CTC TRANSFER PRICING STUDY CIRCLE
TRANSFER PRICING METHODS
CPM & RPM

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Cost Plus Method: Case Study
Key Facts

- X Ltd is engaged in manufacture and supply of tablet tools used by Pharmaceutical Industry.
- These tablet tools are sold to its foreign AEs located in several jurisdictions. The foreign AEs are primarily engaged in distribution of the tablet tools purchased from X Ltd.

Issues for consideration

- Can CPM be adopted to benchmark sales made to overseas AEs?
Cost Plus Method: Case Study

Case Study 1 - Scenario 2

Key Facts

- For manufacture of tablet tools, X Ltd. procures certain components from an AE 1 located in India.
- AE 1 manufactures these raw materials exclusively for X Ltd.

Issues for consideration

- Whether CPM can be still be adopted to benchmark sales made to overseas AEs?
- Whether separate benchmarking is required for components purchased from AE? If so, which method would be the MAM?
Case Study 1: Determination of ALP

Approach 1 – As per Rule 10B

- Identify direct and indirect costs of production
- Compute ‘normal gross profit mark-up’ i.e. average gross profit margins (adjusted for functional differences) earned by comparable companies
- The arm’s length gross profit mark-up is applied on the production costs identified
- The sum of the costs and gross profit mark-up is considered as the ALP

Approach 2

- Compute the gross profit margin earned in the international transaction/SDT under consideration
- Compare such margins with the average gross profit margins (adjusted for functional differences) earned by comparable companies

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Gross Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>X Ltd</td>
<td>113.26%</td>
</tr>
<tr>
<td>Hindustan Everest Tools Ltd.</td>
<td>68.40%</td>
</tr>
</tbody>
</table>
Cost Plus Method: Case Study

Case Study 1: Screenshot from Prowess Database
Cost Plus Method: Case Study
Case Study 2: Benchmarking

**Benchmarking in Year 1**

- Internal CPM was adopted wherein gross margins earned from services rendered to AE was compared with gross margins earned from services rendered to non-AE.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Gross Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>GP earned from services rendered to AE</td>
<td>41.65%</td>
</tr>
<tr>
<td>GP earned from services rendered to non-AE</td>
<td>34.20%</td>
</tr>
</tbody>
</table>

**Benchmarking in Year 2**

- External CPM was adopted wherein gross margins earned by A Ltd. was compared with average gross margins earned by functionally comparable companies.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Gross Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>GP of A Ltd</td>
<td>50.56%</td>
</tr>
<tr>
<td>GP of Capricorn Systems Global Solutions Ltd (Prowess Data)</td>
<td>34.46%</td>
</tr>
</tbody>
</table>
Cost Plus Method: Case Laws
Cost Plus Method: Case Laws

Case Law 1: Key Facts

ITO vs. Alumeca India Extrusion Ltd [ITA. No. 613 & 614/Hyd/2009]

- Taxpayer is engaged in manufacture of aluminium products
- During the year under consideration, taxpayer made export sales to AEs and domestic sales to non-AEs
- The taxpayer adopted Internal CPM to benchmark its international transactions
- TPO rejected internal CPM adopted by the taxpayer alleging that allocation of costs to the AE and non-AE segments was incorrect. He thus adopted external TNMM and made transfer pricing adjustments
Cost Plus Method: Case Laws

Case Law 1: Issues and ITAT Ruling

**Issues**
- Can internal domestic transactions be used for benchmarking international transactions?

**ITAT Ruling**
- ITAT held internal domestic transactions can be used for benchmarking international transactions with AEs as products sold in both segments were similar.
- ITAT observed that TPO’s rejection of internal CPM by merely contending that allocation of costs among various segments was incorrect, was not appropriate. TPO ought to record and substantiate why MAM selected by the taxpayer is incorrect and why some other method needs to be adopted as MAM.
Frigoglass India Pvt. Ltd. vs. DCIT [2014] 45 taxmann.com 101 (Delhi - Trib.)

