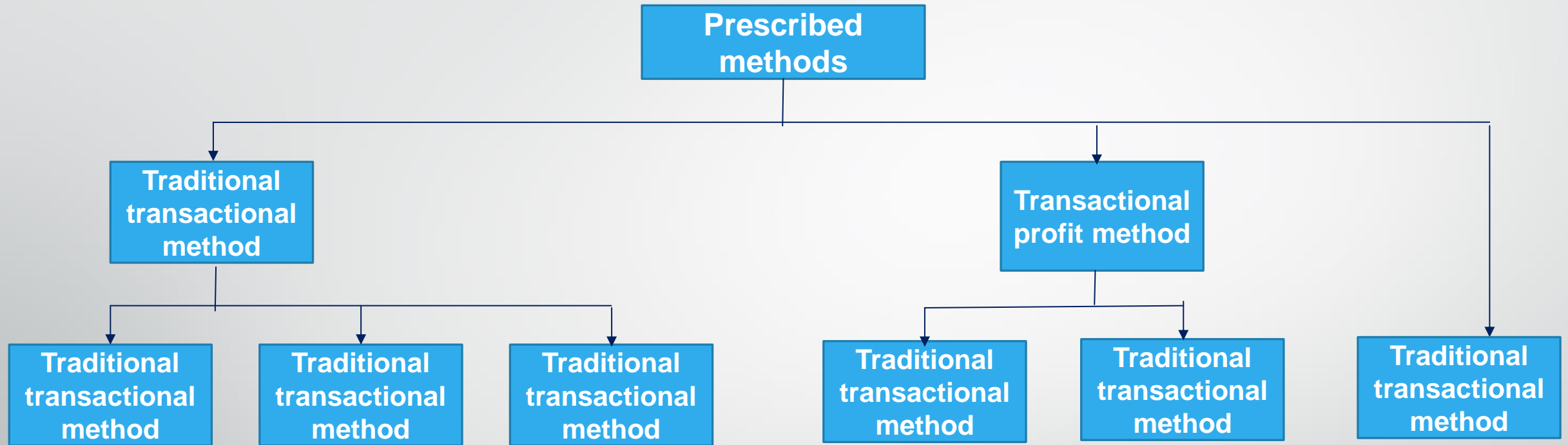
- Determination of ALP is based on usage of one of the prescribed methods
- Most appropriate method is the method which provides the most reliable measure of an arm's length price in relation to the international transaction