- Taxpayer (FIPL) is engaged in manufacturing and trading of glass door merchandising used in alcoholic and non-alcoholic beverages, water, dairy products etc.
- Taxpayer entered into various international transactions including sale of finished goods, sale of components & spares, purchase of raw materials, and purchase of finished goods for resale.
- Taxpayer benchmarked transactions in its manufacturing segment using cost plus method (CPM) and transactions in its trading segment using resale price method (RPM).
- TPO also rejected both these methods on account of various reasons and adopted entity level TNMM to benchmark transactions in both segments.
Case Law 2: Key Facts

- The TPO rejected CPM adopted for manufacturing segment on account of the following reasons:
  - FIPL’s functions were interlinked
  - Cost base of FIPL did not include indirect costs
  - Determination of costs was uncertain and extensive information about cost base of the taxpayer & comparables was not available
  - No clear guidance available on accounting treatment of gross margins
  - No discernable link between level of costs and market price as compensation model varies from case to case
  - When reliable method viz. TNMM is available, there is no need to go to CPM especially when the reliable data either in the taxpayer’s case or in the comparables case is not available for ascertaining the direct and indirect cost of production of services.
Cost Plus Method: Case Laws

Case Law 2: Ruling

ITAT Ruling

- The ITAT did not specifically deal with the reasons provided by the TPO for rejecting CPM.
- It observed that except making theoretical assertions and general observations, TPO did not give any objective findings to reasonably conclude that Taxpayer’s adoption of CPM for manufacturing segment and RPM for trading segment was factually and objectively incorrect.
- It further observed that TNMM method applied by the TPO also suffers from the same inherent aberrations and thus taxpayer’s adoption and application of CPM and RPM need to be upheld.
ACIT v. Tara Ultimo P. Ltd [2011] 47 SOT 401 (Mumbai)

- Taxpayer was engaged in manufacture and export of diamond and gold jewellery. Taxpayer purchased diamonds and sold diamonds and jewellery to its AEs.

- While the taxpayer adopted CUP method for benchmarking diamond purchases and sales, it adopted CPM to compute ALP of jewellery sales, using GP/Sales as the PLI wherein gross margins earned on AE transactions was compared with gross margins earned on non-AE transactions.

- The TPO rejected CPM on the grounds that the taxpayer did not provide detailed calculations of the gross margins, nature of transactions with AEs are functionally different and that it had adopted GP/sales as the PLI which was incorrect. The TPO also rejected CUP Method for purchases and applied TNMM at the entity level.
Issues for consideration

• Can CPM be adopted as the MAM in the instant case?
• Can CPM be applied by comparing the average gross margins earned from AE transactions with gross profit margins earned from non-AE transactions?
• Can gross profit on sales be adopted as PLI to benchmark sale transaction with AEs?

ITAT Ruling

• The ITAT, while rejecting CPM, observed that one of the most important input, i.e. diamond, has been imported at a price for which no ALP documentation is available and the price of these imports have been taken into account in computation of costs while computing gross margins.
• It further observed that no efforts were made by the taxpayer to show that the terms of sale to the AEs and all other relevant factors are materially similar vis-a-vis the transactions with independent enterprises
The ITAT held that though while determining the benchmark, one can take into account several transactions with unrelated enterprises in respect of same or similar transactions, the benchmark so derived cannot be applied on global basis. Each international transaction has to be compared with the benchmark.

ITAT observed that CPM was incorrectly applied by the taxpayer by comparing gross profit on sales, whereas the method requires comparison of mark up on costs on transactions with AEs vis-à-vis mark up on costs on transactions with non AEs.

ITAT further observed that in the absence of documentation to support use of direct method such as CUP and CPM, it was imperative to use indirect methods of determination of ALP i.e. TNMM or profit Split method.
Profit Split Method – Contribution Analysis

Case Study 1: Key Facts

- T Ltd is a manufacturer and distributor of parts and components.
- T Ltd sells parts to AE, and AE combines the same with other parts to produce a product, which it sells to Customers.
- In order to serve customer, T Ltd produced and sold parts to AE, AE combined parts received from T Ltd with its parts and supplied the same to customers, thus each of them contributed integrally towards transaction and received consideration of US$ 50,000 for sale to customers.
Profit Split Method – Contribution Analysis

Case Study 1: Determination of ALP

- Details of revenues shared and costs incurred by the respective entities and the resultant profits earned by them are tabulated below:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>T Ltd</th>
<th>AE</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>30,000</td>
<td>20,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Cost</td>
<td>20,000</td>
<td>8,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Profit</td>
<td>10,000</td>
<td>12,000</td>
<td>22,000</td>
</tr>
</tbody>
</table>

- On the basis of functions performed, risks assumed and assets employed, the relative contribution may be taken at 70% and 30% for T Ltd. and AE respectively.

- Income of T Ltd. on an arm's length basis would thus be US$ 35,400 (20,000+15,400)
R Ltd., is an investment advisory company, which in association with its subsidiaries, assists its clients with foreign acquisitions.

R Ltd is approached by a customer for identifying potential target companies for acquisitions in the USA.

To ensure appropriate content development, each subsidiary performs R&D on multimedia related areas and bears the risk of appropriate content, delivery and standard routine transfer pricing risks.

In order to serve customer, R Ltd and AE 1, have each contributed integrally to identification of potential target and assisting customer with the acquisition process and received consideration of US$ 50,000.
Profit Split Method: Residual Profit Split

Case Study 2: Factors to be considered

- The normal basic return is ordinarily calculated as a percentage of the costs incurred or gross revenues or capital employed. In this example, it is assumed as a percentage of the cost.

- Based on the FAR analysis, the basic return for R Ltd., and AE 1 are determined to be 15% and 10% respectively. Accordingly, the normal basic return for R Ltd in India for the aforesaid operation is US$ 3000. The similar returns for AE 1 US$ 800. The total basic return earned by the Group is thus US $ 3,800.

- On the basis of functions performed, risks assumed and assets employed, the relative contribution may be taken at 70% and 30% for R Ltd. and AE 1 respectively.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>R Ltd</th>
<th>AE 1</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>30,000</td>
<td>20,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Cost</td>
<td>20,000</td>
<td>8,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Profit</td>
<td>10,000</td>
<td>12,000</td>
<td>22,000</td>
</tr>
</tbody>
</table>
Profit Split Method: Residual Profit Split

Case Study 2: Calculation for determination of ALP

<table>
<thead>
<tr>
<th>Details</th>
<th>US $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Basic return</td>
<td></td>
</tr>
<tr>
<td>R Ltd : India return</td>
<td>3,000</td>
</tr>
<tr>
<td>AE 1: US return</td>
<td>800</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,800</strong></td>
</tr>
<tr>
<td>2. Residual net profit (22,000 - 3,800)</td>
<td></td>
</tr>
<tr>
<td>R Ltd: India return – 70%</td>
<td>12,740</td>
</tr>
<tr>
<td>AE 1: US return – 30%</td>
<td>5,460</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>18,200</strong></td>
</tr>
<tr>
<td>Total return for R Ltd (12,740 + 3,000)</td>
<td>15,740</td>
</tr>
<tr>
<td>Total cost of R Ltd.</td>
<td>20,000</td>
</tr>
<tr>
<td>Income of R Ltd. on arm’s length price (A)</td>
<td>35,740</td>
</tr>
<tr>
<td>Actual revenue (B)</td>
<td>30,000</td>
</tr>
<tr>
<td>Increased income (A-B)</td>
<td>5,740</td>
</tr>
</tbody>
</table>
Profit Split Method: Case Laws
Profit Split Method: Case Laws

Case Law 1: Key Facts

ITO vs. Net Freight (India) Pvt. Ltd [2014] 30 ITR(T) 441 (Delhi - Trib.)