Transfer Pricing Methods

Transfer Pricing Methods



No hierarchy or preference of methods is prescribed under the Act



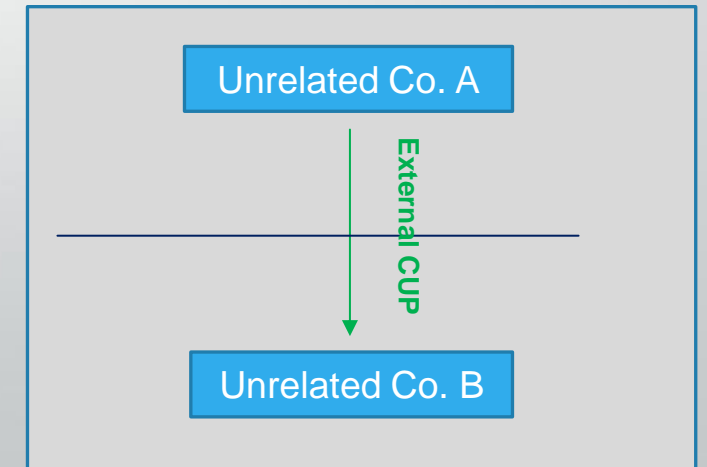
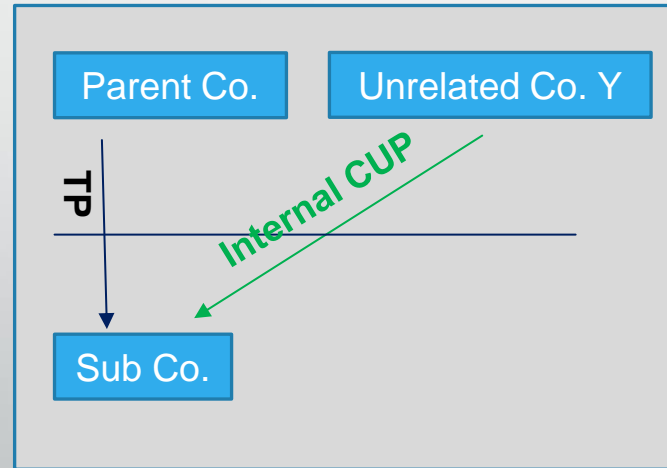
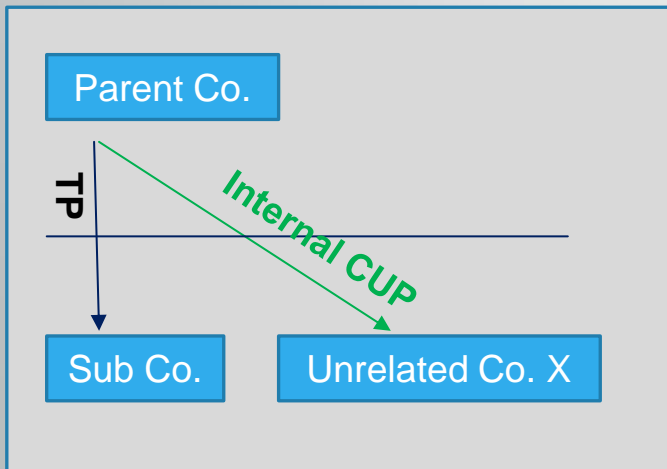
Comparable Uncontrolled Price Method

TP Methods – CUP

- Compares the price charged in a controlled transaction to the **actual price charged in an uncontrolled transaction**
- **Prices are benchmarked** without any reference to the profits
- Most direct and reliable method
- Requires **strict comparability** in respect of following factors, etc.:
 - ✓ Volume / quantity of product
 - ✓ Product similarity
 - ✓ Credit terms
 - ✓ Geographic market
 - ✓ Period of transaction
 - ✓ Other terms of the contract
- CUP method can be used if one of the following conditions is met:
 - ✓ None of the differences (if any) between the controlled and uncontrolled transactions could materially affect the price in the open market; or
 - ✓ Reasonable accurate adjustment can be made to eliminate the material effects of such differences

TP Methods – CUP

- Adjusted price arrived at is to be taken as ALP
- Typical transactions in which CUP method may be adopted are:
 - ✓ Transfer of goods
 - ✓ Provision of services
 - ✓ Intangibles
 - ✓ Interest on loans
- Two types of CUPs available – Internal CUP & External CUP
- Typically, Internal CUP is preferred over External CUP due to higher degree of comparability