- Taxpayer is a logistics service provider offering a comprehensive portfolio of international, domestic and specialized freight handling services.
- Taxpayer along with its fellow subsidiaries mutually appoint each other as exclusive agents with respect to the transportation of shipment. Taxpayer and its AEs have an arrangement of sharing profit in the ratio of 50:50 for these services.
- Taxpayer adopted Residual PSM as the MAM to determine the ALP of the aforesaid international transactions.
Profit Split Method: Case Laws

Case Law 1: Key Facts and Ruling

- TPO rejected Residual PSM on the grounds that sufficient information was not available to determine appropriateness of the 50:50 profit sharing ratio. The TPO thus adopted entity level TNMM to benchmark the taxpayer’s international transactions.

- However, CIT(A) upheld the taxpayer’s plea and deleted the TP adjustment.

ITAT Ruling

- ITAT explained the law on PSM, discussing transactions where PSM can be adopted as MAM, methodology of application of Residual PSM

- ITAT observed that though PSM was the MAM in the present case, the taxpayer didn’t apply Residual PSM correctly. The taxpayer did not allocate appropriate base returns to the respective entities as required under the first stage of PSM.
Profit Split Method: Case Laws

Case Law 1: Ruling

- ITAT noted that benchmarking of base returns by selecting comparables is mandatory under Residual PSM. It further noted that the residual profits may be split based on a scientific allocation basis and benchmarking of the same is not necessary.

- However, relying on SB Ruling in case of LG Electronics, ITAT rejected application of entity level TNMM adopted by the TPO.
Global One India P. Ltd Vs ACIT [2014] 31 ITR(T) 722 (Delhi - Trib.)

- Taxpayer is engaged in providing internet and related network services to the group’s customers in India.
- Taxpayer’s activities are highly integrated & interrelated where transaction passes through multiple AEs & each entity makes contribution by deploying its assets, performing functions & using manpower.
- Accordingly, the taxpayer adopted Residual PSM as the MAM.
- However, TPO rejected PSM on the following grounds:
  - Taxpayer was merely a service provider and costs incurred by it could be identified.
  - Taxpayer runs its business independently in India and is not integrated with other group entities.
Profit Split Method: Case Laws
Case Law 2: Key Facts and Ruling

- Taxpayer did not carry out a benchmarking analysis using external comparables
- Key value drivers identified by the Taxpayer were routine in nature and did not lead to creation of any unique intangibles. Other value drivers forming a major part of the Taxpayer’s costs were not considered.
- Accordingly, TPO adopted TNMM as MAM and made transfer pricing adjustments. The same was upheld by the DRP

**ITAT Ruling**

- ITAT rejected TNMM adopted by TPO. It observed that though taxpayer runs its business independently, inter-company transactions are inter-related and costs are incurred by multiple entities.
- TNMM cannot be applied for benchmarking returns where each group entity makes unique and valuable contributions. In any case, TNMM cannot be applied at entity level
Profit Split Method: Case Laws

Case Law 2: Ruling

- PSM is MAM as taxpayer generates revenues out of highly integrated operations
- PSM was accepted earlier by the TPO, and rule of consistency should be followed
- Acceptance of PSM in other jurisdictions is also a guiding factor for determining appropriateness of PSM
- TPO’s rejection of PSM on the ground that the taxpayer does not own unique intangibles is incorrect. PSM can be applied where there are integral and interrelated transactions with contributions from multiple entities. Use of unique intangibles is not mandatory for adopting PSM. In any case, taxpayer did own unique intangibles
- PSM cannot be rejected merely because the taxpayer has suffered a loss
- ITAT observed that if TPO did not agree with the application of PSM, he should have applied it in the appropriate manner and not reject the method itself. In any case, taxpayer had correctly applied PSM
Profit Split Method: Case Laws

Case Law 2: Ruling

- Taxpayer had benchmarked the basic returns with those earned by comparable companies and the residuary profits was allocated based on the contributions of each entity.
- ITAT observed that though benchmarking of allocation of residuary profits needs to be done with external comparables.
- In absence of such data, allocation can be held to be at ALP if the same is based on relative contributions from each entity. ITAT extensively relied on OECD TP Guidelines and UN TP Manual for the same.
- If the above approach does not fall within the tenets of PSM, then the same can be considered under the ‘Other Method’.
Thank You

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