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Resale Price Method

TP Methods – RPM

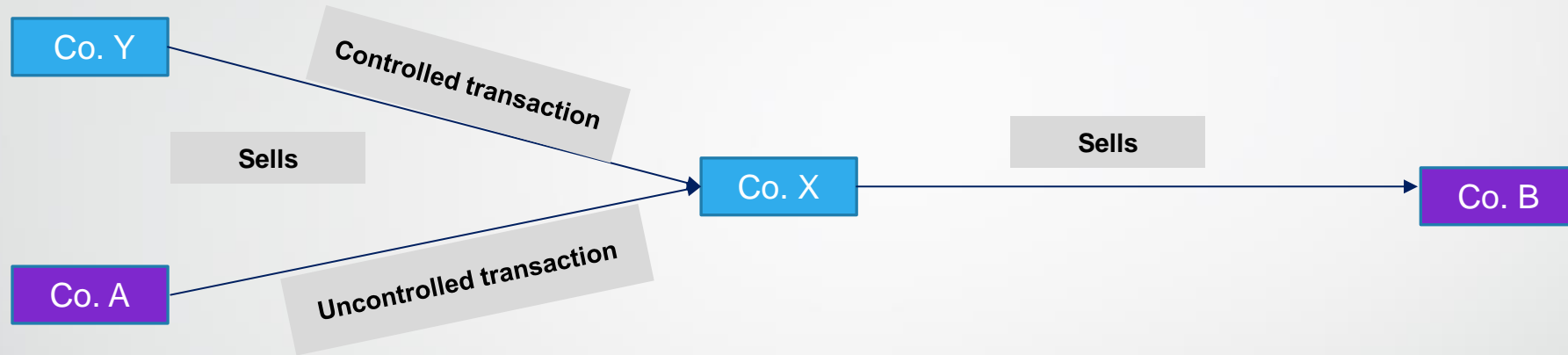
- Preferred method for a **trader / distributor** – buying **purely finished goods** from a group company and **resell to an independent enterprise**
- Most appropriate where **reseller adds no / relatively little value** to the goods i.e., used when reseller does not add substantial value to the goods and does not apply intangible assets to add value
- Difficult to apply where goods are further processed before resale
- **Not applicable** when goods purchased from AE also **sold to AE**
- Compares resale **Gross Margin**
- Comparability is **relatively less dependent on strict product comparability** and additional **emphasis is on similarity of functions performed and risk assumed**

TP Methods – RPM

- Possible adjustments for application of RPM:
 - ✓ Inventory level
 - ✓ Contractual terms
 - ✓ Accounting practices
 - ✓ Sales, marketing, advertising programs and services
 - ✓ The level of the market
 - ✓ Foreign currency risks
- Two types of RPM can be applied – Internal RPM and External RPM

TP Methods – Internal RPM

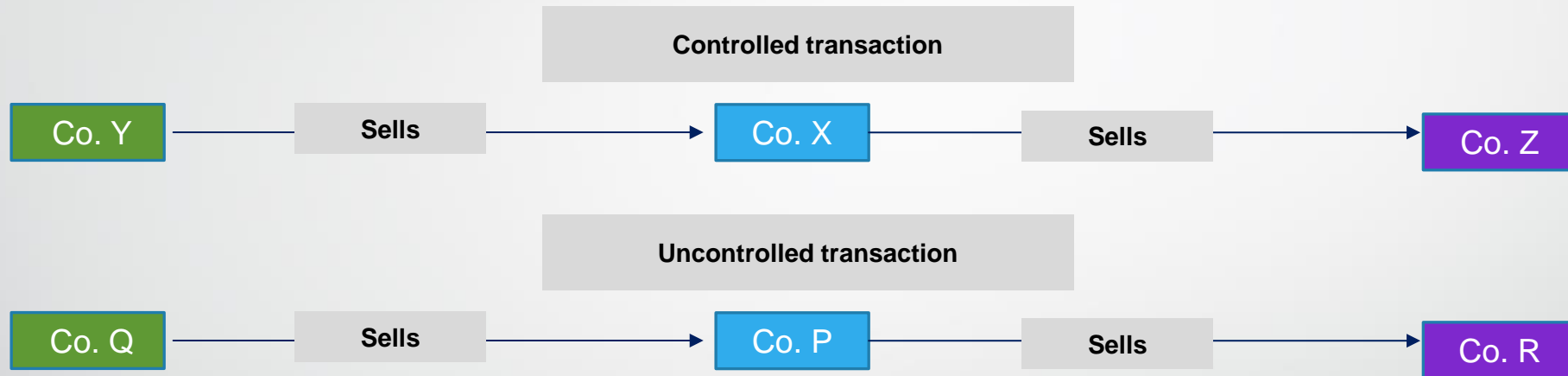
- Internal RPM may be applied when the same reseller is engaged in trading of similar goods in both controlled and uncontrolled circumstances



- In the illustration above Co. X resells the similar goods procured from the related party (Co. Y) and unrelated party (Co. A) to an unrelated party (Co. B)
- Internal RPM can be applied by comparing the gross profit margin realized on goods procured from Co. Y with the gross profit margin realized on goods procured from Co. A

TP Methods – External RPM

- External RPM may be applied when an **independent party** is engaged in **trading of similar goods** as traded by tested party in **uncontrolled circumstances**



- In the illustration above Co. X resells the goods procured from the related party (Co. Y) while Co. P is reselling the similar goods procured from Co. Q, an unrelated party
- External RPM can be applied by comparing the gross profit margin realized by Co. X vis-à-vis the gross profit margin realized by Co. P



Cost Plus Method

TP Methods – CPM

- To be applied in cases involving **manufacture, assembly or production of tangible products or** services that are sold / provided to AEs
- Preferred method in case of:
 - ✓ Semi-finished goods sold between related parties
 - ✓ Contract manufacturing agreement
 - ✓ Provision of services
- **Not applicable** in the case of **receipt of a property or receipt of** services from related party
- **Compares** and identifies **mark-up earned on direct and indirect costs of production** incurred with that of comparable independent companies
- Comparability under this method is **relatively not as much dependent on close physical similarity between the products**
- Larger emphasis on **functional comparability**

TP Methods – CPM

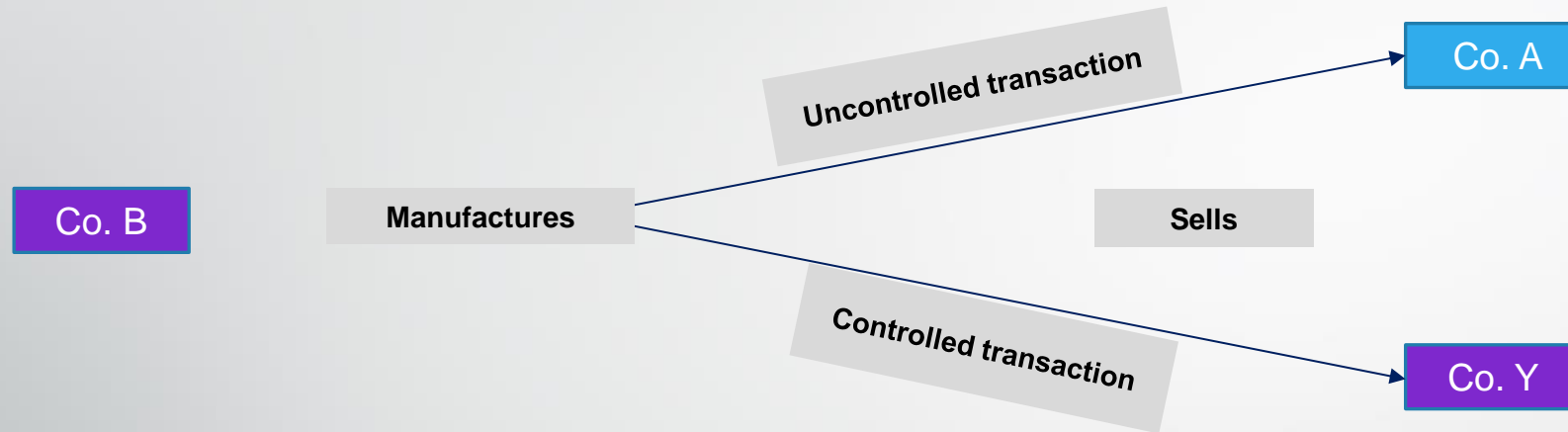
- Possible adjustments for application of CPM:
 - ✓ Inventory level
 - ✓ Contractual terms
 - ✓ Accounting practices
 - ✓ Sales, marketing, advertising programs and services
 - ✓ The level of the market
 - ✓ Foreign currency risks
- Under CPM arm's length price is computed as:

ALP =	Direct & indirect cost of production in respect of property transferred or service provided
(+)	Gross profit mark-up earned in comparable uncontrolled transaction
(+) / (-)	Adjustment for differences which would materially affect the gross profit margins in the open market

- Two types of CPM can be applied – Internal CPM and External CPM

TP Methods – Internal CPM

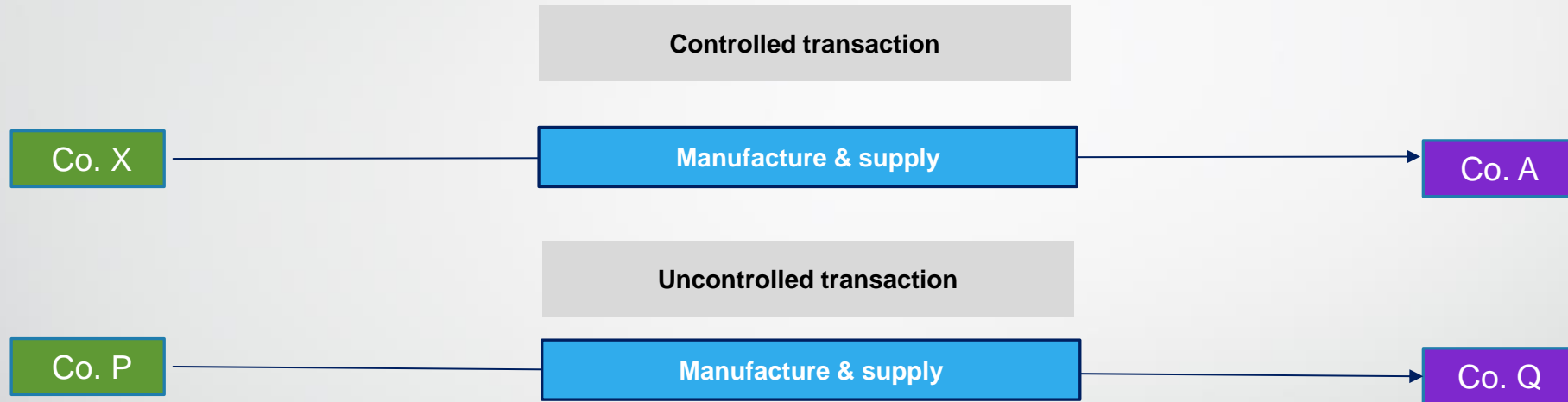
- Internal CPM may be applied when the same manufacturer is engaged in manufacturing & selling of similar goods in both controlled and uncontrolled circumstances



- In the illustration above Co. X manufactures goods and supplies the same to both, the related party (Co. Y) and unrelated party (Co. A)
- Internal CPM can be applied by comparing the gross profit margin realized on goods supplied to Co. Y with the gross profit margin realized on goods supplied to Co. A

TP Methods – External CPM

- External CPM may be applied when an **independent party** is engaged in **manufacture & supply of similar goods** as manufactured & supplied by tested party in **uncontrolled circumstances**



- In the illustration above Co. X is supplying the goods to related party (Co. A) while Co. P is supplying similar goods to Co. Q, an unrelated party
- External RPM can be applied by comparing the gross profit margin realized by Co. X vis-à-vis the gross profit margin realized by Co. P



Profit Split Method

TP Methods – PSM


- PSM determines arm's length profit based on combined profits derived by related parties
- PSM is applied in cases:
 - ✓ involving transfer of unique intangibles
 - ✓ where different related parties are doing typical activity in the value chain
- PSM can be (a) Total profit split or (b) Residual profit split
- PSM requires selection and application of appropriate allocation keys for splitting profits amongst the members of the MNE group contributing to generation of combined profits
- Under PSM, arm's length price is computed as:

ALP = Combined net profit of the AEs arising from the international transaction

Identify the relative contribution made by each of the AEs

Combined net profit is then split amongst the enterprises in proportion to their relative contributions

Profit thus apportioned to the Assessee is taken into account to arrive at an arm's length price in relation to the international transaction



Transactional Net Margin Method

TP Methods – TNMM

- Most frequently used method, due to the lack of availability of data for application of other methods
- Examines **net operating** profit from transaction as a percentage of a certain base (can use different bases i.e. costs, turnover, etc.) of the simplest entity
- Both internal and external TNMM are possible to apply
- Broad level of product comparability and **high level of functional comparability**
- Applicable for most categories of transactions and often used to supplement analysis under other methods
- **Grouping of transactions** – Relevant controlled transactions required to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- Selection of right comparables and PLI are critical factors

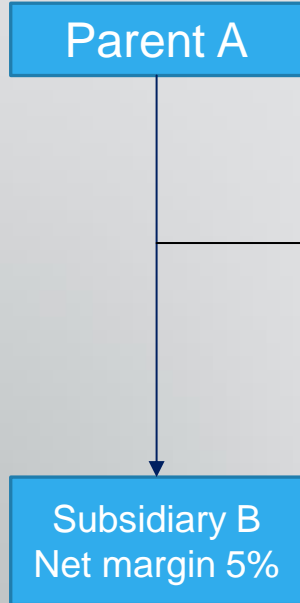
TP Methods – TNMM

- Typical transactions in respect of which TNMM may be adopted are:
 - ✓ Transfer of goods
 - ✓ Provision of services
 - ✓ Purchase of goods

- Factors of comparability to be considered while selecting TNMM:
 - ✓ Functions performed (taking into account assets used and risks assumed)
 - ✓ Contractual terms
 - ✓ Conditions prevailing in the markets, location, laws in force etc.
 - ✓ Business strategies

TP Methods – TNMM

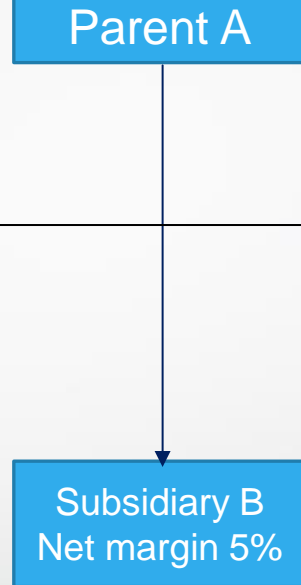
Internal TNMM



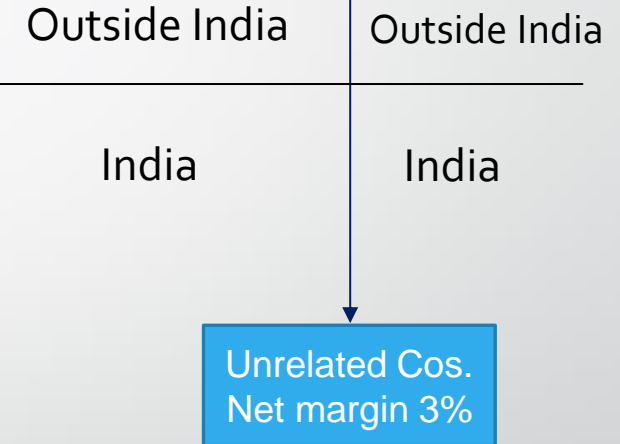
Unrelated Cos.

Subsidiary B
Net margin 3%

External TNMM



Unrelated Cos.



Usually regarded as an indirect method, but is most widely adopted

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Other Method

TP Methods – Other Method

- CBDT had notified the “**Other Method**” vide Notification No 18/2012 dated 23.05.2012
- Applicable from FY 2011-12

Rule 10AB “any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts

- Effectively this implies that “quotations” rather than “actual prices” charged or paid can also be used
- To maintain proper documentations specifying the rejection reasons for non application of other 5 methods and appropriateness of the “Other Method”



Questions & Answers